

Nunnenkamp, Peter; Pant, Manoj

**Working Paper**

## Why the case for a multilateral agreement on investment is weak

Kieler Diskussionsbeiträge, No. 400

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Nunnenkamp, Peter; Pant, Manoj (2003) : Why the case for a multilateral agreement on investment is weak, Kieler Diskussionsbeiträge, No. 400, ISBN 3894562471, Institut für Weltwirtschaft (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/2931>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## Why the Case for a Multilateral Agreement on Investment Is Weak

by Peter Nunnenkamp and Manoj Pant

### CONTENTS

- The demand of industrialized countries for a multilateral agreement on investment to be negotiated under the roof of the WTO is meeting with considerable resistance on the part of developing countries. The proponents of such a multilateral agreement argue that binding disciplines of capital-importing countries would help reduce uncertainty and, hence, result in more foreign direct investment (FDI) in developing countries. By contrast, the opponents consider such an agreement to be biased in favor of business interests and against the development objectives of Third World economies.

- It is for various reasons that the case for a multilateral agreement on investment is not compelling:

Investment regulations have been liberalized progressively by unilateral measures without multilateral obligations to do so. Moreover, the protection of foreign investors against political risk is fairly advanced given the large number of bilateral and plurilateral investment treaties.

A multilateral agreement could reduce FDI-related transaction costs significantly only in the unlikely event that the complex net of existing arrangements would be replaced. A "WTO plus"-type framework appears to be the more realistic outcome of negotiations, with a multilateral agreement defining the smallest common denominator of WTO members and more substantive agreements with limited membership remaining in place.

Empirical evidence suggests that WTO negotiations on investment are neither sufficient nor necessary to induce higher FDI flows to developing countries. Transaction-cost-related impediments to FDI have

played a minor role in driving FDI, and the absence of a multilateral agreement has not prevented the recent boom of FDI in developing countries.

- Wishful thinking prevails on the part of developing countries, which insist on preferential treatment with regard to their own obligations as host countries and on binding obligations for foreign investors and their home countries. It is highly questionable whether developing countries could derive more benefits from FDI if a multilateral agreement were to include "development clauses" allowing for flexible and selective approval procedures and performance requirements such as local-content rules. The call for binding rules on the behavior of foreign investors may discourage multinational enterprises from investing in developing countries altogether, instead of fostering transfers of technology and improving the quality of FDI. By insisting on preferential treatment with regard to FDI incentives, developing countries tend to ignore that incentives-based competition for FDI is mainly between themselves.
- Unless developing countries are prepared to tie their own hands, they cannot reasonably expect significant concessions from industrialized countries. Developing countries will become relevant negotiation partners in the WTO only by offering something on their own. Rather than engaging in a futile attempt to block multilateral negotiations on investment altogether, developing countries should commit themselves to rule-based FDI policies as a negotiating chip. The pressure on industrialized countries to engage in negotiations on labor mobility would mount if developing countries refrained from performance requirements and granted national treatment to foreign investors.

# Contents

<b>1</b>	<b>Why Foreign Direct Investment Is on the Agenda of Policymakers</b>	<b>3</b>
<b>2</b>	<b>Bilateral Investment Treaties</b>	<b>6</b>
<b>3</b>	<b>Plurilateral Investment Agreements</b>	<b>8</b>
<b>4</b>	<b>Multilateral Initiatives on Investment</b>	<b>12</b>
4.1	The OECD's MAI	12
4.2	Multilateral Initiatives in the WTO	14
<b>5</b>	<b>Why a Multilateral Framework?</b>	<b>15</b>
5.1	Conflicting Interests	15
5.2	The Relevance of Transaction Costs	17
5.3	Transaction Costs and Inward FDI	18
5.4	Developing Countries' Demands for Flexible Rules and Corporate Obligations	22
<b>6</b>	<b>Performance Requirements: Making a Fuss about a Minor Problem?</b>	<b>25</b>
<b>7</b>	<b>Incentive-Based Competition for FDI</b>	<b>29</b>
<b>8</b>	<b>Conclusions and Strategic Options</b>	<b>32</b>
	<b>Annex</b>	<b>35</b>
	<b>Bibliography</b>	<b>36</b>

*This paper reports on work in progress which is part of the EU-India Network on Trade and Development. The project is run by the Consumer Unity & Trust Society (CUTS), Jaipur (India), and the University of Sussex. We would like to thank the participants of the Midterm Review Meeting in Jaipur on December 20-21, 2002 for constructive criticism. We are particularly indebted to our discussant T.N. Srinivasan and to Alan Winters for many helpful suggestions. Thanks are also due to Rolf J. Langhammer for comments on the revised version of this paper. Manoranjan Pattanayak provided research assistance.*

# 1 Why Foreign Direct Investment Is on the Agenda of Policymakers

Especially since the recent financial crises in Asia and Latin America, developing and newly industrializing countries have been strongly advised to rely primarily on foreign direct investment (FDI) in order to supplement national savings with capital inflows and promote economic development. Even harsh critics of rash and comprehensive capital account liberalization argue in favor of opening up towards FDI (e.g., Stiglitz 2000). It is for several reasons that developing countries may benefit from FDI inflows:

- Foreign direct investors typically have a longer-term perspective when engaging in a host country. As a consequence, FDI is less volatile and less prone to crisis than other private capital flows (Nunnenkamp 2001a: Figure 9).
- In contrast to debt inflows constituting contractually fixed debt-service obligations, FDI constitutes a residual claim on the host country's resources. In other words, FDI has risk-sharing properties.
- While debt-related capital inflows may be used for consumption, FDI is more likely to add to domestic investment. Yet, overall investment may remain unaffected by FDI inflows, especially if they come in the form of mergers and acquisitions (M&As).
- FDI is more than just capital; it also offers access to internationally available technologies and management know-how. Firms and workers in the host country may benefit from economic spillovers so that productivity increases are not restricted to operations dominated by foreigners.

For all these reasons, it is widely expected that FDI will provide a stronger stimulus to economic growth in the host countries than other types of capital inflows. Recent empirical studies on the FDI-growth link provide some support for this expectation (e.g., Soto 2000). However, the available evidence also suggests a major qualification when it comes to the productivity-increasing effects of FDI in developing coun-

tries:<sup>1</sup> in one way or another, recent studies echo an earlier finding of Blomström et al. (1994), namely that the positive impact of FDI on economic growth is confined to higher-income developing countries. It would seem that developing countries must have reached a minimum level of economic and institutional development before they can capture the growth-enhancing effects of FDI.

Nevertheless, more and more developing countries have entered the worldwide competition for FDI. This trend is clearly reflected in an almost universal move to liberalize national FDI regulations (Figure 1). In 1991–2001, about 95 percent of all changes in national FDI regimes, reported by UNCTAD (2002: 7), were meant to treat FDI more favorably. FDI-friendly changes include liberalization measures or measures aimed at strengthening the functioning of markets as well as increased FDI incentives.<sup>2</sup> By contrast, just 78 out of almost 1,400 measures taken in 1991–2001 intensified control over FDI or reduced FDI incentives.

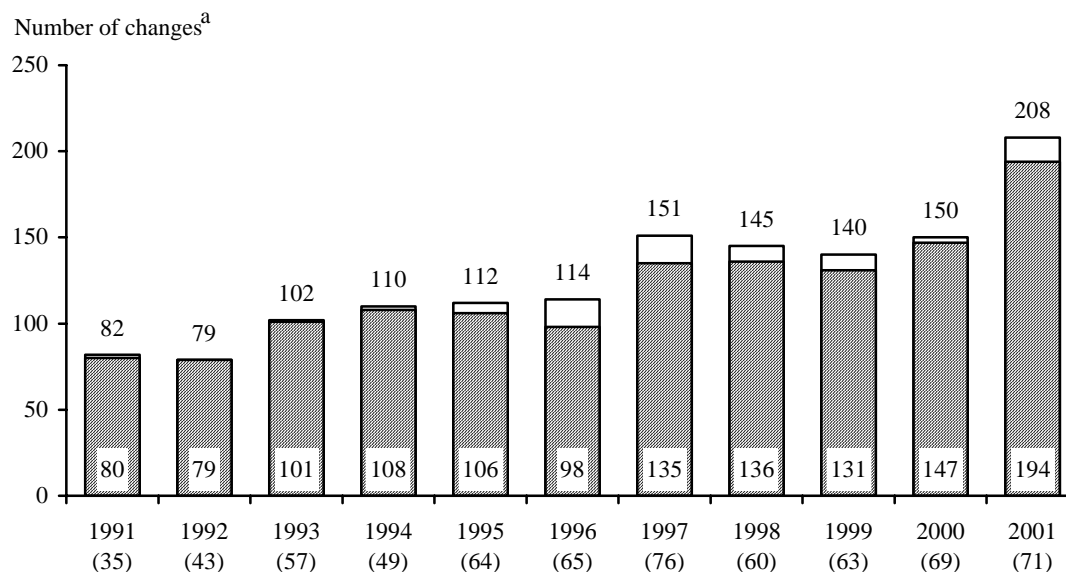
The World Bank (2003: 118) states: “As with trade reforms, unilateral reforms to liberalize foreign direct investment (FDI) are likely to have the greatest and most direct benefit for the reforming country.” Apart from taking unilateral liberalization measures, various countries have entered into bilateral investment treaties (BITs) for the protection and promotion of FDI, and the number of BITs increased significantly to 2099 by the end of 2001. It would seem that both the liberalization of FDI regulations and the protection of foreign investors against political risk is fairly advanced. Hence, the obvious question that arises is why a multilateral agreement on investment may be needed.

---

<sup>1</sup>For a summary of the relevant literature, see Nunnenkamp (2002: Section 9).

<sup>2</sup>In 2001, all regulatory changes which favored FDI (total of 208) were grouped as follows (UNCTAD 2002: 8): more guarantees (24 percent), more liberal entry and operational conditions (28 percent), sectoral liberalization (23 percent), and more promotion including incentives (26 percent).

Figure 1:  
Number of Changes in National FDI Regulations, 1991–2001



<sup>a</sup>Shaded area: changes considered more favorable to FDI; figures in brackets below years refer to the number of countries that introduced changes in their FDI regime.

Source: UNCTAD (2002: 7).

According to the Doha WTO Ministerial Declaration, the purpose of a new multilateral agreement on investment is “to secure transparent, stable, and predictable conditions for long-term cross-border investment” (WTO 2001: Paragraph 20). In the remainder of this introductory section, we present the major arguments of the proponents and opponents of a multilateral agreement on investment. These arguments will then be analyzed in more detail in the subsequent sections. In doing so, we will not apply a strict definition of “investment.” The existing regulatory environment, including BITs and investment-related agreements on a plurilateral level, covers different types of foreign investment, with some agreements extending far beyond FDI. However, our discussion will focus on FDI, since it is mainly the rise of FDI that is widely expected to help developing countries foster their economic development.

Contentious issues related to a multilateral agreement on investment center around four questions: Is there any need for such an agreement? What should it contain? Should binding rules or rather flexible guidelines be aimed at? What would be the likely effects on the quantity

and quality of FDI? Many developing countries are opposed to a multilateral agreement on investment, while its proponents are mainly to be found in industrialized countries. Likewise, disagreement is mainly between developing and industrialized countries when it comes to the contents and character of a multilateral agreement. However, interests differ also within these groups, and independent experts provide different answers to these questions.

As concerns the need for a multilateral agreement, opponents point out that the liberalization of FDI regulations has progressed rapidly through unilateral, bilateral, and plurilateral initiatives. The accompanying boom in FDI is said to reveal the irrelevance of a multilateral framework. By contrast, proponents conjecture that multilateral negotiations on investment can achieve greater openness of investment regimes than can be achieved unilaterally. They also argue that it is precisely because of the proliferation of BITs and plurilateral rules that a multilateral agreement is required. This proliferation is deemed unwarranted, since it increases, rather than decreases, the complexity and opaqueness of FDI regulations. If a multilateral agreement

were to become “a ‘one-stop’ substitute for the complex and legally divergent web of existing BITs” (World Bank 2003: 127), this would not only improve transparency. According to the proponents of a multilateral agreement, this could also help counterbalance the bargaining asymmetries built into BITs and regional agreements. For example, it might become easier for developing countries to prevent noninvestment matters such as labor and environmental standards from being included in agreements on investment. However, many developing countries appear to be reluctant to buy the argument that their bargaining power would be stronger in a multilateral context than in their bilateral dealings with major industrialized countries.

The proponents in industrialized countries suggest that the contents of a multilateral agreement should be similar to what was discussed during the failed attempt at the Multilateral Agreement on Investment (MAI) among OECD countries in the 1990s (for details, see Section 4 below). This implies that the focus would be on guarantees for foreign investors related to entry and post-entry conditions. Developing countries are opposed to this approach which they regard as biased towards the interests of foreign investors. If a multilateral agreement is not plainly rejected, developing countries ask for a “balanced” agreement which, according to their view, should include obligations for foreign investors.

Whether rules should be binding or flexible is debated on different levels. Most fundamentally, skeptics doubt whether it is feasible, theoretically and empirically, to apply to investment the principle of free movement as applied to goods and services. Unlike goods and services, investment is considered an ill-defined entity and a reflection of imperfect international markets for technology. It is pointed out that the activities of foreign investors are highly diverse, involving operation, maintenance, use, sale or liquidation of an investment. More practically, it is disputed

what exactly should be binding. Developing countries are pressing for binding rules on corporate behavior, but are reluctant to tie their own hands. Not surprisingly, the business community in industrialized countries favors exactly the opposite: Binding commitments by host countries are considered necessary in order to lock in unilateral reforms and provide additional protection of investors’ rights.

As concerns possible effects of a multilateral agreement, developing countries are mainly concerned about the quality of FDI. In other words, they want to ensure, e.g., through corporate obligations, that FDI fosters economic development in the host country. On the other hand, the business sector in industrialized countries is striving for an agreement which would expand investment opportunities in potential host countries. As will be argued below, the effects of a multilateral agreement on both, the quality and quantity of FDI may easily be exaggerated.

Against this backdrop, we proceed by presenting the basic characteristics of BITs and discussing their possible shortcomings in Section 2. Subsequently, we review plurilateral arrangements related to the treatment of FDI in regional trade agreements (RTAs) (Section 3). This leads to the question of what a multilateral agreement on investment may offer in addition to what existing agreements offer. The failure in the late 1990s to conclude the MAI among OECD countries provides the starting point for addressing this question (Section 4). Next, we discuss whether and why another attempt to agree on a multilateral framework should be undertaken (Section 5). Major issues related to such a framework, such as performance requirements and incentive competition, are analyzed in more detail in Sections 6 and 7. Section 8 summarizes and discusses strategic options that developing countries have in proceeding in investment-related multilateral negotiations.

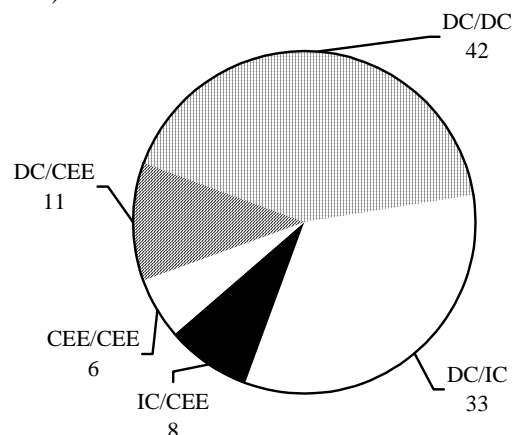
## 2 Bilateral Investment Treaties

The desire of governments to facilitate FDI flows is also reflected, apart from unilateral regulatory changes, in the dramatic increase in the number of BITs for the protection and promotion of FDI during the 1990s (UNCTAD 1997: 19). Less than 400 BITs were reported at the beginning of the 1990s, more than 80 percent of which involved at least one developed country as a partner. The number of BITs soared to 2,099 by the end of 2001.

