Multilateral Disciplines for Investment-Related Policies?∗

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Abstract: In this paper we provide a selective survey of the literature on foreign direct investment (FDI) policies and evaluate the potential benefits of international disciplines on such policies for developing countries. The discussion focuses on technology spillovers from FDI, fiscal and financial incentives, and the economics of investment measures because these issues are central from the viewpoint of developing countries. In principle the major potential gain from a multilateral agreement is avoidance of wasteful competition for FDI and attenuating the locational distortions resulting from regional integration agreements. However, to be effective, such an agreement would need to be highly comprehensive and would be costly to negotiate. At present, this does not seem like a promising prospect. Multilateral negotiating efforts that center on further market access liberalization on a nondiscriminatory basis, including services, are likely to be most fruitful from an economic welfare and growth perspective.

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1. Introduction

The value of sales by foreign affiliates of multinational firms now exceeds global exports of goods and services (UNCTAD, 1996). The observed growth in foreign direct investment (FDI) is a consequence of many changes in the world economy. For example, services are becoming more important in GDP as activities are outsourced and the information technology revolution creates markets for an ever expanding set of new services. Often such services cannot be traded, or suppliers must have a physical presence in a market in order to compete efficiently. Falling costs of communication have also eased the constraints on global rationalization of production, leading to ever greater geographic specialization and splicing of the production (value added) chain.

However, changes in the economic environment have not been purely market driven; there has been a substantial change in the policy environment as well. Perceptions about multinational firms and their effects on host countries have undergone a transformation. Most countries are now quite eager to attract FDI; many (including some industrialized countries at both the central and local government level), offer fiscal and financial incentives to attract FDI. Another measure of the desire to attract FDI is the proliferation of bilateral investment treaties (BITs) between countries. As of Jan 1, 1997, there existed a total of 1330 BITs compared to some 400 at the beginning of 1990 (UNCTAD, 1997). During 1996 alone, 180 BITs were signed: one every other day.

On the other hand, many countries impose additional requirements on the conduct of multinationals. For example, they may be subject to local content requirements, export
requirements, technology transfer requirements etc. The schizophrenic nature of the overall
policy environment reflects the guarded optimism with which many countries continue to view
the entry of multinational firms into their territory. Such firms would prefer not to be subject to
discriminatory entry and conduct constraints and are supporters of efforts to discipline the ability
of governments to do so. They are also concerned that mechanisms exist to provide
compensation in cases of expropriation or nationalization. These are major motivations for the
negotiation of BITs, regional integration agreements (RIAs) and the recent attempt to conclude
a multilateral agreement on investment (MAI) under OECD auspices.

This paper asks (i) what are the main issues confronting developing countries in the area
of investment policies; (ii) whether international cooperation could help solve these problems;
(iii) if so, how bilateral or regional agreements compare to a global, nondiscriminatory set of
disciplines; and (iv) whether there is a strong case for developing countries to support the
creation of a multilateral agreement on investment.

In the case of trade policy, the rationale for engaging in reciprocal negotiations and
concluding trade agreements is straightforward. While free trade (or low and uniform protection
through tariffs if revenue considerations predominate) is optimal for countries that cannot affect
their terms of trade, political economy constraints may impede a government from attaining this
outcome. Reciprocal negotiations can help mobilize interest groups, especially exporters, to
oppose efforts by import-competing industries to retain protection. In the process, a country not
only reaps the gains from liberalization at home, but also gets better access to foreign markets.
Does a similar rationale apply to investment policies?
Three sets of potential gains from cooperation can be identified. The first is that policies may be in place that prevent entry by foreign firms that are detrimental to society: producer rents are less than consumer losses but local incumbents capturing the rents are able to block FDI liberalization. Note that such rents cannot be very high in tradable industries as long as a liberal trade policy stance is pursued, as foreign firms can contest the market through exports. Thus, such a situation that is more likely to prevail in nontradable industries or sectors subject to significant regulation (e.g., licensing requirements): i.e., in service sectors. Alternatively, investment policies that are detrimental to the welfare of the country may be imposed: foreign entry may be allowed but investors are subjected to performance requirements that raise production costs. In both cases, one must ask how international investment agreements could help solve the underlying political economy problem.