The proliferation of BITs can at least be partly attributed to the absence of a multilateral framework on investment. Yet, it is open to question whether this trend can be reversed by including investment in the Doha agenda (see also Section 5 below). Many developing countries are opposed to binding multilateral investment rules, despite the argument that their bargaining position would become stronger in a multilateral context. As a matter of fact, the proliferation of BITs is largely because developing countries were eager to conclude BITs, both with developed countries and with other developing countries. In 2001, 86 percent of the 158 BITs concluded involved at least one developing partner country (Figure 2). Moreover, the largest share of BITs concluded in 2001 were an intra-developing-country affair. It should also be noted that BIT activity was not restricted to relatively advanced developing countries, but also involved various least developed countries. In 2001, 23 least developed countries concluded 51 BITs, 13 of which were concluded with other least developed countries.

As mentioned before, BITs are considered a means to facilitate FDI flows and to provide foreign investors with a clear legal framework, in order to reduce uncertainty related to the treatment of FDI in potential host countries before and after entry. However, reducing legal uncertainty by concluding a large number of BITs may come at a cost for foreign investors. An ever-increasing number of BITs tends to reduce transparency and may render it difficult for foreign investors, notably relatively small enter-

Figure 2:  
BITs Concluded in 2001 by Country Group<sup>a</sup> (percent)



<sup>a</sup>DC= developing countries; IC = developed countries; CEE = Central and Eastern European countries.

Source: UNCTAD (2002: 8).

prises engaging in FDI, to collect and evaluate relevant information. Transaction costs related to FDI can, thus, be expected to rise with the number of BITs.

Consider the case of a German investor who wants to outsource relatively labor-intensive parts of his production to a developing country. Apart from evaluating economic fundamentals in potential developing host countries, the investor will have to study various BITs and compare the legal framework laid out there. As of January 2000, Germany had signed 124 BITs, more than any other country at that time (UNCTAD 2000b: 9); 102 BITs had been concluded with developing countries. Even if the investor shortlists some developing countries on the basis of economic fundamentals, information costs might still be substantial when it comes to evaluating the relevant BITs.

Information costs and transparency do not only depend on the number of BITs. Actually, lack of transparency would be a minor problem if legal and administrative procedures and regulations were the same in all BITs signed by one particular country. This is not the case, however, even though most BITs do have common features (see Box 1). There is considerable unifor-

*Box 1:*Important Similarities between BITs<sup>a</sup>

- Broad and open-ended definition of foreign investment.
- Entry and establishment subject to national laws and regulations.
- Fair and equitable treatment of foreign investors.
- Principle of national treatment of foreign investors, but often subject to qualifications and exceptions.
- MFN treatment, subject to some standardized exceptions.
- Right of the host country to expropriate foreign investors, subject to the condition that expropriation is nondiscriminatory and accompanied by compensation.
- Guarantee of free transfer of payments related to a foreign investment, often qualified by exceptions in case of balance of payments problems.
- State-to-state dispute settlement provisions; investor-to-state dispute settlement becoming standard practice.

<sup>a</sup>For a more detailed presentation, see UNCTAD (1998a: 100) and CUTS (2001: 8–9).

mity in various principles, but specific formulations vary. Furthermore, some BITs go beyond the principles noted in Box 1. This is the case particularly in two respects. First, most BITs do not grant the right of establishment to foreign investors, whereas some BITs provide a guarantee of national and MFN treatment on entry and establishment. Second, some BITs prohibit performance requirements with regard to local content, exports, and employment, as conditions for the entry or operation of foreign investors.

From the perspective of foreign investors, the limitations of BITs are primarily related to transaction costs. In addition to the sheer number of BITs with different regulations and procedures, the reduction in noneconomic risk through BITs is sometimes considered insufficient. Major shortcomings of most BITs are seen in lacking protection against violations of intellectual property rights, and in discretionary interventions by subnational authorities of host countries that are not prevented by BITs.

Developing host countries, too, are concerned about shortcomings of BITs. This may be surprising since, as mentioned before, developing countries were signatories of most of the recently concluded BITs. It would seem that developing countries faced a dilemma: They entered into BITs in order to improve their chances of attracting FDI, even though the bargaining position of an individual host country, especially if it was small, vis-à-vis foreign investors and their home countries was too weak for it to have a say in the

exact terms of BITs.<sup>3</sup> Hence, developing countries frequently complain that BITs are biased in that host countries (have to) agree to binding obligations in various respects, whereas foreign investors benefit from rights without assuming any obligations. For example, BITs typically do not include provisions against restrictive business practices, they do not define basic labor standards to which foreign investors shall adhere, and they do not address the issue of binding obligations of foreign investors with regard to social responsibilities and transfers of technology.

Coordination between developing countries may offer a way to strengthen their bargaining position in dealing with foreign investors and their governments. However, as shown below, the widely perceived bias of rights and duties in favor of foreign investors also underlies the reluctance of many developing countries to enter into negotiations on a multilateral framework on cross-border investment issues (Kumar 2001; Singh 2001). Moreover, it is open to question whether FDI would offer more benefits to developing host countries if investment agreements were to include binding commitments of foreign investors. On the one hand, the “quality” of realized FDI projects may improve if agreements ensure that FDI helps host countries to achieve

<sup>3</sup>The World Bank (2003: 127) notes: “The negotiating asymmetries that are common to bilateral agreements have led to treaties in which developing countries have taken on substantive obligations without any reciprocity other than the promise of increases in future private investment.”



their development objectives. On the other hand, strict requirements imposed on foreign investors may cause the amount of FDI flowing to developing countries to decline. Foreign investors always have the option of not undertaking FDI projects under conditions they consider unprofitable. The severity of this trade-off depends on whether or not investment agreements can reasonably be expected to induce more FDI.

Experience with BITs suggests that the amount of FDI flowing to developing countries is largely determined by factors other than investment agreements. UNCTAD (1998a: 117) argues that “it would be unreasonable to expect that any improvements in the investment climate brought about by BITs, which relate only to parts of the FDI policy framework, could exert a significant impact on FDI flows.” Several empirical analyses confirm the relative insignificance of BITs in determining FDI:

- UNCTAD (1998b) analyzed time-series data on bilateral FDI flows between the signatory countries of a BIT. It was shown that the host country’s share in the outward FDI of the home country increased only marginally after the signing of a BIT.
- Hallward and Driemeier, whose results are summarized in World Bank (2003: Box 4.4), compared FDI flows in the three years after a BIT was signed to those in the three years before. No significant increase in FDI was found.
- When analyzing FDI determinants across 133 countries, UNCTAD (1998b) found that the number of BITs signed by a host country played only a minor role for both FDI flows and stocks in 1995.
- The cross-country evaluation of Hallward and Driemeier made use of 20 years of data on bilateral FDI flows from OECD countries

to 31 developing countries. Controlling for a time trend, they found little independent role for BITs in accounting for the increase in FDI.

Each approach may have its particular data problems and econometric shortcomings. Yet, it is striking that all available evidence comes to the same conclusion, namely that policymakers are well advised not to put their faith in BITs as a major stimulus to higher FDI inflows. Variables such as market size and growth, exchange rates, and country risk turned out to be more important than BITs as FDI determinants.

The proliferation of BITs since the 1990s may have eroded the effectiveness of BITs in attracting FDI. The conclusion of BITs is no longer a distinctive factor signaling host countries’ readiness to offer favorable investment conditions by reducing noneconomic risk. Rather, foreign investors tend to regard BITs as a standard feature of the institutional structure prevailing worldwide. In other words, the proliferation of BITs may be characterized by diminishing returns. Nevertheless, BITs should still turn out to be relevant in empirical analyses if the few developing countries not taking part were considered relatively risky locations by foreign investors for this reason and, therefore, suffered negative effects on FDI inflows. However, weak economic fundamentals and markets, rather than the absence of BITs, appear to be the major factors working against FDI flows into these countries. BITs per se do little more than enable multinational enterprises to invest in a partner country. It is a completely different question whether FDI will actually be undertaken as a result of BITs. This is rather unlikely, at least until economic fundamentals are conducive to FDI.

### 3 Plurilateral Investment Agreements

In the previous section, we argued that there has been a tremendous proliferation of BITs, particularly in the 1990s. We also noted that BITs are not a sufficient condition to induce FDI. In

essence, the role of the BITs seems to be to ensure some certainty in FDI transactions. From another point of view, it allows countries to pre-commit to certain investment rules which can

then be immunized from local interest group interference (Low and Subramaniam 1995). In this section, we will show how the principles underlying bilateral treaties tend to be modified in plurilateral investment treaties (PITs).

Most of the PITs have been of recent origin and immediately preceded or followed the conclusion of the Uruguay Round Agreement in 1995. The signing of PITs also coincided with the tremendous growth in regional trading arrangements (RTAs) (UNCTAD 2001). While not as large in number as the BITs, the PITs (like RTAs) proliferated mainly in the 1990s, with most countries being a member of more than one PIT (e.g. UNCTAD 1999a: Chapter IV). Here we will address major issues related to PITs by looking at the treatment of investment in five specific RTAs: the Energy Charter, the Free Trade Agreement of the Americas (FTAA), MERCOSUR, NAFTA, and ASEAN. While the Energy Charter is largely an area-specific RTA involving developed and developing countries, MERCOSUR and ASEAN consist of only developing countries and the remaining two involve both developing and developed countries. Even as regards RTAs such as the FTAA that have not yet come into force, the treaties' intentions and expected features may offer valuable insights. Moreover, a closer look at RTAs may help us understand the factors that led to the failure of the OECD's attempt at a MAI which straddled a large number of developed and developing countries.

There are almost no multilateral agreements which are investment specific. Rather, PITs have largely evolved as chapters or clauses in RTAs. Even the **Energy Charter** focuses on trade, transit, and efficiency issues apart from investment. The 52 countries (as of Sept. 2002) which are signatories are drawn from both developing and developed countries in Europe. A number of African countries as well as the United States and Canada have an observer status. In Asia, Japan is a recent signatory. The charter came into force in April 1998, four years after the signing in 1994.

The charter relates only to energy. Being highly focused, the agreement guarantees post-entry nondiscriminatory treatment to member

country investments. As concerns pre-entry establishment, however, the charter only allows for a "best endeavor" clause. Furthermore, the charter "grandfathers" existing exceptions and restrictions, and it allows for the reservation of privatized assets for local firms. Finally, the charter includes a comprehensive dispute settlement procedure for both state-state and investor-state disputes. The extremely limited product coverage of the charter has probably allowed countries to come to an agreement rather quickly. Countries may accede to the charter over time as and when they are ready, thus providing the flexibility required by countries at different stages of development.

The initiative for the **Free Trade Agreement of the Americas (FTAA)** envisages a far more general RTA.<sup>4</sup> The negotiations were launched in 1998 and the agreement was scheduled to come into force by 2005 (UNCTAD 1998a: 59). In making an inventory of the national rules on investment already prevalent in prospective member countries, it turned out that there was a high degree of similarity in respect of national and MFN treatment, equality between foreigners and nationals, principles of private property, and agreements on dispute settlement. As concerns the last issue, many negotiation partners were already members of the *World Bank's International Convention on the Settlement of Investment Disputes between States and Nationals of Other States* (ICSID; see UNCTAD 1998a: 62–63). The exceptions to MFN were also the same in most of the countries, namely economic integration agreements, tax treaties, and bilateral concessionary finance schemes. In international finance, the countries were committed to mobility of capital subject to a balance of payments exception. Finally, there was also convergence in expropriation decrees and compensation criteria. The divergence came in the definition and scope of investment, processes of authorization and registration of foreign investment, treatment of subnational authorities and industry exceptions.

---

<sup>4</sup>FTAA negotiations involve 34 developing countries of Latin America and the West Indies. The United States and Canada are the only developed countries taking part.

In addition, countries differed on pre-entry and post-entry establishment commitments.

A somewhat different treatment of investment obtains in the **ASEAN** agreement. Concluded in October 1998, the Framework Agreement on the ASEAN Investment Area derives its value from the perceived need to promote the Asian Free Trade Area (AFTA). The agreement includes a waiver of the 30 percent national equity requirement under the ASEAN Industrial Cooperation Scheme, and it extends to all services and modes of supply (UNCTAD 1999a). However, the agreement relies on voluntary cooperation with no legal bindings or dispute settlement mechanisms (UNCTAD 1998a). There is no provision for investor-state dispute resolution in the Protocol on Dispute Settlement Mechanism. Furthermore, the agreement specifies a negative list of industry exceptions and balance of payments safeguards in case of external financial difficulties (ASEAN 1998). The national treatment (including right to entry) is presently limited to ASEAN investors, with a large number of sectoral exceptions to go only by 2010 (UNCTAD 2002). In general, the ASEAN agreement on investment reflects the unwillingness of East and South East Asian countries to be tied down to legal specifics in international agreements (Pant 2002).

The ASEAN RTA has evolved in a series of steps. The 1987 Agreement for the Promotion and Protection of Investments was followed by the Framework Agreement on Economic Cooperation in 1992, the setting up of the ASEAN Investment Area (AIA) at the fifth ASEAN summit and the protocol of 1996 to enhance investor confidence. As a PIT, the ASEAN initiative was much like the MERCOSUR agreement (to be discussed below), i.e., it was largely meant to promote trade among partner countries. Thus, national treatment was to be extended to non-ASEAN investors only by 2020. The AIA specifically refers only to FDI, which has traditionally contributed a great deal to exports of South East Asian countries in particular. Finally, the agreements do not prevent any of the constituent countries from joining other subregional

initiatives or growth triangles involving adjacent countries.<sup>5</sup>

By contrast, **NAFTA** provides for a very comprehensive treatment of investment (*NAFTA Treaty* 1994). The free trade area of Canada, Mexico, and the United States will come into full operation by 2005, ten years after NAFTA was agreed upon.<sup>6</sup> Chapter 11 of the NAFTA Treaty deals specifically with investment. The dominance of the United States in framing the treaty is reflected in the definition of investment, which is extremely broad and includes, apart from both direct investment and portfolio investment, intellectual property and loans. The scope of the treaty extends MFN and national treatment (NT) to both investors and investment. The application of the nondiscrimination principles is extended by the addition of the clause on “fair and equitable treatment (FET)” to foreign investors. The treaty specifically states that no formal and substantive rule can be made which would give advantage to local investors. In addition, it specifies that “in like circumstances” there cannot be any discrimination with respect to any sphere of operation of an investment instrument.

The NAFTA Treaty also contains an elaborate dispute settlement mechanism. A regional Dispute Settlement Body (DSB) allows for international arbitration of disputes. No appeal to the host country is available regarding decisions of the DSB, and the treaty requires that there be some international element involved in any investment dispute. In other words, the DSB is only available when the investor and/or the investment belong to two different country jurisdictions. Unlike most RTAs, there is provision of investor-state dispute settlement (except for pure Canadian companies in Canada) and the

<sup>5</sup>India and China are also now attempting to enter into a free trade agreement with ASEAN.

<sup>6</sup>The accession to NAFTA by Mexico was due to the expected significant investment and trade benefits which would accrue (Krueger 2000). It has been argued that Mexico was able to overcome one decade of opposition to NAFTA due to the debt crisis of the 1980s, its extreme trade dependence on the United States, and its semi-authoritarian regime prior to 1991 (Schirm 2002). In addition, the formation of NAFTA was propelled by Mexico's GATT membership since 1986 and fears of a “Fortress Europe.”

private party has the right to nominate one of the three members of the DSB (*NAFTA Treaty* 1994).<sup>7</sup> The treaty applies also to subnational authorities. In a controversial clause, investors are entitled to dispute any governmental action that harms their investment (“regulatory takings”). This has been a bone of contention in the widely publicized Ethyl case in Canada (UNCTAD 1998a).

**MERCOSUR** is an RTA consisting of Argentina, Brazil, Paraguay, and Uruguay, with Chile and Bolivia as associate members. Created under what is known as the Treaty of Asuncion, MERCOSUR was initially to be a common market. Internal struggles and several crises notwithstanding, considerable trade liberalization has been achieved since 1991. This is true especially for internal tariffs. In addition, the common external tariff applied to 85 percent of all products by June 1995 (Machado 1995: 19; Schirm 2002: chapter 4). Somewhat like the EU, MERCOSUR also aimed at a coordinated policy in regional economic fora.

Yet, MERCOSUR has little to offer as a PIT. The only instrument is the 1994 Protocol on Promotion and Protection of Investments from States not Parties to MERCOSUR. Even this instrument only undertakes not to treat foreign investors more favorably than set out in the protocol. Furthermore, the parties signatory to the protocol enjoy the discretion to give or not to give MFN and national treatment to foreign investments. The protocol does not contain any provisions to bar performance requirements or incentives.

In a recent survey, Gestrain (2002) noted that the extent to which signatories to an RTA attempt to establish wide-ranging and ambitious rules on foreign investment is largely a function of their previous experience with liberal investment regimes. Thus, for example, provisions very similar to those of NAFTA can be found in the FTAA agenda.<sup>8</sup> Similarly, the OECD’s attempt at the MAI (discussed in the next section)

came after many years of experience with liberal investment regimes in the OECD countries.

Yet, one has to take into account various additional factors to see whether or not RTAs include a comprehensive treatment of investment issues. First of all, it is mainly through BITs, rather than RTAs that negotiations on investment are pursued (Gestrain 2002). Out of the 172 RTAs (as of 2000), only a few deal with investment issues. In contrast to many BITs, investment is narrowly defined as FDI in most RTAs, with NAFTA and possibly also the FTAA representing major exceptions. A comprehensive treatment of investment in RTAs may be difficult to achieve if a large and heterogeneous (in terms of development criteria like per capita income) set of countries is involved. However, our short account of major RTAs also suggests that RTAs between developing countries have a limited coverage of issues like dispute settlement and national treatment of foreign investors. Developing countries appear to be more oriented towards promoting trade and supporting national companies, rather than foreign investment, when it comes to provisions in RTAs. For example, this is the case as regards both MERCOSUR and ASEAN.

The limitations of many RTAs are particularly striking with regard to dispute settlement. The importance of a dispute settlement mechanism cannot be doubted given the increase in the number of disputes over the last decade. As noted in Gestrain (2002), between 1972 and 1999, 69 disputes were registered with ICSID, or about two and a half per year. Between January 2000 and February 2002, 29 disputes were registered, i.e., about 14 per year. Dispute settlement mechanisms are common in BITs, but included in just a few comprehensive RTAs like NAFTA.<sup>9</sup> As we will see in the next section, dispute settlement was also among the contentious issues in the OECD’s attempt at the MAI, which was the first truly multilateral investment initiative. Some of the points raised here come out in stark relief when looking at the factors that led to the failure of the MAI.

<sup>7</sup>The framework for a binational judicial review of tribunal decisions is laid down in Chapter 19 of the NAFTA Treaty.

<sup>8</sup>However, as mentioned before, pressure by the United States played a role in NAFTA and may also shape investment rules in the FTAA.

<sup>9</sup>According to Rugman and Anderson (1997), however, the NAFTA dispute settlement mechanism was running into problems.

## 4 Multilateral Initiatives on Investment

### 4.1 The OECD's MAI

It has been argued that the objective to launch talks on the MAI in the OECD reflected the logical culmination of the process of liberalization in the constituent countries as far back as 1961 (Henderson 1999). The aim was to broaden the liberalization process via an investment-specific instrument. To put it another way, it was deemed necessary to extend to investment the same liberal treatment that already existed for commodity trade. The MAI essentially attempted to implement the report to the OECD submitted by the Committee on International Investment and Multinational Enterprises (CMIE) and the Committee on Capital Movements and Invisible Transactions (CMIT) in 1995 (OECD 1995). Restrictions on outflows of capital had been almost completely eliminated by 1995. Hence, it seemed logical to extend the liberalization to inflows of capital and to codify these rules in the context of both international movements of investment and services (Henderson 1999). The MAI was supposed to reduce transaction costs, to which the plethora of BITs tended to add. As noted in Section 2, most countries have signed a large number of bilateral treaties, resulting in increasing costs of understanding the regulations governing FDI in any country. Transaction costs can be entry barriers especially for small foreign investors (Gara 2002).

The starting conditions appeared to be favorable at the beginning of MAI negotiations. Exchange controls had been lifted in all OECD countries along with restrictions on the outward movement of capital. Even though restrictions on inflows of capital remained, inflows of FDI had been deregulated in the context of major liberalizations of domestic financial markets in the 1990s and RTAs like NAFTA, the EU, and MERCOSUR. A similar liberalization does take place in other countries like Australia and New Zealand (Caves and Krause 1984; OECD 1996). The 1980s had witnessed extensive liberalization of inflows of capital in Latin American countries like Brazil and Chile. In the same vein,

Asian countries like China, India and those of ASEAN as well as countries of Eastern Europe had opened up to inflows particularly of FDI (UNCTAD 2000a).

In general, it could be argued that, both for suppliers and demanders of capital, the mood was extremely optimistic in the mid-1990s (Pant 1995). According to Henderson (1999), conditions for the MAI could not have been better than in 1995, in terms of the enabling environment and the technical preparedness. Consequently, the MAI represented the most ambitious initiative so far, involving the 29 countries of the OECD and eight developing countries, including China, Brazil, and Argentina. However, the developing countries had only an observer status and, thus, had little influence on the agenda. In addition, the WTO, World Bank, and IMF were represented in MAI negotiations.

As argued in Witherell (1995), the MAI had to be fairly comprehensive to be an improvement over other multilateral instruments and the two existing codes of the OECD which related to the liberalization of capital movements and the liberalization of invisible transactions. Box 2 summarizes the main features of the planned MAI (for details, see Ley 1997; Witherell 1995; UNCTAD 2001).

Despite the favorable environment, however, the MAI discussions broke down in 1998. There were several issues on which substantial disagreement remained. For one, on the "scope" of the agreement, the United States supported extraterritorial application of national laws, which was opposed by EU countries (UNCTAD 1999b: 20; Henderson 1999). Second, exceptions for regional integration organizations (the REIO clause that is common in other agreements) were opposed by the United States, in particular on the grounds that such exceptions were contrary to the basic objective of market access (UNCTAD 1999b). Third, in the context of "cultural exceptions," barring the United States, Japan, and New Zealand, none of the other countries was willing to accept the "stand-still" clause in the audiovisual industry. Fourth,

*Box 2:*

## Principal Features of the MAI

- Unlike the previous OECD codes, the MAI was to be a full-fledged treaty ratified by legislatures.
- A formal dispute settlement mechanism was planned, including provisions for investor-state and state-state disputes.
- Investment was broadly defined as in the NAFTA agreement.
- All phases of investment, including pre-entry establishment, were to be covered by the principles of nondiscrimination (MFN and national treatment).
- Reservations (country-specific exceptions) were subject to “standstill”, “rollback”, and “ratchet” clauses. In other words, there could be no new reservations and existing ones were time bound.
- The negative list approach was used with regard to general and specific exceptions.
- Performance requirements were to be prohibited or limited, while incentives were to be subjected to well-defined rules.
- Right of access to key foreign personnel was to be guaranteed.
- As in GATT, the disciplines of the treaty were to apply to subnational authorities.

there was considerable disagreement on the introduction of the clause on labor and environmental standards. The MAI was abandoned by the time any agreement on the issue of standards was reached (Henderson 1999). Fifth, the “pre-entry establishment” clause was supported by the United States, whereas it was opposed by EU countries like France. Finally, there was disagreement on including the “investor to state” clause in dispute settlement particularly in the context of “regulatory takings” (Graham 1998). All this resulted in a plethora of reservations which went into a large number of chapters which are still not available as public documents. Coupled with the exclusion of taxation from the ambit of the MAI, the treaty would at best have been a political liability (Henderson 1999; UNCTAD 1999b).

With hindsight, the MAI failed because of a multiplicity of factors (see also Dymond 1999). Some of these were treaty specific. As regards clauses like cultural exceptions, extraterritorial application, and dispute settlement there seemed to be no meeting ground even within the set of OECD countries. In addition, many countries were unwilling to commit to the broad definition of investment used. It may thus be argued that the initial agenda was overambitious. Subsequently, the envisaged treaty was rendered rather meaningless by the special interests of many countries as well as the number of reser-

vations and exemptions sought (UNCTAD 1999b).

More generally, the political economy of multilateral negotiations changed substantially in the 1990s (Pant 2002; UNCTAD 1999a). Business groups, for example, were considerably interested in the MAI when negotiations started (ICC 1996). Yet, they lost interest with taxation off the agenda, the possibility of minimum labor and environmental standards coming on the agenda, and the dispute settlement mechanism being watered down. At the same time, NGOs emerged as an important force opposing the MAI agenda. The impact of the NGOs (from both developed and developing countries) was aided substantially by the developments in instant electronic communication via the Internet (Rothkopf 1998; Mathews 1997). The NGOs projected some aspects of the MAI as impinging on the sovereignty of consumers and individual countries by giving foreign investors rights without obligations. In their view, this was particularly true of investor-state dispute settlement with third party intermediation, regulatory takings, and labor and environmental issues (UNCTAD 1999b).

The broad sweep of the MAI also alienated many countries which saw the prospective treaty as placing private interests above state interests (Henderson 1999; France 1998). It must be remembered that, in the 1990s, the electorate in

many countries had returned left/center governments which were more responsive to the concerns of NGOs. In addition, the developing countries were effectively excluded from the negotiations and were offered only the choice of taking it or leaving it. With developing countries being increasingly opposed to the process, the MAI came to symbolize all that was perceived to be wrong with globalization (Sauve 1998). In the light of all these developments, it would have been political suicide to persist with the MAI.

What are the lessons to be learnt? First of all, the existence of a large number of BITs does not indicate that countries are ready for a comprehensive multilateral treaty on investment. The specific trade-offs that can be negotiated in BITs are not easy to pursue in a multilateral context. Furthermore, an ambitious multilateral negotiation agenda is unlikely to succeed unless it offers scope for quid pro quo deals between participating countries pursuing different objectives. The potential for such deals was fairly limited in the case of the MAI, as negotiations in the OECD were restricted to investment-related issues. Under such conditions, it might have been more promising if a modest and incremental approach had been taken in MAI negotiations. Considering that even the relatively small and homogeneous group of OECD countries could not agree on the ambitious agenda, it was all the more unlikely that a larger number of heterogeneous countries, including developing countries, were prepared to join.

The situation is different if investment issues are negotiated under the roof of the WTO, where considerable scope exists for quid pro quo concessions in different areas of negotiations. The Uruguay Round is a reminder to this effect. Therefore, we consider different strategic options open to developing countries in Section 8 below. Yet, the MAI experience suggests an important caveat: if multilateral treaties go beyond trade promotion (the basic objective of GATT) to attempting to homogenize the pace of liberalization in contracting parties, the process of negotiation and the final settlements may be difficult to sell politically. After the conclusion of the Uruguay Round, policymakers in OECD countries pushed ahead with liberalization in ar-

eas such as investment without anticipating the resistance emerging among developing countries, NGOs, and their own electorates. Recently, wariness of new multilateral initiatives has mounted, especially in developing countries which are dissatisfied with the implementation of the results of the Uruguay Round.

## 4.2 Multilateral Initiatives in the WTO

The WTO initiatives that impact on foreign investment are largely contained in four agreements: Trade Related Investment Measures (TRIMS), General Agreement on Trade in Services (GATS), Trade Related Intellectual Properties (TRIPS), and Dispute Settlement Undertaking (DSU). While TRIPS and DSU provide minimal standards of protection for investment (Sauve 1998), the main provisions affecting investment are contained in TRIMS and GATS.

The TRIMS measures are reasonably comprehensive in that they ban the imposition of performance requirements on foreign investors. This is not normally a part of BITs, with the exception of those BITs involving the United States (Vandeveld 1998; Read 1999). In addition, TRIMS includes "standstill" and "rollback" provisions. Countries are required to notify all non-conforming measures to the Council for Trade in Goods, and there is a commitment to roll back these measures in five years for developing countries and seven years for least developed countries. Article III of the agreement imposes national treatment on signatories, while Article XI forbids quantitative restrictions on exports and imports. It has been argued that TRIMS offers a natural base for consideration of a multilateral agreement on investment (Low and Subramaniam 1995; Hoekman and Saggi 2001). However, the principal problem with TRIMS is that it is restricted to trade in goods and does not cover services. Moreover, TRIMS rules have remained highly contentious and various WTO members appear to have violated them.

Important measures for investor protection under the WTO are contained in GATS. To the extent that GATS covers FDI as a mode of supply ("commercial presence") as well as the

movement of related skilled personnel (“temporary movement of natural persons”), its provisions have a direct bearing on investment. Sauve (1998) argued that GATS contains “provisions relating both to matters of investment liberalisation and investment protection, albeit with different degrees of comprehensiveness.” While Article II(1) imposes MFN treatment (a measure of liberalization), transparency (indicating investment protection) across all sectors is required by Article III. However, GATS Article II(v) allows for exceptions to MFN. These exceptions relate mainly to regional trade arrangements (RTAs), bilateral tax treaties, and reasons of public health or morality. This is in conformity with most BITs.

Likewise, national treatment is subject to limitations in GATS (Read 1999). National treatment is guaranteed only in service sectors listed in a member country’s schedule (Article XVII (1)). The number of sectors where national treatment is granted is expected to increase over time in line with the “positive list” approach of GATS. In another clause, Article III(3) imposes “transparency” on members, who are required to publish and notify the Council for Trade in Services of all laws, regulations, and administrative measures relevant to the agreement in the case of committed service sectors (Read 1999).

According to Article XXIII, all disputes relating to GATS are to be governed by the Dispute Settlement Undertaking (DSU). The DSU con-

tains the usual provisions for negotiations, consultations, arbitration, and compensation (Sciarra 1998). However, unlike the NAFTA agreement, there is no provision for investor-state dispute settlement.

Even though TRIMS and GATS offer a number of provisions relating to investment, the main lacunae are in the context of expropriation, compensation, and subrogation (Read 1999). In addition, provisions for investor-state dispute settlement are missing. A multilateral agreement on investment might help fill these gaps. However, following this route would involve several critical issues. First, in the case of commodity trade, it is easy to associate traded goods with particular countries. This is not always possible in the context of FDI, as the principal feature of transnational corporations is that their base of operations spans several countries. Second, multilateral attempts to constrain a country’s sovereignty through redefinition of jurisdiction (as investor-state dispute settlement would do) would be as hotly contested by developed as by developing countries. The concern is that this would confer advantages to foreign companies not available to local companies, which could be considered “reverse discrimination.” As we have seen earlier, this issue contributed to the breakdown of OECD talks on the MAI. Subsequently, we will discuss whether there are better prospects for a multilateral framework for investment in the context of WTO negotiations.