A second set of circumstances is conceptually more straightforward. National policies may be detrimental to other countries (negative spillovers), or lead to an inefficient noncooperative outcome for the world as a whole (e.g., a prisoner’s dilemma). If so, in principle there are gains from cooperation. Here the question is whether there exists a non-empty negotiation set, which depends in part on whether an effective (i.e., enforceable) agreement can be designed. Finally, governments may be pursuing all the “right” policies to attract FDI, but there may be no significant “supply response” because of a history of policy reversals. If investors are risk averse, they may then continue to avoid the country altogether, impose large risk premia, not transfer “sensitive” technologies, etc. In such a setting an international agreement may serve as a mechanism through which governments make irrevocable commitments and lock in policy reversals, thereby anchoring expectations of investors.
We start this paper with a brief discussion of policies that restrict FDI and summarize existing WTO rules and disciplines (Section 2). We then examine the economic rationale for financial and fiscal incentives designed to lure in multinationals and conclude that there does not exist a strong argument for the use of fiscal and financial incentives (Section 3). Given that the use of such incentives may lead to tax competition, a MAI that outlaws location subsidies might be beneficial. However, attempts to discipline subsidies may be easily circumvented unless the focus centers on the complete set of policy instruments that governments can use to influence investment decisions and market structures more generally, independent of residency status. These include not just location subsidies, but also production and operating subsidies, competition policies, environmental regulation and technical standards, R&D regimes, procurement regimes, etc.

A number of RIAs have included liberalization of FDI (Section 4). Such agreements illustrate that even if a right of establishment in included, substantial scope tends to remain for governments to restrict access to markets and/or to engage in competition for FDI. Many RIAs do not go much further than the WTO in key areas such as market access for services. At the same time they create potential locational distortions by encouraging investment in “hub” countries and may discriminate against FDI originating in non-members. A MAI could reduce (ideally eliminate) such discrimination, and is therefore preferable to RIAs. However, little evidence exists regarding the prevalence and impact of any discrimination. As this is a problem that is likely to be most prevalent in service industries, attention should focus on efforts to liberalize access to service markets.
We conclude that stand-alone agreements on FDI are unlikely to generate large gains for developing countries (Section 5). Countries that are serious about attracting FDI can implement the appropriate policy mix unilaterally. Conversely, countries such as China have demonstrated that they can attract FDI without committing to the types of disciplines likely to figure on the agenda of a MAI. Many countries will find it difficult to attract FDI in manufacturing even with all the “right” policies in place. The key need therefore is to continue the process of multilateral trade liberalization, focusing attention as far as investment (establishment) policies are concerned on services markets.

2. **Restrictive Policies toward FDI**

Policies toward FDI exhibit considerable variation over time and space. In countries that historically emphasized import substituting industrialization such as most of Africa, Latin America, and Southeast Asia, FDI was typically not allowed or multinational firms had to operate under severe restrictions. Even in countries where technology acquisition was a major concern of governments, multinationals were rarely permitted to operate wholly owned subsidiaries. For example, Japan, Korea, and Taiwan imposed restrictions on FDI at various points in time,\(^1\) even though foreign trade was viewed positively.

In recent years, government policies toward FDI have been liberalized across the world. For example, of the eighty two policy changes made with respect to FDI policies by thirty five countries in 1991, eighty were in the direction of greater liberalization (UNCTAD,

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\(^1\) Ozawa (1974) provides a detailed account of the Japanese experience. The Ministry of International Trade and Investment (MITI) restricted FDI until 1970, and never greatly liberalizing it, and even insisted that
This trend reflects an increasing awareness on the part of many governments that multinational firms play an important role in economic development by serving as conduits of superior technology as well as management techniques. Such a realization stems partly from the success of countries such as Singapore, Thailand, and Malaysia that rely heavily on FDI.

However, while there has been a global trend toward liberalization with respect to FDI, many countries—both industrialized and developing—impose performance yardsticks on multinationals. Examples include equity ownership limits, licensing regimes, foreign exchange restrictions, and export or local content requirements. Collectively, these are referred to as trade-related investment measures (TRIMs). In other words, the perception seems to be that while FDI is a good thing, the conduct of multinational firms may have to be subjected to certain regulations and restrictions in order to maximize benefits for the host country—assuming such indeed is the motivation behind the various TRIMs instituted by host countries. While it is quite likely that like other forms of protectionist measures, TRIMs reflect the underlying political economy of the host country, it is nevertheless worthwhile to ask if there is a case that can be made for such policies on purely welfare grounds (i.e. the aggregate welfare of the host country).

In the neoclassical world of perfect markets, investment measures are bound to be distortionary whereas in a world of imperfect competition or one in which there exist other distortions, such measures may have some beneficial aspects. An early analysis of domestic content requirements as well as content preferences in a model of perfect competition is found in

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foreign firms share their technology with local firms as a precondition for doing business in Japan. A similar story can be told about South Korea's experience.
Grossman (1981). The basic point of this paper is that content protection raises the price of domestic inputs, by requiring multinationals to use more of them, and thus benefit input suppliers at the expense of final goods producers. However, multinationals are pervasive in oligopolistic industries and can have significant market power. Thus, examining the effect of TRIMs under conditions of imperfect competition is important. Analyses of content protection and export performance requirements are available in Richardson (1991; 1993) and Rodrik (1987). Once one grants the second best setting under which TRIMs are typically implemented, their negative effects are somewhat mitigated.\(^2\) It is well known in general that policy intervention in oligopolistic markets can improve local welfare by altering the distribution of product market rents between domestic and foreign firms. Nevertheless, even if policies are used as tools for transferring rents, they are bound to be second-best tools, at least strictly from an economic viewpoint.

Existing evidence shows that investment measures tend to be concentrated in specific industries with automotive, chemical, and petrochemical and computer industries leading the list (UNCTAD, 1996). Furthermore, local content requirements are most important in the auto industry whereas export requirements are more important in the computer industry. In chemicals and petrochemicals, both local content requirements and export requirements are employed extensively.

In many cases, surveys show that investment measures make firms do what they would have done anyway, except that they may do it sooner as a result of constraints or incentives.

\(^2\) As is well known, in the presence of pre-existing distortions, introducing another distortion, say in the form of a content protection scheme, can raise welfare.
imposed. For example, a TRIM that requires firms to export is inconsequential if firms were going to export even in the absence of such a requirement. Thus, the actual effect of investment measures may be quite small. The US Department of Commerce’s survey of 1977 and 1982 indicate that only six percent of all the overseas affiliates of US firms thought themselves to be affected by TRIMs, although a far greater percentage operated in sectors where such TRIMs existed. In other words, the constraints imposed by TRIMs often fail to bind (UNCTAD, 1991).

The empirical evidence notwithstanding, the issue was put on the Uruguay Round agenda. An Agreement on TRIMs was negotiated that prohibits measures that are inconsistent with the GATT national treatment principle (Art. III) and the prohibition on the use of quantitative restrictions (Art. XI). The TRIMs agreement includes a list of prohibited measures (local content, trade-balancing, foreign exchange-balancing and domestic sales requirements), requires that all policies not in conformity with the agreement be notified within 90 days of entry into force of the agreement, and that they be eliminated within two, five or seven years, for industrialized, developing and least developed countries, respectively. The latter two groups may request extension of these transition periods. The agreement is to be reviewed in the year 2000 at which time it may be complemented by provisions on competition and investment policy.

Although the TRIMs agreement is widely held to be relatively weak, as all it does is to re-iterate that the GATT national treatment principle and the prohibition of quantitative restrictions apply to policies intended to foster investment. Notably, the agreement does not address export performance requirements, nor does it affect FDI in services, which is covered
by the GATS. Notwithstanding its limited reach, the GATT has been a constraint on countries using TRIMs such as local content requirements, and can be expected to become a more serious source of discipline in future as transition periods expire.