## 5 Why a Multilateral Framework?

### 5.1 Conflicting Interests

The earlier failure of OECD countries to conclude the MAI notwithstanding, industrialized countries, including the EU, are pressing for a multilateral agreement on investment to be integrated into the WTO framework. The negotiating stance of industrialized countries largely reflects the business perspective in these countries. For instance, according to UNCTAD (1999a: 140), the Union of Industrial and Employers Confederations in Europe (UNICE) “attached high priority to the establishment of a global re-

gime for FDI that is non-discriminatory, transparent, stable and liberal.” UNICE claimed that appropriate provisions on FDI would be in the interest of WTO members at all levels of development. Likewise, the International Chamber of Commerce (ICC) argues that a single set of legally binding multilateral rules and disciplines to govern international investment is needed for two reasons: firstly, to better protect the great volume of existing FDI and to facilitate further expansion; secondly, to replace the large and rapidly growing number of overlapping legal in-



struments and initiatives in the investment area (DSE Forum 2002: 40–41).

On the other hand, various developing countries remain skeptical whether they would benefit from a multilateral investment agreement. The fear is that the bargaining position of developing host countries would weaken further. As pointed out by Kokko (2002), the TRIMS agreement has already tilted the playing ground in favor of multinational enterprises (MNEs). While this agreement prohibits measures (e.g., performance requirements) traditionally applied to promote so-called development friendly FDI, it does not limit the scope for subsidy-based competition for FDI. A multilateral investment agreement aiming primarily at protecting existing FDI and encouraging additional FDI may shift the balance of power even more in favor of MNEs.

Policymakers from developing countries emphasize the need to take due account of national development goals and policies in a multilateral investment agreement.<sup>10</sup> This position is supported by many NGOs. UNCTAD (1999a: 140) summarizes their view as follows:

The main priority for international negotiations is not liberalization, but setting a framework to ensure that international investment promotes sustainable development and real economic efficiency. Specific priority areas for rules include investor behavior and transparency, competition and restrictive business practices, regulation of investment incentives, and support for least developed countries to enable them to attract high quality investment.

It seems that conflicting interests are mainly between industrialized and developing countries. It fits into this picture that, for instance, the Minister of Small and Medium Enterprises and Commerce of Senegal argued for a “compromise between the investor and the receiving country in question” (DSE Forum 2002: 39). However, recent research on where the economic benefits of FDI go suggests that interests tend to diverge also among developing countries. This is not only because some developing

countries, notably those offering neither promising markets nor relevant cost advantages, may not have reasonable chances to attract FDI, no matter what investment agreement they sign. In addition, the bottom line of various empirical investigations appears to be that developing countries must have reached a minimum level of economic development before they can capture positive effects of inward FDI on economic growth.<sup>11</sup> Higher-income developing countries have better prospects than low-income countries to benefit from economic spillovers of FDI by absorbing superior technology and knowledge. Hence, more advanced developing countries may find it easier to accept, as a *quid pro quo*, the demands of MNEs and industrialized countries for clearly defined multilateral rules. By contrast, the cost-benefit calculus of poorer countries for which FDI has less to offer may lead them to reject such demands.

The finding that beneficial effects of FDI in developing host countries cannot be taken for granted has further implications, which will be discussed in the remainder of Section 5. It is far from obvious that FDI would have more favorable effects in poor countries if a “development clause” were to be included into a multilateral investment agreement. Similarly, it is open to question whether a “balanced” agreement, containing corporate obligations in addition to rules binding host countries, would foster transfers of technology and know-how. Strict obligations may rather discourage MNEs from investing in poor developing countries altogether.

However, as argued in the following, wishful thinking also prevails on the part of those pushing for the liberalization of FDI regulations through a multilateral agreement. Cost savings are likely to be limited, as a multilateral agreement would not replace, but rather complement, bilateral and plurilateral agreements. Moreover, the importance of transaction costs, relative to other determinants of FDI in developing countries, tends to be overstated. As a consequence, it is unlikely that a multilateral agreement would

<sup>10</sup>See, for example, the summary of discussions with regard to trade and investment in DSE Forum (2002: 39–43).

<sup>11</sup>For a summary of relevant studies, see Nunnenkamp (2002).

induce significantly more FDI in developing countries.

## 5.2 The Relevance of Transaction Costs

A multilateral investment agreement could potentially reduce transaction costs related to FDI by providing for a transparent regime of rules and regulations. As argued in OECD (2002: 176 ff.), a lack of transparency may deter FDI in several ways:

- It adds to operational risks for MNEs and imposes higher information costs on them.
- It gives rise to information asymmetries which tend to benefit market incumbents and discourage FDI by new entrants.
- It leads to adverse selection among foreign investors, by favoring those who possess privileged information and are politically well connected in the host country.

An illustrative list of transaction costs caused by a lack of transparency in rules and regulations governing FDI has been presented by UNCTAD (1999a: 179–180); this list, which largely applies to domestic investment as well, is shown in Table 1. The cost effects of lacking transparency in these respects are impossible to quantify. Yet, UNCTAD reckons that unclear rules and regulations “can increase the transaction costs of investment and operations significantly” (*ibid.*). In a similar vein, the OECD (2002: 176) stresses that “a lack of transparency will almost certainly discourage foreign investors,” even though transparency *per se* will not induce FDI if other deterrents remain. To support this argument, the OECD refers to a recent study by the Asian Development Bank Institute on various aspects of transparency in 55 (industrialized and developing) countries. It turns out that inward FDI is relatively low where transparency is poor.

Nevertheless, the relevance of a multilateral agreement on investment for enhancing transparency and reducing transaction costs is questionable on several grounds. For a start, even if all transaction costs listed in Table 1 were addressed by such an agreement, other FDI-related

transaction costs would remain unaffected. Hoekman and Saggi (2000: 643) argue in this context that “the major proportion of the transaction costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country [rather than from the costs imposed by the multitude of BITs on multinational firms].”

Even for cost elements to be addressed in a multilateral agreement, reductions in transaction costs will be less than hoped for by the business community. A far-reaching multilateral agreement might render various less comprehensive BITs redundant. However, the Doha Round will at best mark the starting point of a long-term process towards substantive and binding multilateral investment rules. Most if not all, bilateral and plurilateral investment agreements will remain in place for the time being. Investment agreements of different sorts with narrow or broad membership will coexist, as is the case in international trade.<sup>12</sup> A multilateral agreement would define the smallest common denominator of WTO members, while regional groupings or bilateral partners would still be free to go beyond multilaterally agreed rules. In other words, the realistic scenario with regard to investment rules is what trade negotiators labeled a “GATT plus”-framework.

The expected pattern of a “GATT plus” (or, rather, “WTO plus”)-type framework for international investment is easy to explain in collective action terms. The degree of common interests and perspectives is typically higher among a smaller homogeneous group of countries; coordination problems mount with the number of contracting parties. It follows that more and stricter investment rules can be fixed in BITs and regional agreements. As Sauvart (2000: 9) put it, “what would be acceptable at the bilateral or even at the regional level may not necessarily be acceptable at the multilateral level.” The unpleasant consequence for foreign investors is

<sup>12</sup>The so-called spaghetti bowl of trade preferences (Bhagwati) clearly suggests that such an outcome would be sub-optimal from an economic point of view. Yet, for political-economy reasons, we consider it unlikely that a multilateral agreement on investment will achieve what has proved impossible so far in trade negotiations.

*Table 1:*  
Transaction Costs Related to the Legal and Regulatory Environment for FDI

	Transaction	Enterprise exposure	Effects on
Business entry	Registration	Monetary costs fo firm	Rate of new business entry
	Licensing	Time costs (including	Distribution of firms by size,
	Property rights	compliance and delays)	age, activity
	Rules	Facilitation costs	Size of shadow economy
	Clarity	Expert evaluations of rules	Rate of domestic investment
	Predictability	and their functioning	FDI inflows, quantity and
	Enforcement	Number of rules and	quality
	Conflict resolution	formalities	Investment in R&D
Business operation	Taxation	Cost of compliance	Business productivity
	Trade-related regulation	Higher costs of operation	Export growth
	Labor hiring/firing	Costs of conflicts and conflict	Size of shadow economy
	Contracting	resolution	Growth of industries with
	Logistics	Search costs and delays	specific assets or long-
	Rules	Insufficient managerial	term contracting
	Clarity	control	Rate of innovation and R&D
	Predictability	“Nuisance” value	Rate of business expansion
	Enforcement	Problems in making contracts	Rate of investment in new
	Conflict resolution	Problems in delivery	equipment
Business exit			Subcontracting
	Bankruptcy	Rate of change of rules	Rate of exit (and entry)
	Liquidation	Changes in costs and number	Prevalence of credit
	Severance/layoffs	of rules	Distribution of profitability
	Rules	Availability of rules and	of corporations
	Clarity	documents to firms	
	Predictability	Rates of compliance and/or	
	Enforcement	evasion	
	Conflict resolution	Use of alternatives to formal	
		institutions	

*Source:* UNCTAD (1999a: 179–180) on the basis of World Bank information.

that they will continue to encounter considerable information needs and transaction costs resulting from a lack of transparency when planning to invest in a country which is a WTO member and, at the same time, a contracting party of more far-reaching investment agreements. The remaining complexity of trade regulations at different levels is a clear reminder to this effect.

It may actually be the foreign investors themselves who will contribute to the emergence of a “WTO plus”-framework. This could happen if, as widely assumed, multilateral negotiations on investment strengthened the bargaining position of developing countries. As a consequence, the business community may lose interest in a multilateral agreement, and instead prefer the stron-

ger protection of investors’ rights in BITs (World Bank 2003: 127).

### 5.3 Transaction Costs and Inward FDI

There is another reason for not expecting too much from a multilateral investment agreement in terms of transaction cost reductions. Survey results on investment conditions in 28 developing countries, presented by the European Round Table of Industrialists (ERT 2000) in cooperation with the United Nations and the International Chamber of Commerce, suggest that impediments to FDI that give rise to transaction costs were already relaxed substantially, largely

on a unilateral basis, throughout the 1990s.<sup>13</sup> It is, thus, debatable whether a multilateral agreement is needed as urgently as suggested by statements made by the business community on the significance of transaction costs.<sup>14</sup>

ERT (2000) lists, country-wise, impediments to FDI on a scale ranging from 0 (most liberal) to 6 (most restrictive). In this section, we consider impediments that give rise to transaction costs (see Box 3 for details). These impediments are grouped into five indices: administrative bottlenecks, entry restrictions, post-entry restrictions, risk factors, and technology-related regulations. Table 2 indicates that transaction costs have come down considerably in all five dimensions if ERT's assessment of the severity of FDI impediments provides a reasonable yardstick:

- In the early 1990s already, the average score of all sample countries was below 2 (i.e., fairly liberal) in all dimensions except for entry restrictions.
- As concerns changes between 1992 and 1999, just 8 out of 140 country-specific entries in Table 2 point to higher transaction costs at the end of the observation period.
- For only two countries (Guatemala and Sri Lanka), were FDI impediments rated more restrictive in 1999 in more than one dimension.
- The average score of all sample countries declined to about half the score in 1992 for each of the five indices.

All this suggests that foreign investors do not have not to wait for a multilateral agreement on investment in order to benefit from transaction cost reductions. This is especially the case as regards some specific factors that figured prominently among investors' concerns in the more

distant past. Relevant examples are the risk of nationalization or expropriation (subsumed under risk factors in Table 2) and exit restrictions, including restrictions on the repatriation of capital (subsumed under post-entry restrictions in Table 2). According to the survey results of ERT, the threat of nationalization or expropriation has diminished tremendously. The number of sample countries where it was considered relevant at all declined from 13 in 1992 to 5 in 1999 (among them India and China, though their score of 0.5 indicated a fairly low risk of expropriation). A similar move towards liberalization is reported for exit restrictions; in this regard, India's score improved from 2 in 1992 to 1 in 1999 (China: 2 in 1992 versus 0.5 in 1999). A multilateral agreement may help lock in previous liberalization measures undertaken unilaterally and render such measures more difficult to reverse. However, there appears to be little a multilateral agreement can offer in terms of further reducing the risk of expropriation and liberalizing exit restrictions.

Correlation and regression analyses that we performed on the link between the indicator values presented in Table 2 and inward FDI in the sample countries support the view that transaction-cost-related impediments to FDI were of minor importance in the past already.<sup>15</sup> For a start, we calculated bivariate (Spearman rank) correlation coefficients between the indices in Table 2 on the one hand, and FDI stocks in 1999 and FDI inflows in 1997–2000 on the other hand.<sup>16</sup>

The first two columns of Table 3 suggest that more serious administrative bottlenecks and higher risks discouraged inward FDI in a significant way. However, inward FDI was not correlated significantly with either entry restrictions, post-entry restrictions, or technology-related regulations.<sup>17</sup> This provides a first indication that the distribution of FDI among devel-

<sup>13</sup>The small sample of 28 countries may compromise the representativeness of survey results for the developing world. Note, however, that the sample accounted for 62 percent of FDI flows to all developing countries in 1997–2000 (UNCTAD online data base).

<sup>14</sup>The business community may have had incomplete information on unilateral liberalization in the past. Improved information could then contribute to a fading interest of the private sector in a multilateral agreement. On the other hand, the business community may still consider a multilateral agreement to be the best means to lock in previous unilateral liberalization measures, i.e., to render them irreversible.

<sup>15</sup>The remainder of this section draws on Nunnenkamp and Spatz (2003).

<sup>16</sup>Both FDI stocks and flows were considered in dollars per capita of the sample countries' population in the correlation analysis. In this way, we avoid the large-country bias that characterizes the distribution of FDI in absolute terms.

<sup>17</sup>The robustness of results was checked in two respects; see Annex for details.

*Box 3:***Survey Results by the European Round Table of Industrialists on Impediments to FDI Giving Rise to Transaction Costs**

Comparable survey results are available from ERT (2000) for 28 developing countries and the years 1992, 1996, and 1999. We draw on ERT findings for the first and the final year. The checklist of ERT covers 33 items, ranging from restrictions on overall management control and freedom of decision of private investors to crime and civil disturbances in the sample countries. We focus on those impediments that give rise to transaction costs.

We consider the following ERT items and aggregate them into five indices, by averaging survey results on specific items:

1. *administrative bottlenecks*

- inefficient administration and red tape

2. *entry restrictions*

- ownership restrictions: mandatory state or local partnership; limitations related to industrial property and land;
- access to sectors and activities: industries reserved for the state or local enterprises; restrictions related to acquisition of existing enterprises; minimum investment requirements;
- approval procedures: discrimination against private business or FDI; complex procedures; rapidly expiring licenses; red tape

3. *post-entry restrictions*

- management control/freedom of decision: political pressure on management; discretionary state intervention;
- performance requirements: requirements with regard to exports, local content and manufacturing; foreign exchange neutrality; import and local sales licenses depending on export performance;
- foreign exchange transactions: restrictions with regard to profit remittances, import financing, and payment of fees; delays imposed on transfers; additional taxation of remittances;
- exit restrictions: restrictions on repatriation of capital;
- price controls: freezing prices and/or wages;
- marketing and distribution: interference in the structure of sales organizations and product distribution

4. *risk factors*

- inconsistent, unclear and/or erratic regulations;
- risk of nationalization or expropriation;
- shortcomings in legal and regulatory systems;
- political instability;
- environmental risks (e.g., contingent liabilities for previous environmental damage);
- high crime rates;
- civil disturbances and violence
- technology-related regulations
- intellectual property protection: insufficient protection for patents, copyrights, trademarks, etc.; no, insufficient or highly taxed remuneration for brand use, technical assistance, and technology transferred;
- technology targeting: interventions into corporate technology transfers; pressure to dissipate a company's R&D efforts; insistence on local R&D.