So far there have been only a few disputes brought before GATT/WTO panels in this area, the most notable of which are a case brought against Canada’s Foreign Investment Review Act (FIRA) by the US in 1984, and a more recent case brought by the EU, Japan and the US against provisions of the National Car Program introduced by Indonesia in 1996. In the FIRA case the panel found that written undertakings submitted by foreign investors to the government regarding sourcing of inputs and export objectives to be a violation of national treatment, as it implied discrimination against importing inputs. The Indonesia case also revolved around local content measures. Under the contested program, the government granted “National Car” company status to Indonesian companies that met specified criteria as to ownership of facilities, use of trademarks, and technology. National Cars companies were required to meet increasing local content requirements over a three year period; if so, they benefited from exemption from the prevailing luxury tax on sales of cars and exemption from import duties on parts and components. “National Cars” manufactured in a foreign country by Indonesian nationals and which fulfilled the local content requirements prescribed by the Minister of Industry and Trade were also exempt from import duties and luxury tax. Such imported National Cars were deemed to comply with the 20 per cent local content requirement for the end of the first production year if the value of “counter-purchased” Indonesian parts and components accounted for at least 25 per cent of the value of the imported cars (WTO, 1998b). The panel found that this program violated the TRIMS Agreement (national treatment).
More disputes may arise under the TRIMs agreement once the transition periods for full compliance on the part of developing countries have expired (a major reason Indonesia was “targeted” was that the policy measures were introduced after the entry into force of the TRIMs agreement—a number of countries apply similar policies but are sheltered by the transition period). This should help ensure that markets are contestable through trade flows. However, much will depend on the incentives for multinationals to bring complaints. Insofar as they are incumbents that have invested and incurred the costs of whatever policies are applied, they may be loath to upset the existing status quo if this is profitable. In many cases complaints are more likely to be brought by “outsiders” with an interest in exporting into formerly protected markets.

3. Policies to Promote FDI

Economic theory dictates that when domestic distortions and externalities from FDI are both absent, the optimal FDI policy ought to be no policy at all—i.e. governments should allow for unfettered market transactions. Thus, a role for policies promoting FDI requires domestic distortions or market failures. Since multinational firms typically arise in oligopolistic industries, a possible example of a domestic distortion is the presence of imperfect competition in the host economy. Suppose, following Glass and Saggi (1998b), one imagines an economy with an oligopolistic sector (manufacturing) and a numeraire sector (agriculture). Inward FDI into the manufacturing sector generates increased demand for skilled labor, which benefits skilled workers through raising wages in the host country but consequently damages the profits of host firms (positive due to imperfect competition). The tension between wages and profits implies that government policies toward FDI benefit one group at the expense of the other. Developing
countries usually have small or non-existent local firms in industries that are dominated by multinationals since brand names, R&D, and reputation are of central importance in such industries and these assets are rarely available to developing country firms. Furthermore, in many small open economies, a substantial fraction of the ownership of firms may belong to other countries. Thus, if the economic environment of a country is such that profits of local firms are unimportant either because local industries are extremely underdeveloped (so that national income comprises mostly of wage earnings) or because local profits do not accrue to domestic agents, the country is likely to take a favorable view of inward FDI. In such countries, the loss in profits incurred due to the increased entry of multinationals is small relative to the gain accruing to workers. Similarly, one can imagine other domestic distortions that may create a role for policy toward FDI, although such policies need not be first best.

A second possible rationale for inducing FDI has to do with technology spillovers. Developing countries hope not only to import modern foreign technologies via FDI but also to generate technological spillovers for local firms thereby making more efficient use of existing resources. There exists a large literature that tries to determine whether or not host countries enjoy ‘spillovers’ (positive externalities) from FDI (Blomstrom and Kokko, 1997, provide an excellent overview). The central difficulty is that spillovers, by their very nature, often do not leave a paper trail -- they are externalities that the market fails to take into account. Nevertheless, it is useful to ask what are the potential channels through which spillovers from FDI may arise so as to identify possible policy options. In the following discussion, we restrict

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3 The usage of the word ‘spillovers’ is somewhat unfortunate since productivity improvements are unlikely to be costless and automatic.
attention to those effects of FDI that may be classified as externalities. For example, increased competition will generally result from FDI but this is not typically understood to be an externality. At a general level, the literature suggests the following potential channels of spillovers:

- **Demonstration Effects** – local firms may adopt technologies introduced by the multinational through imitation or reverse-engineering.