Some of the specific items will be considered separately in Section 6 on performance requirements. It should also be noted that the assessment of FDI impediments, especially the weighting done by ERT, may be rather subjective. This drawback, which is common to surveys, has to be accepted in the absence of hard (quantitative) data. Moreover, it is foreign investors who take locational decisions, so that ERT is probably best qualified to assess the restrictiveness of FDI impediments in potential host countries.

*Source:* ERT (2000); Nunnenkamp and Spatz (2003).

Table 2:  
Transaction-Cost-Related Impediments to FDI in 28 Developing Countries<sup>a</sup>, 1992 and 1999

	Administrative bottlenecks		Entry restrictions		Post-entry restrictions		Risk factors		Technology-related regulations	
	1992	1999	1992	1999	1992	1999	1992	1999	1992	1999
Argentina	0.5	0.5	0.7	0	0.6	0.3	0.1	0	1.0	0.5
Bangladesh	2.0	1.5	1.0	0.7	0.7	0.3	0.6	0.4	2.0	1.0
Brazil	1.0	0	1.3	0.7	1.2	0.3	0.7	0.2	2.5	0.5
China	3.0	2.0	3.7	2.7	3.3	2.4	1.6	0.9	2.5	1.3
Colombia	2.0	0	2.5	1.0	0.8	0.8	0.7	0.3	2.0	2.0
Ecuador	1.0	1.5	2.0	0.8	0.7	0.4	0.4	0.1	1.0	0.8
Egypt	2.0	2.0	3.0	1.8	1.1	0.5	0.6	0.1	2.0	1.3
Ghana	2.0	0	3.0	1.0	0.5	0.2	0.4	0.1	1.0	0.3
Guatemala	0	0	0.8	1.0	0.7	0.3	0.1	0.6	1.5	0.8
India	3.0	1.0	2.3	1.3	1.5	0.9	1.4	0.4	2.5	2.3
Indonesia	2.0	0	3.3	1.2	1.5	0.3	1.1	0.4	2.0	0.8
Iran	3.0	1.0	3.8	2.7	2.4	1.8	1.3	0.3	2.5	2.0
Kenya	2.0	1.0	2.3	1.3	1.7	0.2	0.7	0.7	1.5	0.8
Korea, Rep.	1.0	0	3.3	1.2	1.3	0.5	0.6	0.3	2.5	1.3
Malaysia	0	0	2.8	2.0	1.8	1.0	0.4	0	2.5	3.0
Mexico	1.0	1.0	3.0	0.5	1.3	0.2	0.4	0.3	1.0	0.5
Nigeria	3.0	2.5	3.3	1.0	2.2	0.5	1.9	0.8	2.5	1.5
Pakistan	2.0	1.0	1.3	0	1.3	1.3	0.8	0.6	1.5	1.3
Philippines	1.0	2.0	2.2	1.2	1.7	0.8	1.1	0.3	2.5	1.0
Saudi Arabia	0	0	3.2	3.3	0.8	0.7	0.4	0.1	1.8	1.0
Sri Lanka	1.0	1.0	1.7	1.3	1.0	0.3	0	0.6	0	1.0
Syrian Arab. Rep.	3.0	2.0	3.0	1.7	2.8	1.5	1.7	0.9	1.5	0.3
Taiwan	0	0	2.0	1.3	1.3	0.8	0.4	0.1	2.5	1.8
Thailand	0	0	4.0	1.5	1.0	0.6	2.3	0.3	1.5	0.3
Tunisia	1.0	0	0.5	0.5	0.8	0.8	0.6	0.1	2.5	1.0
Turkey	3.0	2.0	2.3	0.8	0.8	0.5	0.4	0.3	2.5	1.5
Vietnam	3.0	1.0	3.8	1.8	2.3	0.9	1.6	0.4	3.0	2.5
Zimbabwe	3.0	2.0	3.0	1.5	1.8	0.3	1.7	1.1	1.5	0.3
Average 28 DCs	1.6	0.9	2.5	1.3	1.4	0.7	0.9	0.4	1.9	1.1

<sup>a</sup>Survey results range from 0 (most liberal) to 6 (most restrictive); see Box 3 for a more detailed description of survey items and aggregation into indices.

Source: ERT (2000).

oping countries was shaped by locational factors other than the transaction costs captured by these three FDI impediments. For instance, per capita FDI stocks in 1999 were highest in Malaysia, among all sample countries, even though this country was rated relatively restrictive with regard to entry conditions and technology-related regulations.

The minor importance of transaction costs, as reflected in the indices on FDI impediments,

was borne out more clearly once we controlled for market-related determinants of FDI in developing countries. In a simple multivariate regression analysis, we examined whether transaction-cost-related impediments provide explanatory power for the distribution of FDI over and above the host countries' population and GDP per capita. We ran a regression of log FDI (flows and stocks, in millions of dollars) on log population, log GDP per capita, and each of the five indices

*Table 3:*  
Transaction-Cost-Related FDI Impediments and Inward FDI: Correlation and Regression Results

FDI impediments <sup>a</sup>	Bivariate correlations <sup>b</sup>		Partial correlation coefficients <sup>c</sup>	
	FDI stocks in 1999	FDI flows in 1997–2000	FDI stocks in 1999	FDI flows in 1997–2000
Administrative bottlenecks	–0.53***	–0.39**	–0.23	–0.17
Entry restrictions	–0.09	–0.01	–0.10	–0.17
Post-entry restrictions	–0.01	0.04	–0.11	–0.18
Risk factors	–0.62***	–0.54***	–0.24	–0.03
Technology-related regulations	–0.01	0.02	0.07	–0.12

\*, \*\*, \*\*\* significant at the 10 percent, 5 percent and 1 percent level, respectively (two-tailed).

<sup>a</sup>As of 1999 for correlations with FDI stocks; as of 1996 for correlations with FDI flows. – <sup>b</sup>Spearman rank correlation coefficients; inward FDI in dollar per capita of the sample countries' population. – <sup>c</sup>See text for underlying regression and calculation procedure; inward FDI in millions of dollars.

*Source:* Nunnenkamp and Spatz (2003).

on FDI impediments.<sup>18</sup> The two market-related determinants of FDI turned out to be highly significant in all regressions.<sup>19</sup> The t-values of these regressions were then used to calculate the partial correlation coefficients of each index on transaction-cost-related FDI impediments with both, FDI stocks and FDI flows. All partial correlation coefficients were insignificant (see the third and fourth column of Table 3). This implies that even the role of administrative bottlenecks and risk factors in explaining the distribution of FDI among developing countries is small at best if market-related variables are controlled for.

Our findings underscore the view of Hoekman and Saggi (2000: 642–643) and Singh (2001), who consider transaction costs to be a weak argument for a multilateral agreement on investment. Furthermore, as argued before, it is far from clear that transaction costs would be substantially lower than under current conditions in the counterfactual situation of a multilateral investment agreement. Of course, it cannot be

ruled out that FDI in developing countries would have been still higher if multilateral rules had existed. Yet it should be noted that the boom of FDI in developing countries occurred without a multilateral investment agreement (Singh 2001), and some countries, notably China and Malaysia, attracted enormous amounts of FDI despite their relatively restrictive investment regimes.

#### 5.4 Developing Countries' Demands for Flexible Rules and Corporate Obligations

According to Singh (2001), the attractiveness to FDI of countries such as China and Malaysia also proves the case for flexible investment rules, which would allow for selectivity of developing host countries in targeting and regulating inward FDI. A strict application of WTO principles such as national treatment and MFN to FDI is deemed harmful by this author to economic development in the Third World. It is for several reasons that developing countries are urged to monitor and regulate the amount, structure, and timing of FDI: (i) to avoid financial fragility, (ii) to prevent crowding-out of domestic investment,

<sup>18</sup>It is for two reasons that we ran separate regressions for each index with the same controlling variables. First, the indices on FDI impediments revealed a fairly high degree of multicollinearity. Second, we retained more degrees of freedom in this way.

<sup>19</sup>These results are not shown here in order to save space.

and (iii) to promote economic development by technology transfers and economic spillovers.

Likewise, the request for a balanced multilateral agreement to include corporate obligations is meant to improve the developmental impact of FDI in the Third World. Corporate obligations are considered a vital element of a multilateral agreement, as MNEs “often only aimed at maximizing their own profits” (DSE Forum 2002: 39). The profit motive of MNEs may conflict with development needs of the host countries of FDI and, thus, provides a rationale for restrictive FDI policies if market failure is prevalent: “Since multinational firms typically arise in oligopolistic industries, the presence of imperfect competition in the host country is an obvious candidate” (Hoekman and Saggi 2000: 632).

The wish list of multilateral rules on corporate behavior includes the following (for details, see CUTS 2001; 2002):

- observance of human rights, labor rights, and environmental protection (“Global Compact”);
- corporate disclosure and accountability;
- respect for national laws;
- social responsibility, e.g., with regard to illicit payments and product safety;
- transparency in transfer pricing;
- precautions against restrictive, abusive, and unfair business practices (e.g., market segmentation, discriminatory pricing, collusion, exclusive dealing);
- promotion of technological dissemination, local entrepreneurship, and local workers.

Even though it was for good reasons that developing countries have resisted linking trade with labor and environmental standards and human rights, they would now like to have binding rules on corporate behavior in these respects. Previously established guidelines and codes of conduct are dismissed as insufficient. Similar to restricting incentive-based competition for FDI (see Section 7 below), however, the real challenge is enforceability. The criticism leveled against nonbinding guidelines, that they have little impact on corporate behavior, may apply to

binding rules, too, unless they can be enforced effectively.

In essence, developing countries demand more flexible rules with regard to their own behavior and more binding rules with regard to corporate behavior in order to improve the developmental impact of FDI. Developing countries may be tempted to dismiss the opposition of industrialized countries and MNEs against these demands by pointing to the selfishness of opponents in the political bargaining process. Yet, developing countries should take into account that their demands also give rise to some economic questions. In the subsequent paragraphs, we address possible trade-offs and opportunity costs, and discuss the effectiveness of “development clauses” in a multilateral investment agreement.

Possible trade-offs are twofold. First, the required flexibility of rules on FDI policies by host countries comes at the cost of transparency and predictability. According to Sauvart (2000: 10), a balance has to be achieved: “On the one hand, it is unavoidable that any international agreement—almost by definition—establishes certain obligations that reduce the freedom of action for any signatory and that, on the other hand, the distinct and specific needs of any particular country to promote its own development objectives in light of its own situation need to be taken into account.” In striking this balance, negotiators should be aware that the transaction-cost argument, discussed in the previous section, might become irrelevant altogether if rules were to become rather flexible. Put differently, reductions in transaction costs will be less, the more flexible rules become.

Second, while corporate obligations can only have an impact on the quality of inward FDI if they are binding and enforceable,<sup>20</sup> strict obligations may reduce the quantity of inward FDI. Foreign investors are always free not to invest if profit opportunities are considered poor in the light of obligations to be fulfilled. This might not be a problem for recipient countries if only “development-unfriendly” FDI projects were

---

<sup>20</sup>For an evaluation of mandatory technology transfers and other performance requirements, see Section 6.



discouraged in this way. It cannot be ruled out, however, that foreign investors would generally become more reluctant. Almost by definition, the profits of MNEs and, thus, their incentive to undertake FDI will decline to the extent that developing countries succeed in shifting rents from MNEs to host countries by imposing binding obligations on the former.

Likewise, the effectiveness of flexible rules and “development clauses” cannot be taken for granted. The special treatment developing countries were granted in trade is a clear reminder in this regard.<sup>21</sup> Trade preferences traditionally rule the way many developing countries perceive the GATT/WTO, even though they “did little for the poor countries” (Bhagwati 2002: 27).<sup>22</sup> The economic results from special treatment in trade have been “disenchanted” (Langhammer 1999: 21) according to several studies. Well-intended as they were, trade preferences did the poorest WTO members no good in promoting their world-market integration. Rather, the special treatment appears to have discouraged African countries, for example, from actively participating in trade negotiations by committing themselves to binding trade liberalization (*ibid.*). As a result, African markets are still most heavily protected. Another consequence was that developing countries insisting on preferential treatment were not relevant negotiation partners for industrialized countries in various trade rounds: “The rich countries, denied reciprocal concessions from the poor countries, wound up concentrating on liberalising trade in products of interest largely to themselves” (Bhagwati 2002: 26). The implication for multilateral negotiations on investment is fairly obvious: it is rather unlikely that developing countries can achieve much, e.g., with regard to binding corporate obligations if they are not prepared to constrain flexibility on their own part.

<sup>21</sup>Special treatment of developing countries was codified in GATT through the so-called Part IV Extension in 1965 and the Enabling Clause on “Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries” in 1979.

<sup>22</sup>See also Langhammer (1999) and the literature given there.

Besides *quid pro quo* considerations in the political bargaining process, it should be taken into account that market failure provides a necessary, but not a sufficient condition for flexible rules to be effective in promoting development-friendly FDI in developing countries. Hoekman and Saggi (2000: 636), though acknowledging the relevance of market failure, emphasize that “in practice it is rather difficult to design strategic [FDI] policies that are effective. The informational requirements for formulating a successful policy are substantial and such policies invite lobbying and other socially-wasteful activities. ... The best rule of thumb for policymakers is to refrain from pursuing strategic policies.”

The general skepticism of these authors about whether flexibility and selectivity will help promote development-friendly FDI may be specified in several respects.<sup>23</sup> For instance, developing countries in Asia (e.g., Korea and Taiwan) chose to restrict FDI and instead to rely on domestic investors in technologically advanced industries, in order to strengthen local technological capabilities. According to UNCTAD (1999a: 173), selective FDI policies paid off in some of these countries; “in many cases, however, the emergence of successful domestic producers in a new, technologically-advanced industry is unlikely or might take a long time with uncertain results. An example of a costly intervention in favour of domestic firms in high-technology industries is the Brazilian informatics policy of the early 1980s, which involved restrictions on FDI.”

In other words, it cannot be simply assumed, as in Singh (2001), that some success stories of flexible and selective FDI policies could be easily copied by all developing countries. Poor developing countries in particular, may lack administrative capabilities to effectively screen FDI and channel foreign investors into activities which foster national economic development. Government failure may then hamper economic development even more seriously than market failure.

<sup>23</sup>See also Section 6 on performance requirements.

Finally, in the course of time, selective FDI policies may turn out to be less successful than first-round effects suggest. The empirical results of Agosin and Mayer (2000) on FDI-induced crowding-out and crowding-in of domestic investment provide an example. According to Singh (2001), the findings of these authors strengthen the case for selective FDI policies, as crowding-in was observed in Asian countries with less liberal FDI policies, whereas crowding-out prevailed in more liberal Latin American countries. This misses a point made in a recent

OECD study: “Crowding out of domestic investment through FDI may not necessarily be a problem, and can even be a healthy sign” (OECD 2002: 64). The host economy may benefit if local enterprises lacking competitiveness are replaced by foreign firms, provided that released domestic resources are used for more productive purposes. With hindsight, it might have been not so bad after all if Asian governments had allowed MNEs to outcompete local firms; this might have helped prevent overinvestment in unproductive activities.

## 6 Performance Requirements: Making a Fuss about a Minor Problem?

Conflicts of interest between developing and developed countries appear to be particularly pronounced with regard to performance requirements. Developed countries are widely expected to intensify pressure on developing countries to abolish performance requirements when it comes to multilateral negotiations on investment. On the other hand, the resistance of developing countries to enter into multilateral negotiations under the WTO umbrella is largely because they regard performance requirements as an essential means to improve the “quality” of FDI inflows.

This controversy suggests that performance requirements are widely used and considered a major bottleneck to FDI by multinational enterprises. All the more surprisingly, the OECD (2002: 185) notes: “Little concrete evidence is available to shed light on the pervasiveness of performance requirements.” Under the TRIMS agreement, which prohibits certain types of performance requirements (e.g., export restrictions, trade-balancing requirements, and local content obligations), only 26 countries had notified performance requirements that did not conform with this agreement, and many of these requirements have since been repealed (OECD 2002). On the other hand, notifications may seriously underreport the actual use of TRIMs, which is now one of the implementation issues in the Doha agenda.<sup>24</sup>

Survey data on investment conditions in 28 developing countries, presented in ERT (2000), indicate that both the proponents and the opponents of performance requirements miss an important point: The implicit assumption made on both sides of the debate, namely that performance requirements are highly relevant, seems to be in conflict with the available evidence.

The ERT survey covers various aspects of investment conditions in the 28 sample countries (see also Section 5.3). The following three items, included in the checklist, are of particular interest in the present context:<sup>25</sup>

- performance requirements related to exports, local content, manufacturing, and foreign exchange neutrality (including requirements that are not codified);
- requirements related to employment conditions (discrimination of foreign investors against comparable local employers) and work permits for international staff;
- technology targeting, i.e., interventions into the corporate transfer of technology and insistence on R&D efforts in the host country and R&D dissipation.

For each of these items, ERT (2000) lists country-wise impediments to FDI on a scale ran-

<sup>24</sup>We owe this point to Alan Winters.

<sup>25</sup>Note that performance requirements related to exports etc. constituted one element of post-entry restrictions considered in Section 5.3; technology targeting constituted one element of technology-related regulations (see Box 3 for details).

ging from 0 (most liberal) to 6 (most restrictive). Table 4, which presents the results for 1992 and 1999, i.e., the first and the final year for which comparable surveys are available, reveals some interesting insights. Even in the early 1990s, the restrictiveness of performance requirements was considered rather low for the average of all sample countries; the average score was below 2 in 1992 already. Moreover, the average score declined significantly during the 1990s, indicating a relaxation of performance requirements in all three dimensions. Performance requirements became less restrictive in almost all sample countries.<sup>26</sup> Specific exceptions are employment requirements in Nigeria and Zimbabwe, and technology targeting in China.

More surprisingly perhaps, a (Spearman rank) correlation analysis does not support the proposition that more restrictive performance requirements tend to discourage FDI in a significant way. This proposition, which seems to underlie the negotiating stance of developed countries in the WTO, would require a significantly negative correlation between host countries' performance requirements, as given in Table 4, and inward FDI stocks per capita of the host countries' population.<sup>27</sup>

However, the correlation coefficients shown in Table 5 are statistically insignificant; for technology targeting, the coefficients even reveal a positive correlation with FDI stocks.<sup>28</sup> Although the evidence is admittedly weak, the most heavily disputed performance requirements related to exports, local content, manufacturing production, and foreign exchange neutrality may even have become less relevant as a hindrance to FDI during the 1990s.

These findings seem to strengthen the case of developing countries attempting to improve the

"quality" of FDI inflows by insisting on performance requirements. As it seems, the costs of doing so, in terms of a lower quantity of inward FDI, are marginal at most. Before drawing such a conclusion, however, two issues have to be taken into account. First, it is open to debate if (and what) performance requirements actually help improve the "quality" of FDI. Second, there may be other costs involved, notably special incentives granted to foreign investors, which compensate for restrictive performance requirements and, therefore, prevent FDI from falling. These issues are discussed in the remainder of this section.

Performance requirements are designed by host countries to enhance the benefits and minimize the costs of FDI (OECD 2002: 185). For example, local content requirements are regarded as an important means to strengthen economic links between foreign and local producers and, thereby, create local employment opportunities as well as technological spillovers (Kumar 2001). Requirements related to local content, exports, and foreign exchange neutrality are intended to reduce the risk that FDI leads to a deterioration of the current account. And mandatory technology transfers may help promote the development of an indigenous industry that is competitive internationally.

Some proponents of performance requirements tend to take it for granted that reasonable development objectives will be achieved in this way (e.g., Kumar 2001; Singh 2001). The detailed account by Moran (1998) of host-country policies for shaping foreign investor activities portrays a differentiated picture. In a summary paper, this author draws the following conclusions (Moran 1999): Export performance requirements have encouraged the integration of foreign affiliates into the global operations of their parent companies and have, thus, helped economic development of host countries. By contrast, FDI is found harmful to the growth and welfare of developing host countries when foreign investors are sheltered from competition in the host-country market and burdened with high domestic content, mandatory joint venture, and technology-sharing requirements.

<sup>26</sup>The score improved (i.e., declined) in 43 out of 84 entries in Table 4; it remained constant in 38 cases.

<sup>27</sup>FDI stocks were considered in per capita terms, in order to control for country size; further details can be found in Nunnenkamp and Spatz (2003).

<sup>28</sup>This unexpected result is mainly because Malaysia reported the highest inward FDI stock per capita in 1999 (\$2,234) among all sample countries, even though it was rated most unfavorably in Table 4 with regard to technology targeting in 1999.

Table 4:  
FDI Impediments Related to Performance Requirements in 28 Developing Countries<sup>a</sup>, 1992 and 1999

	Export, local content, and manufacturing requirements		Employment requirements		Technology targeting	
	1992	1999	1992	1999	1992	1999
Argentina	1	0.5	0.5	0.5	0	0
Bangladesh	1	0	3	3	1	0.5
Brazil	0.5	0	1	1	2	0
China	4	3.5	2.5	2	0	0.5
Colombia	1	1	1	0.5	1	1
Ecuador	1	1	0	0	0	0
Egypt, Arab Rep.	2	1	3	2	0	0
Ghana	1	0	2	1.5	1	0
Guatemala	1	0	2	1	0	0
India	1.5	1	3	2	0	0
Indonesia	3	0	2	1	0	0
Iran, Islamic Rep.	3	3	3	1	0	0
Kenya	2	0	0	0	0	0
Korea, Rep.	0	0	1	0	2	0
Malaysia	3	2.5	2	2	2	2
Mexico	2	0	2	1	0	0
Nigeria	3	0.5	2	2.5	0	0
Pakistan	3	3	2	0	0	0
Philippines	2	1	2	0	2	0
Saudi Arabia	0	0	2	1	0	0
Sri Lanka	2	1	0	0	0	0
Syrian Arab Rep.	2	2	3	2	3	0
Taiwan	1	1	1	0	1	1
Thailand	2	1	2	0	0	0
Tunisia	0	0	3	1.5	3	0
Turkey	0	0	1	0	0	0
Vietnam	0	0	2	1.5	1	1
Zimbabwe	3	0	0	1	0	0
Average 28 DCs	1.6	0.8	1.7	1.0	0.7	0.2
Coefficient of variation <sup>b</sup>	0.7	1.2	0.6	0.9	1.4	2.2

<sup>a</sup>Survey results range from 0 (most liberal) to 6 (most restrictive); see text for a more detailed description of survey items.

– <sup>b</sup>Standard deviation divided by mean.

Source: ERT (2000).

*Table 5:*  
Performance Requirements<sup>a</sup> and Inward FDI Stocks<sup>b</sup>: Spearman Rank Correlation Results across 28 Developing Countries, 1992 and 1999

	Export, local content, and manufacturing requirements	Employment requirements	Technology targeting
		<b>1992</b>	
FDI stocks, 1992	-0.23	-0.12	0.12
		<b>1999</b>	
FDI stocks, 1999	-0.10	-0.15	0.18

<sup>a</sup>According to Table 4. – <sup>b</sup>Dollar per capita of the host countries' population.

*Source:* Own calculations based on Table 4 and UNCTAD online data base.

Likewise, a recent OECD study provides little comfort to those supposing that performance requirements are generally in the interest of developing countries (OECD 2002: 185–192). The relevant literature, summarized in this study, suggests that the development impact of performance requirements varies across countries, sectors, and motives for FDI. Similar to Moran (1998), the case for export requirements is considered stronger than the case for local content requirements. The former can play a crucial role in pushing multinational enterprises to integrate their affiliates in developing countries more closely into corporate sourcing networks,<sup>29</sup> and may counteract the “high incidence of restrictive clauses imposed by MNEs on [the export activities of] their local affiliates” (Kumar 2001: 3153, with regard to India). By contrast, local content requirements tend to protect inefficient local producers. Foreign investors who are forced to use inputs that are not up to world-market standards suffer cost increases and impaired international competitiveness. As a consequence, local content requirements may backfire on export objectives. The OECD (2002: 192) concludes that the record for performance requirements in achieving development objectives is “less than encouraging.” In an earlier survey on the diffusion of technological know-how of foreign investors, Blomström and Kokko (1997) found that local competence and a competitive environment tend to be more important than

technology transfer requirements for achieving productivity benefits from FDI.

As concerns the economic costs of performance requirements, incentives granted to foreign investors by host country governments have to be taken into account. If multinational enterprises undertake FDI in spite of performance requirements, this may be because they perceive such requirements as a quid pro quo for compensatory advantages offered by the host country (OECD 2002: 187).<sup>30</sup> Compensatory incentives may have prevented adverse consequences of performance requirements on the quantity of inward FDI, but tend to involve economic costs in terms of allocative distortions and/or budgetary strains. Allocative distortions are likely if foreign investors are granted privileged access to protected host-country markets and local resources (e.g., raw materials). For example, FDI in various Latin American countries was traditionally concentrated in sophisticated manufacturing industries in which host countries lacked comparative advantage (Nunnenkamp 1997). Import protection supported high rates of return so that the efficiency and international competitiveness of market-seeking FDI was not a major concern of foreign investors (UNCTAD 1998a: 253).

More apparent costs arise when fiscal and financial incentives are granted to foreign investors as a quid pro quo for performance requirements. FDI in the automobile industry of various coun-

<sup>29</sup>This remains unlikely, however if the host country pursues trade policies giving rise to a strong anti-export bias.

<sup>30</sup>According to Hoekman and Saggi (2000: 630), “the schizophrenic nature of the overall policy environment” is reflected in that FDI incentives are granted in conjunction with performance requirements.

tries provides a case in point. As noted in OECD (2002: 186–187), local content requirements are widely used in this industry. At the same time, host-country governments incurred huge fiscal or financial costs to attract FDI in the automobile industry. Oman (2001: 69) presents data, gathered from unofficial sources, according to which “the direct cost of financial and fiscal subsidies paid by governments (predominantly subnational governments) to attract FDI in major automobile factories rose substantially over the course of the 1980s and 1990s, and amounted to hundreds of thousands of dollars per job-to-be-created in countries as diverse as Brazil, Germany, India, Portugal and the United States.”

In conclusion, the issue of performance requirements must not be considered in isolation.

Performance requirements are not to be recommended, unless they help achieve development objectives and the direct and indirect costs involved do not exceed the benefits. Incentive-based competition for FDI, an issue to which we turn next, may be particularly perilous for developing countries lacking the financial means to compete successfully with developed countries. All this underlies the suggestion, e.g., by Moran (1999), that developing countries might offer to refrain from imposing performance requirements in exchange for a commitment of developed countries to refrain from engaging in incentive-based competition for FDI. See Section 8 for a discussion of strategic options of developing countries.

## 7 Incentive-Based Competition for FDI

Comprehensive statistics on the use and significance of FDI incentives do not exist. That is why the World Bank (2003: 118) considers it of high priority for international collaboration to systematically compile information on FDI incentives. For obvious reasons, however, neither the governments that offer incentives nor the investors who receive them are willing to disclose the amount of incentives (Oman 2001). Most of the relevant literature on FDI incentives refers to the limited evidence presented by UNCTAD (e.g., Moran 1998; Kumar 2001; Kokko 2002). This evidence allows the following conclusions:

- Major FDI projects involved subsidies amounting to hundreds of thousands of dollars per job-to-be created.
- Both developed and developing countries engaged in incentive-based competition; “bidding wars” frequently involved local and provincial authorities.
- Incentive-based competition has increased considerably since the mid-1980s. More than 100 countries provided various FDI incentives in the mid-1990s. In recent years, few countries appear to have competed for FDI without any form of subsidies.

- Financial incentives are common in developed countries, while incentive schemes in developing countries are often based on tax holidays and other fiscal measures that do not require direct payments of scarce public funds.
- FDI incentives appear to be concentrated in some technologically advanced industries such as automobiles, petrochemicals, and electronics.
- Incentive packages are offered particularly for large, “high-visibility” projects.

The economic justification of FDI incentives depends on whether they are (i) effective in increasing the amount of FDI inflows and (ii) efficient in that the costs of providing incentives do not exceed the benefits to the host country.<sup>31</sup> The effectiveness of FDI incentives has been considered highly questionable by most economists in the past (Oman 2001; Nunnenkamp 2001a). However, Kokko (2002) argues that globalization has made incentives a more important determinant of international investment decisions, and refers to recent surveys and econometric studies supporting this view.

---

<sup>31</sup>The subsequent discussion draws on Kokko (2002) and the literature given there.

The strongest efficiency argument in favor of FDI incentives is based on prospects for economic spillovers. Foreign firms often have superior technology and knowledge. Local firms may benefit from productivity-enhancing externalities or spillovers, e.g., through forward or backward linkages with foreign firms. Such spillovers do not enter the private cost-benefit calculus of foreign firms. Hence, FDI tends to be less than is optimal from the host-country perspective. FDI incentives can bridge the gap between private and social returns. It follows that the efficiency of FDI incentives depends on the significance of spillovers.

The empirical evidence on spillovers is mixed. Kokko (2002: 5) summarizes as follows: "There is strong evidence pointing to the potential for significant spillover benefits from FDI, but also ample evidence indicating that spillovers do not occur automatically." Hence, the efficiency of FDI incentives is not obvious, and systematic differences between countries are to be expected. Hoekman and Saggi (2000: 638) conclude that "the elusive nature of spillovers makes it difficult to justify the use of investment incentives on the scale they are being used today."

From a developing country perspective, two qualifications with regard to the efficiency of FDI incentives deserve particular attention when defining their negotiation stance on multilateral investment rules. First, the economic justification of FDI incentives may be relatively weak in developed countries characterized by a well-advanced indigenous technology and knowledge base. Under such host-country conditions, it is rather unlikely that huge subsidies granted by various developed countries will be matched by similarly large spillovers. Second, the potential for FDI-induced catching-up processes should, in principle, be inversely related to the per capita income of host countries. Yet it would be wrong to conclude that the efficiency of FDI incentives is highest in low-income countries. The available evidence, rather, suggests that productivity-enhancing spillovers materialize only if the host country has reached a threshold of sufficient local capabilities to absorb superior technologies

and knowledge of foreign investors.<sup>32</sup> This implies that FDI incentives amount to a waste of scarce public resources in many poor developing countries.

Especially where FDI incentives are difficult to justify economically, the pervasiveness of incentives is probably largely due to political considerations. FDI incentives are politically attractive: Host-country governments can point to visible results of their promotional efforts when an FDI project is attracted by granting incentives, whereas the costs of incentives are typically widely spread and hardly visible. There is, thus, a built-in bias towards offering overly generous incentives. In other words, politically motivated competition for FDI tends to raise incentive levels and shifts benefits from host countries to foreign investors (Haaland and Wooton 1999). It is precisely the lack of transparency which renders incentive-based competition for FDI problematic. Secrecy creates "significant possibilities for graft, corruption and many other types of rent-seeking behaviour" (Oman 2001: 79).