- **Labor Turnover** – workers trained by the multinational may transfer important information to local firms or may start their own firms leading to diffusion of technology.

- **Linkages** – derived demand by multinationals may lead to local provision of services or inputs that can also be used by local firms.

  In its simplest form, the demonstration effect argument states that the close proximity to multinational firms may lead to efficiency gains by local firms who may modify their own production methods upon exposure to the superior technology of multinationals. The main point here is that in the absence of FDI, adoption of certain technologies may simply be infeasible because local firms lack the necessary information. In other words, it is simply too costly for local firms to acquire the required information for adopting new technologies if they are not first introduced in the local economy by multinationals (and hence demonstrated to succeed in the local environment). Hence, geographical proximity is a vital part of this argument.

The main insight of the demonstration effect argument is that FDI may expand the set of technologies available to local firms. One must be careful, however since a mere expansion in choices need not imply externalities, especially if incentives for adoption are also affected by FDI. Even if one can argue that FDI increases the incentives for adoption, it is not necessarily
the case that this implies that FDI generates positive externalities. FDI may expand choices but it generally also increases competition. The net effect on the incentives for adopting new technologies may be ambiguous. However, if competition reinforces the incentives for adoption, FDI may indeed spur local incentives.\(^4\) Some empirical support for this prediction is found by Blomström, Kokko and Zejan (1994).

Faster adoption of new technologies by local firms due to inward FDI does not necessarily constitute a spillover for the local economy. Multinationals will face more severe competition as a result of upgrading by local firms. Foreseeing the consequences of technology transfer, multinationals may alter the very terms of their original technology transfer. For example, a multinational firm may choose to transfer technologies of lower quality when there is a risk of leakage or adoption of the technology by local firms. While an expansion in the set of possibilities, along with the competitive spur of FDI, may lead local firms to make adoption decisions that they would not make in the absence of FDI, such an effect need not imply the existence of externalities.

As is often the case with such difficult issues, the evidence is mixed. Using industry level data, Blomström and Persson (1983), found that domestic labor productivity is positively influenced by foreign presence in an industry, as measured by the foreign share of industry

\(^4\) In a recent paper, Glass and Saggi (1998a) examine the question of spillovers in a dynamic general equilibrium product cycle model. In their North-South model, the demonstration/proximity argument is formalized as follows: Southern firms can imitate multinationals located in the South at a lower cost than they can imitate firms located in the North. However, as they point out – multinational firms are also stronger competitors than firms that produce only in the North since they produce in the same low wage location as potential imitators. Their model delivers the surprising result that a faster flow of FDI need not increase technology transfer to the South since imitation focussing on firms located in the North slows down with a hastening of imitation targeting multinationals. See also Das (1987) and Wang and Blomström (1992) for an alternative dynamic model of technology transfer from a parent company to its subsidiary. In their model, investment in learning activities by the domestic firm provides a competitive spur for technology transfer.
employment. On the other hand, more recent studies using firm level data are not supportive of
the spillover hypothesis: Aitken, Hanson, and Harrison (1997) and Haddad and Harrison
(1993) actually find that foreign investment has a negative effect on the performance of
domestically owned firms. One needs to be cautious in interpreting this finding. Case-study
evidence is strongly suggestive of spillovers (see Schive, 1990) and a more complete
econometric study would require a more dynamic approach: it is very unlikely that significant
improvements in the productivity of local firms can be realized without costly investments that
yield payoffs in the future.