The "race to the top" in offering FDI incentives is difficult to stop, even though the economic case for not taking part in incentive-based competition may be strong. Politically, it may not be feasible to withdraw incentives unilaterally. Even if economic fundamentals of host countries remain a more important pull factor for FDI inflows, incentives can make a difference in an investor's final locational choice between short-listed countries with similarly favorable fundamentals (Oman 2001: 68). Host-country authorities, including subnational governments, find themselves in a prisoner's dilemma when multinational enterprises start playing the authorities off against one another to bid up the value of incentives. Incentives offered by one particular country may have negative external effects on another country, in terms of either countervailing incentives or forgone FDI inflows.

---

<sup>32</sup>For an overview of the relevant literature in this regard, see Nunnenkamp (2002).

*Box 4:*

## Limiting Incentive-Based Competition for FDI: The Example of the EU

Since the creation of the European Economic Community in 1957, the European Commission has been empowered to limit the ability of member countries to offer subsidies to firms and investors. The underlying reason was that uncontrolled subsidies could undermine the objective of the Treaty of Rome to achieve a common market and a convergence in living standards across member countries. As a result, a system of “bounded competition” has emerged, in which subsidies are confined by the European Commission to geographically defined lower-income regions (“development areas”). The system may be far from perfect, but it offers:

- a functional regulatory framework,
- an autonomous supervisory body,
- procedures for enforcement, and
- sanctions backed by provisions for judicial review.

The EU model may not be easily copied by other countries, or a larger group of less integrated countries. Nevertheless, it seems worthwhile to study its features in more detail, in order to tackle the prisoner’s dilemma in multilateral negotiations.

*Source:* Oman (2001: 66).

Policy coordination seems key to escaping this dilemma. The scarcity of serious attempts to overcome coordination problems and limit competition for FDI is all the more surprising. As noted by Oman (2001), there is one major exception, namely the European Union, which offers some lessons on how to limit incentive-based competition (Box 4). Developing countries may find the EU approach fairly attractive, as “development areas” are granted preferential treatment. If this principle were applied in multilateral negotiations on incentive-based competition for FDI, developing countries would have more leeway than developed countries to attract FDI by offering incentives.

However, a multilateral agreement that seeks to discipline incentives designed to attract FDI “will be difficult to achieve and difficult to enforce, given that governments have multiple instruments at their disposal to attract FDI or to retain investment” (Hoekman and Saggi 2000: 640). The hope of developing countries for an agreement that effectively restrains industrialized countries in providing subsidies to foreign investors may prove illusory. The failure of the MAI among OECD countries is quite telling in this regard (see Section 4).

Furthermore, it is open to question whether developing countries could attract substantially more FDI, without putting too much strain on

their financial resources if only developed countries were restrained in subsidizing FDI. For most FDI projects, developing countries compete with each other, rather than with highly developed countries. Oman (2001: 65) observes that “much of the competition for FDI is effectively among governments in the same geographic region, i.e. among relative neighbours.” Hence, preferential treatment of developing countries with regard to FDI incentives would hardly be instrumental to strengthening the bargaining position of developing host countries in resisting the demand for incentives by multinational enterprises.

Its political attractiveness notwithstanding, preferential treatment along the lines of the EU system would solve only the minor part of the problem. From an economic perspective, developing countries would be well advised to go beyond requests directed at developed countries to reduce their FDI incentives and, thereby, offer developing countries better chances in incentive-based competition. Self-restraint appears to be indispensable, in order to strengthen the bargaining position of developing countries vis-à-vis multinational enterprises. A unilateral withdrawal of incentives is rendered difficult by the prisoner’s dilemma. Unless this dilemma is tackled effectively by a binding multilateral framework, policy coordination at the regional level could be helpful in preventing an incentive race to the top.



## 8 Conclusions and Strategic Options

Several arguments suggest that multilateral negotiations on an investment agreement should not figure high on the WTO agenda. Investment rules do already exist in BITs, RTAs or even at the multilateral level in TRIMS and GATS. Existing rules may be far from perfect, but it is difficult to conceive that a clearly superior set of rules could be agreed upon under the roof of a WTO agreement on investment.

The most likely outcome of multilateral negotiations on investment will be a “WTO-plus” framework. Any WTO member could move beyond the multilaterally defined smallest common denominator, by concluding more far-reaching agreements either bilaterally or plurilaterally with regional partners. This has an important implication for one of the widely perceived strong points of a multilateral agreement, the reduction of transaction costs. Whatever the relevance of FDI-related transaction costs might be under current conditions (the available evidence suggests that they are frequently overstated), the complexity of different investment rules and regulations would persist, unless BITs and investment rules in RTAs were replaced by a multilateral agreement. This cannot reasonably be expected from the Doha Round, which may at most mark the starting point of WTO negotiations on investment. Our reasoning is supported by the World Bank (2003: 127–128), which notes that the Doha Ministerial Declaration reflects a rather limited approach that does not view a multilateral framework as a substitute for BITs and RTAs. It is also mentioned in this context that recent negotiating briefs in the WTO indicate that some countries have withdrawn support for investor-state dispute settlement, which would lessen investor protection compared to various bi- and plurilateral agreements. The transaction-cost argument would become close to irrelevant if developing countries succeeded in preventing strict and generally enforceable rules and insisted on flexibility and “development clauses.”

This is not to ignore that Doha could initiate a long-term process towards more substantive and

binding multilateral investment rules. Even so, the experience with trade rules suggests that the potential of reductions in transaction costs is easily overstated. Substantial trade liberalization at the multilateral level has not prevented the “spaghetti bowl” of bilateral and plurilateral trade preferences. It is, thus, hardly compelling to argue that, in the course of time, progress with respect to multilateral investment rules will render more and more BITs and RTAs redundant.

The chances to effectively constrain incentive-based competition for FDI do not appear promising either. Even though some economists have questioned the public good character of a multilateral agreement to stop “bidding wars” (e.g., Langhammer 1999; Kumar 2001), policy coordination seems key to escaping the prisoner’s dilemma. It would be an important first step to develop an inventory of the extent and costs of FDI incentives granted by all WTO members (World Bank 2003). However, due to strong opposition, especially from subnational authorities, the critical issue of incentive-based competition for FDI had been removed from the agenda of OECD countries even before the attempt to agree on the MAI among themselves failed completely. It seems highly unlikely that developing countries unwilling to tie their own hands can achieve binding concessions from industrialized countries to cut FDI subsidies. Apart from quid pro quo considerations, the practical consequences of a multilateral agreement would remain limited at best, unless negotiations “enter deeply into the taxation regulations of host countries” (Langhammer 1999: 352) and developing countries were prepared to constrain incentive-based competition between themselves.

Furthermore, our analysis underscores the skeptical view expressed in World Bank (2003: 118) that “new international agreements that focus on establishing protections to investors cannot be predicted to expand markedly the flow of investment to new signatory countries.” There are several reasons why the effects of a multilat-

eral agreement on FDI flows to developing countries are likely to fall short of high expectations:

- The absence of such an agreement has not prevented the recent boom of FDI in developing countries.
- Likewise, substantial unilateral liberalization of FDI regulations was undertaken in the past even though multilateral obligations to do so did not exist.
- The coverage of protections provided for investors in various BITs (and RTAs) goes beyond what can be expected from the Doha Round. Nevertheless, BITs do not appear to have had a significant impact on FDI flows to signatory countries.
- As shown elsewhere, it is also questionable whether RTAs such as NAFTA as well as MERCOSUR had a strong and lasting effect on FDI flows to developing member countries (Nunnenkamp 2001b).

It is against this backdrop that developing countries have to decide on their negotiation strategy when it comes to investment-related issues in the current WTO round. Harsh critics of a multilateral agreement on investment, e.g., Kumar (2001) and Singh (2001), urge developing countries to take a firmly defensive stance. Accordingly, resisting the efforts of industrialized countries to go beyond TRIMS is considered the first-best option for developing countries. As a fall-back position, Kumar (2001) suggests minimizing developing countries' own commitments (e.g., by excluding pre-entry rules, and by insisting on development clauses and exceptions from national treatment even in the post-entry phase) and, at the same time, sticking to demands for binding corporate obligations and restraints on FDI subsidies granted by industrialized countries.

The rationale underlying this defensive strategy appears to be that essentially nothing will change if a large enough number of developing countries follows this route. Developing countries and industrialized countries would block each other. To the extent possible under current conditions, the former could still pursue flexible FDI policies deemed necessary to promote eco-

nomic development. The latter could take this as an "excuse" for not offering concessions to developing countries.

Whether a defensive stance is the appropriate strategy for developing countries depends on two factors: (i) the costs of giving up flexible FDI policies, and (ii) the benefits to be derived from possible concessions by industrialized countries. As concerns the former, the proponents of a defensive strategy tend to ignore that the record of governments in developing countries as regards promoting economic development by pursuing flexible and selective FDI policies is mixed at best (see Sections 5 and 6). Moreover, as argued by Hoekman and Saggi (2000: 637), "if a country pursues free trade, a restrictive FDI policy will not transfer any rents as foreign firms will not engage in FDI. Instead, they will contest the market through exports." Hence, the costs of giving up discretion are frequently overstated.

This leads us to suggest an offensive strategy, even though we consider the economic case for a multilateral investment agreement to be weak. Developing countries may offer in multilateral negotiations not to impose any new performance requirements and phase out existing ones. The available evidence on the effectiveness of performance requirements (see Section 6) reveals that developing countries have little to lose if they offered to refrain from imposing joint-venture and technology-sharing requirements, which are not included in the illustrative list of the TRIMS agreement. The WTO may be used as a scapegoat for such a move and may, thus, help overcome the opposition of rent-seeking constituencies within developing countries. By offering something on their own, developing countries will become more relevant negotiation partners for industrialized countries. Only then could developing countries reasonably expect industrialized countries to make concessions as a *quid pro quo*. Concessions by industrialized countries may comprise the relaxation of rules of origin applied by the EU and NAFTA, which create similar distortions as local-content requirements of developing countries; the inclusion of corporate obligations into a multilateral

agreement; and restraints on the use of FDI incentives.

The proposal for developing countries to enter into a “grand bargain” (Moran 1998; 1999) with industrialized countries has been criticized by Hoekman and Saggi (2003) for two reasons:

- Given the limited use of existing agreements (notably TRIMS), these authors question the marginal value of yet another multilateral agreement. However, TRIMS is widely considered to be biased against the interests of developing countries. Hence, it may be politically more attractive to developing countries to strive for a more balanced agreement by making a fresh start in negotiating on investment.
- Devising a grand bargain may prove a two-edged sword for developing countries. The potential downside can be seen in cross-issue linkage in areas such as labor standards and the environment, pushed by industrialized countries and civil-society organizations. Yet, Hoekman and Saggi (2000) agree that the grand-bargain argument is one of the *raison d'être* of the WTO. Hence, the question for developing countries is not whether to offer anything, but what to offer and what to demand as a *quid pro quo*.

The offensive strategy outlined so far is rather narrowly defined, as cross-issue linkages are confined to FDI-related policies. Developing countries may be well advised to look beyond negotiations on investment, especially when it comes to concessions demanded from industrialized countries. Concessions from industrialized countries would be easier to achieve if developing countries made additional offers related to trade under existing agreements, i.e., GATT and GATS (Hoekman and Saggi 2000). Yet, rule-based FDI policies are an important negotiating chip for developing countries. Far-reaching offers related to FDI policies would render it increasingly difficult for industrialized countries to block negotiations in other areas that are of vital interest to developing countries.

Linking national treatment of foreign investors in the pre-entry stage with cross-border movements of workers is an obvious case in

point. At present, the request of industrialized countries for an agreement on investment is frequently rejected as it would result in an asymmetry, unless free capital movement is matched by free labor mobility (e.g., Kumar 2001; Panagariya 2000, quoted in Kumar). However, developing countries should consider the option to transform this defensive stance into an offensive strategy by presenting national treatment in the pre-entry stage as a carrot for industrialized countries to engage in negotiations on labor mobility. Economically speaking, the arguments for labor mobility are no weaker than those for capital mobility (Hoekman and Saggi 2000). The political resistance on the part of industrialized countries to treat labor and capital symmetrically may weaken in the longer run at least when demographic problems mount in various industrialized countries.

Finally, it is for political-economy reasons that we prefer a broadly defined offensive strategy of developing countries over the currently prevailing defensive stance. As argued in Section 5.1, the cost-benefit calculus with respect to a multilateral investment agreement differs across developing countries, e.g., depending on what FDI has to offer under different host-country conditions. This implies that a united front of developing countries against such an agreement is rather unlikely.

Furthermore, various developing countries may have little choice but to join a multilateral agreement on investment eventually. Some developing countries with large markets and strong economic fundamentals could possibly afford to remain outsiders. But small and less attractive countries probably cannot, even though a multilateral agreement may not induce more or higher-quality FDI inflows. The reason is similar to what UNCTAD (1998a) observed with regard to national FDI regulations: Not taking part in the trend towards more liberal FDI policies can effectively close the door to FDI, whereas liberal FDI policies (or agreeing to a multilateral agreement on investment, for that matter) are just a necessary condition for FDI to help achieve national development objectives.

Conflicting interests among developing countries strengthen the bargaining position of

industrialized countries. A purely defensive strategy, as suggested by Kumar (2001) and Singh (2001), is thus likely to fail. Rather than engaging in a futile attempt to block multilateral negotiations on investment altogether, it appears

more promising to us for developing countries to actively take part in negotiations, by making their own offers and demanding quid pro quo concessions from industrialized countries.

## Annex

### Transaction-Cost-Related FDI Impediments and Inward FDI: Robustness of Correlation Results

The robustness of correlation results presented in Table 3 in Section 5.3 may be questioned on two grounds:<sup>33</sup>

- Transaction costs might become an issue only if, in their absence, investors wished to invest in a developing country. In other words, our correlation results for the overall sample may understate the relevance of transaction costs due to the inclusion of developing countries in which reasonable profit opportunities do not exist, so that FDI will not take place even if transaction costs are low.
- The relevance of transaction costs may differ between different types of FDI. Most notably, transaction-cost-related variables may have varying effects on greenfield investments on the one hand, and mergers and acquisitions (M&As) on the other hand.

The first argument suggests re-running the correlations for a reduced sample. We excluded six (out of 28) countries, namely Bangladesh, Ghana, Iran, Kenya, Syria, and Zimbabwe. The assumption that, due to more fundamental bottlenecks to FDI, transaction costs are more or less irrelevant there is based on two criteria met by these six sample countries: per capita FDI stocks in 1999 were extremely small (below \$100)<sup>34</sup> and their share in FDI stocks in all developing countries was below 0.2 percent.

Spearman rank correlations did turn out to be somewhat stronger for the reduced sample (Annex Table 1). Yet, the results deviate surprisingly little between the full and the reduced sample. None of the correlations lacking significance at conventional levels for the full sample becomes significant when the above mentioned countries are excluded. This is the case for correlations with both FDI stocks in 1999 and FDI flows in 1997–2000. This corroborates the finding that transaction costs were a minor factor shaping the distribution of FDI among developing countries. This conclusion holds even for those developing countries for which transaction costs could be expected to play a more important role.

The second argument calls for a disaggregation of overall FDI inflows. We separated greenfield investment from M&As by subtracting M&A sales, as given in UNCTAD (2002: Annex Table B.7), from total FDI inflows.<sup>35</sup> Spearman rank correlations are reported in Annex Table 2. As before with regard to sample selection, the disaggregation of FDI inflows had some impact on the correlation results, but all major conclusions drawn in Section 5.3 remained valid. Entry restrictions appear to have discouraged M&As more than greenfield investment, even though the correlation coefficient turned out to be insignificant for both types of FDI inflows. In all other respects, the correlation exercise revealed only minor differences between M&As and greenfield investment. The

<sup>33</sup>We owe the following arguments to T.N. Srinivasan and Simon Evenett.

<sup>34</sup>The average for all 28 sample countries amounted to almost \$500.

<sup>35</sup>Note that this resulted in an imperfect proxy of greenfield investment, since the data sets on total FDI flows and M&As are not consistent with each other.

two transaction-cost-related factors that were negatively correlated with total FDI inflows in a significant way (administrative bottlenecks and risk factors)

affected M&As and greenfield investment to the same extent.

*Annex Table 1:*

Transaction-Cost-Related FDI Impediments and Inward FDI: Correlation Results for Full and Reduced Sample<sup>a</sup>

FDI impediments <sup>b</sup>	FDI stocks in 1999		FDI flows in 1997–2000	
	Full sample	Reduced sample	Full sample	Reduced sample
Administrative bottlenecks	–0.53***	–0.64***	–0.39**	–0.49**
Entry restrictions	–0.09	–0.05	–0.01	–0.05
Post-entry restrictions	–0.01	–0.21	0.04	–0.11
Risk factors	–0.62***	–0.76***	–0.54***	–0.64***
Technology-related regulations	–0.01	–0.27	0.02	–0.11

\*, \*\*, \*\*\* significant at the 10 percent, 5 percent and 1 percent level, respectively (two tailed).

<sup>a</sup>For reasons given in the text, we excluded Bangladesh, Ghana, Iran, Kenya, Syria, and Zimbabwe. Spearman rank correlation coefficients; inward FDI in dollars per capita of the sample countries' population. – <sup>b</sup>As of 1999 for correlations with FDI stocks; as of 1996 for correlations with FDI flows.

*Source:* Own calculations on the basis of UNCTAD online data base and ERT (2000).

*Annex Table 2:*

Greenfield Investment vs. M&As: Spearman Rank Correlations with Transaction-Cost-Related FDI Impediments

FDI impediments <sup>a</sup>	FDI flows in 1997–2000 <sup>b</sup>		
	Total	M&As <sup>c</sup>	Greenfield <sup>c,d</sup>
Administrative bottlenecks	–0.39**	–0.43**	–0.41**
Entry restrictions	–0.01	–0.29	0.16
Post-entry restrictions	0.04	–0.07	0.14
Risk factors	–0.54***	–0.48**	–0.48**
Technology-related regulations	0.02	–0.01	0.15

\*, \*\*, \*\*\* significant at the 10 percent, 5 percent and 1 percent level, respectively (two tailed).

<sup>a</sup>As of 1996. – <sup>b</sup>Dollars per capita of the sample countries' population. – <sup>c</sup>Excluding Iran due to missing data. – <sup>d</sup>Approximated by the difference between total FDI inflows and M&A sales.

*Source:* Own calculations on the basis of UNCTAD (2002 and online FDI data base) and ERT (2000).

## Bibliography

- Agosin, M.R., and R. Mayer (2000). Foreign Investment in Developing Countries: Does It Crowd in Domestic Investment? UNCTAD Discussion Paper 146. Geneva.
- ASEAN (1998). *Framework Agreement on ASEAN Investment Area*. Makati, Philippines.
- Bhagwati, J. (2002). The Poor's Best Hope. *The Economist*, June 22: 25–27.
- Blomström, M., and A. Kokko (1997). How Foreign Investment Affects Host Countries. World Bank, Policy Research Working Paper 1745. Washington, D.C.
- Blomström, M., R.E. Lipsey, and M. Zejan (1994). What Explains Developing Country Growth? NBER Working Papers 4132. National Bureau of Economic Research, Cambridge, Mass.

- Caves, R.E., and L.B. Krause (eds.) (1984). *The Australian Economy: A View from the North*. Sidney: Allen and Unwin.
- CUTS (2001). All About International Investment Agreements. Monographs on Investment and Competition Policy 7. Jaipur.
- CUTS (2002). Regulating Corporate Behaviour. Briefing Paper 4/2002. Jaipur.
- DSE Forum (2002). *The Development Dimensions of World Trade: Implementing the Doha Development Agenda. International Policy Dialogue*. Berlin: German Foundation for International Development.
- Dymond, W.A. (1999). The MAI: A Sad and Melancholy Tale. In F.O. Hampson, M. Hart, and M. Rudner (eds.), *Canada Among Nations*. Oxford: Oxford University Press.
- ERT (2000). *Improved Investment Conditions: Third Survey on Improvements in Conditions for Investment in the Developing World*. Brussels: European Round Table of Industrialists.
- France (1998). Discours et Interventions, 14 Octobre 1998. See the web site <http://www.premier-ministre.gouv.fr/PM/D141098.htm>
- Gara, J. (2002). Investment: Scope and Definition. Paper presented at the Brainstorming Meeting on Competition and Investment organized by CUTS, Jaipur, India, 9–10 Nov., 2002.
- Gestrain, M. (2002). *Investment*. Paris: OECD.
- Graham, E.M. (1998). Regulatory Takings, Supranational Treatment and the Multilateral Agreement on Investment: Issues Raised by Non-governmental Organisations. *Cornell International Law Journal* 31 (1): 599–614.
- Haaland, J.I., and I. Wooton (1999). International Competition for Multinational Investment. *Scandinavian Journal of Economics* 101 (4): 631–649.
- Henderson, D. (1999). *The Multilateral Agreement on Investment: A Story and Its Lessons*. Wellington: New Zealand Business Roundtable.
- Hoekman, B., and K. Saggi (2000). Assessing the Case for Extending WTO Disciplines on Investment-Related Policies. *Journal of Economic Integration* 15 (4): 629–653.
- Hoekman, B., and K. Saggi (2001). From TRIMs to a WTO Agreement on Investment? In B. Hoekman and W. Martin (eds.), *Developing Countries and the WTO: A Pro-active Agenda*. Oxford: Blackwell.
- ICC (1996). Multilateral Rules for Investment. Document No. 103/179 Rev. International Chamber of Commerce, Paris.
- Kokko, A. (2002). Globalization and FDI Incentives. Paper presented at the Annual Bank Conference on Development Economics in Europe, Oslo. Mimeo.
- Krueger, A.O. (2000). NAFTA's Effects: A Preliminary Assessment. *World Economy* 26 (6): 761–775.
- Kumar, N. (2001). WTO's Emerging Investment Regime: Way Forward for Doha Ministerial Meeting. *Economic and Political Weekly* 36 (33): 3151–3158.
- Langhammer, R.J. (1999). The WTO and the Millennium Round: Between Standstill and Leapfrog. Kiel Discussion Papers 253. Institute for World Economics, Kiel.
- Ley, R. (1997). The Scope of the MAI. Multilateral Agreement on Investment: State of Play in April 1997. Paris, OECD.
- Low, P., and A. Subramaniam (1995). TRIMs in the Uruguay Round: An Unfinished Business? In W. Martin and L. A. Winters (eds.), *The Uruguay Round and the Developing Economies*. World Bank Discussion Papers 307. World Bank, Washington, D.C.
- Machado, J.B. (1995). MERCOSUL entra em Operacao a Uniao Advaneira Flexival. *Revista Brasileira de Comercio Exterior (FUNCEX)* 42 (11): 15–20.
- Mathews, J.T. (1997). Power Shift. *Foreign Affairs* 76 (1): 50–66.
- Moran, T.H. (1998). *Foreign Direct Investment and Development. The New Policy Agenda for Developing Countries and Economies in Transition*. Washington, D.C.: Institute for International Economics.

- Moran, T.H. (1999). Foreign Direct Investment and Development: A Reassessment of the Evidence and Policy Implications. In OECD, *Foreign Direct Investment, Development and Corporate Responsibility*. Paris: OECD.
- NAFTA Treaty (1994). Ottawa: Government of Canada.
- Nunnenkamp, P. (1997). Foreign Direct Investment in Latin America in the Era of Globalized Production. *Transnational Corporations* 6 (1): 51–81.
- Nunnenkamp, P. (2001a). Foreign Direct Investment in Developing Countries: What Policymakers Should Not Do and What Economists Don't Know. Kiel Discussion Papers 830. Institute for World Economics, Kiel.
- Nunnenkamp, P. (2001b). European FDI Strategies in Mercosur Countries. *Journal of World Investment* 2 (3): 457–480.
- Nunnenkamp, P. (2002). To What Extent Can Foreign Direct Investment Help Achieve International Development Goals? Kiel Working Papers 1128. Institute for World Economics, Kiel.
- Nunnenkamp, P., and J. Spatz (2003). Determinants of FDI in Developing Countries: Has Globalization Changed the Rules of the Game? *Transnational Corporations* 11 (2): 1–34.
- OECD (1995). A Multilateral Agreement on Investment: Report by the Committee on International Investment and Multinational Enterprises (CMIE) and the Committee on Capital Movements and Invisible Transactions (CMIT). Paris.
- OECD (1996). *OECD Benchmark Definition of Foreign Direct Investment*. Third edition. Paris: OECD.
- OECD (2002). *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*. Paris: OECD.
- Oman, C.P. (2001). The Perils of Competition for Foreign Direct Investment. In OECD, *Foreign Direct Investment Versus Other Flows to Latin America*. Development Centre Seminars. Paris: OECD.
- Pant, M. (1995). *FDI in India: The Issues Involved*. New Delhi: Lancer Books.
- Pant, M. (2002). The Millennium Round of Trade Negotiations: A Developing Country Perspective. *International Studies* 39 (3): 213–226.
- Read, P. (1999). International Investment in the WTO: Prospects and Challenges in the Shadow of the MAI. [www.bond.edu.au/law/blr/vol11-2/Read.doc](http://www.bond.edu.au/law/blr/vol11-2/Read.doc)
- Rothkopf, D. (1998). Cyberpolitik: The Changing Nature of Power in the Information Age. *Journal of International Affairs* 51 (2): 325–359.
- Rugman, A.M., and A.D.M. Anderson (1997). NAFTA and the Dispute Settlement Mechanisms: A Transaction Cost Approach. *World Economy* 20 (7): 935–950.
- Sauvant, K.P. (2000). Rapporteur's Report. In German Foundation for International Development, Summary Report: Pre-UNCTAD X Seminar on International Investment Policies: Which Strategies for Developing Countries? Berlin.
- Sauve, P. (1998). Multilateral Attempts at Investment Rule Making: Why So Difficult? Harvard University. Mimeo.
- Schirm, S.A. (2002). *Globalisation and the New Regionalism*. Cambridge: Blackwell.
- Sciarra, V.P. (1998). The World Trade Organisation: Services, Investment and Dispute Resolution. *International Lawyer* 32 (3): 9–23.
- Singh, A. (2001). Foreign Direct Investment and International Agreements: A South Perspective. Occasional Papers 6. South Centre, Geneva.
- Soto, M. (2000). Capital Inflows and Growth in Developing Countries: Recent Empirical Evidence. Technical Paper 160. OECD Development Centre, Paris.
- Stiglitz, J.E. (2000). Capital Market Liberalization, Economic Growth, and Instability. *World Development* 28 (6): 1075–1086.
- UNCTAD (1996) *International Investment Instruments. A Compendium, Vol. II*. New York: United Nations.

- UNCTAD (1997). *World Investment Report*. New York: United Nations.
- UNCTAD (1998a). *World Investment Report*. New York: United Nations.
- UNCTAD (1998b). *Bilateral Investment Treaties in the Mid-1990s*. New York: United Nations.
- UNCTAD (1999a). *World Investment Report*. New York: United Nations.
- UNCTAD (1999b). *Lessons from the MAI*. New York: United Nations.
- UNCTAD (2000a). *World Investment Report*. New York: United Nations.
- UNCTAD (2000b). Bilateral Investment Treaties, 1959–1999. United Nations, UNCTAD/ITE/IIA/2. New York, <http://www.unctad.org/en/docs/poiteiiad2.en.pdf>
- UNCTAD (2001). *World Investment Report*. New York: United Nations.
- UNCTAD (2002). *World Investment Report*. New York: United Nations.
- Vandeveld, K.J. (1998). The Political Economy of a Bilateral Investment Treaty. *American Journal of International Law* 92 (4): 621–630.
- Witherell, W.H. (1995). The OECD Multilateral Agreement on Investment. *Transnational Corporations* 4 (2): 1–14.
- World Bank (2003). Global Economic Prospects and the Developing Countries 2003. Washington, D.C., <http://www.worldbank.org/prospects/gep2003/toc.htm>
- WTO (2001). Doha WTO Ministerial Declaration. WT/MIN(01)/DEC/1. Geneva.



## Kieler Diskussionsbeiträge

### Kiel Discussion Papers

- 386. The Stalling Engine in *Wirtschaftswunder-Land*: Germany's Economic Policy Challenges. By Horst Siebert. Kiel, Mai 2002. 16 S. 8 Euro.
- 387. The European Electricity Market: Centralization of Regulation or Competition between Regulatory Approaches? By Lars Kumkar. Kiel, Mai 2002. 28 S. 8 Euro.
- 388. IWF und Weltbank: Trotz aller Mängel weiterhin gebraucht? Von Peter Nunnenkamp. Kiel, Mai 2002. 34 S. 8 Euro.
- 389./ Fit für die EU? Indikatoren zum Stand der Wirtschaftsreformen in den Kandida-  
390. tenländern. Von Federico Foders, Daniel Piazzolo und Rainer Schweickert. Kiel, Juni 2002. 69 S. 16 Euro.
- 391. Fortschritte beim Aufbau Ost. Forschungsbericht wirtschaftswissenschaftlicher Forschungsinstitute über die wirtschaftliche Entwicklung in Ostdeutschland. Kiel, Juni 2002. 53 S. 8 Euro.
- 392./ Subventionen in Deutschland. Von Alfred Boss und Astrid Rosenschon. Kiel,  
393. August 2002. 71 S. 16 Euro.
- 394. 75 Punkte gegen die Arbeitslosigkeit. Von Horst Siebert. Kiel, August 2002. 23 S. 8 Euro.
- 395. Vom Mangel zum Überfluss – der ostdeutsche Wohnungsmarkt in der Subventionsfalle. Von Dirk Dohse, Christiane Krieger-Boden, Birgit Sander und Rüdiger Soltwedel. Kiel, September 2002. 52 S. 8 Euro.
- 396. Euroland: Upswing Postponed. By Kai Carstensen, Klaus-Jürgen Gern, Christophe Kamps and Joachim Scheide. Kiel, Oktober 2002. 19 S. 8 Euro.
- 397. Central Exams Improve Educational Performance: International Evidence. By Ludger Wößmann. Kiel, Oktober 2002. 45 S. 8 Euro.
- 398. Makroökonomische Reformen und Armutsbekämpfung in Bolivien: Ebnet die HIPC-Initiative den Weg zu sozialverträglicher Anpassung? Von Rainer Schweickert, Rainer Thiele und Manfred Wiebelt. Kiel, Februar 2003. 41 S. 9 Euro.
- 399. Higher Economic Growth through Macroeconomic Policy Coordination? The Combination of Wage Policy and Monetary Policy. By Klaus-Jürgen Gern, Carsten-Patrick Meier and Joachim Scheide. Kiel, Februar 2003. 29 S. 9 Euro.
- 400. Why the Case for a Multilateral Agreement on Investment Is Weak. By Peter Nunnenkamp and Manoj Pant. Kiel, März 2003. 9 Euro.

Mehr Informationen über Publikationen des Instituts für Weltwirtschaft unter <http://www.uni-kiel.de/ifw/pub/pub.htm>, mehr Informationen über das IfW unter <http://www.uni-kiel.de/ifw/>