The type of FDI may also matter importantly. Djankov and Hoekman (1998) find that
foreign investment has a negative spillover effect on firms in Czech industry that do not have
foreign partnerships. This effect is relatively large and statistically significant. However, if joint
ventures are excluded and the focus of attention is restricted to the impact of majority-owned
foreign affiliates (i.e., FDI) on all other firms in an industry (including joint ventures), the
magnitude of the negative effect becomes much smaller and loses statistical significance. This
result illustrates that the initial negative spillover result may not be robust and that tests for
spillovers with the methodology used here (and in the literature more generally) require some
assurance that in distinguishing between two subsets of firms in an industry on the basis of
whether or not there is majority foreign ownership (or more generally foreign linkages of some
kind) one is not ignoring other important determinants of the performance of firms. One such
determinant likely to be important is the technological effort of firms. Survey questionnaires
reveal that joint venture firms invested significantly more in training and new technologies than
pure “domestic” firms. It may be that the technological ability and effort expended by many of
the firms without foreign partners is too low to be able to absorb spillovers when they occur, or that the firms with foreign linkages have absorbed a significant share of the available stock of labor with requisite skills.

While direct imitation and reverse-engineering have been extensively studied as channels of inter-firm technology diffusion, the role of labor turnover has been neglected. Labor turnover differs from these channels because knowledge embodied in workers moves across firms only through the physical movement of workers. Empirical evidence regarding the magnitude of labor turnover from multinationals to local firms is mixed. For example, while a study of Kenyan industries by Gershenberg (1987) finds limited evidence of labor turnover from multinationals to local Kenyan firms, several other studies do document substantial labor turnover from multinational to local firms. UNCTAD (1992) discusses the case of Bangladesh's garment industry in some detail. Desh—the first Bangladeshi firm to manufacture and export garments—was supplied with technology and credit by Korea's Daewoo. Eventually, 115 of the 130 initial workers left Desh to set up their own, or to join other newly established, garment companies. The remarkable speed with which the former Desh workers transmitted their know-how to other factories is a good example of the role labor turnover can play in technology diffusion.5

Pack (1997) also discusses evidence documenting the role of labor turnover in disseminating technologies of multinationals to local firms in Taiwan. For example, in the mid 1980s, almost fifty percent of all engineers and some sixty percent of all skilled workers that left multinational affiliates in Taiwan joined local firms. The figures reported in the Gershenberg

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5 Bloom (1992) reports that substantial spillover effects were created in South Korea when production managers left foreign firms to join local ones.
study of Kenyan industry are less assuring: of the ninety one job shifts studied, only sixteen percent involved turnover from multinationals to local firms. This difference may reflect the fact that in countries such as South Korea and Taiwan, local competitors are less disadvantaged relative to their counterparts than in many African economies, thereby making labor turnover possible. Thus, the ability of local firms to absorb the technologies introduced by multinationals may be a key determinant of whether or not labor turnover occurs as a means of technology transfer in equilibrium.\(^6\) This is the argument advanced in Glass and Saggi (1998c). The rationale of their model is as follows. Since superior technology is one of the key intangible assets that permit multinationals to successfully compete with local firms, multinationals have an incentive to limit diffusion of their technology to local rivals. An effective method of limiting technology diffusion is to curtail labor turnover by offering higher wages than local rivals. Thus, if multinationals are observed paying higher wages than local firms, the wage premiums paid by a multinational can provide a rough estimate of the value it places on the knowledge it transfers to its workers. The more interesting point is that such a premium may either exceed or fall short of the benefit the local economy would enjoy if the multinational were to sit back and allow its workers to leave.

Many recent studies document that multinationals pay higher wages than local firms. Using data from Mexico, Venezuela, and United States, Aitken, Harrison, and Lipsey (1995) show that higher levels of foreign investment are associated with higher wages in all three countries. Note that if the multinational must raise wages in order to restrict technology transfer

\(^6\) In the case of Desh, the technology being transmitted was quite simple and local absorptive capacity would have been adequate.
to local firms and given that the wage premium has no necessary relation to the social value of
the knowledge embodied in workers, technology transfer is not necessarily optimal for the local
economy. Thus, policies designed to encourage technology transfer do not always raise welfare
of the recipient country.

Consider finally the argument that multinationals generate externalities through backward
and forward linkages. In this context, Rodriguez Clare (1996) makes the important point that
multinationals improve welfare only if they generate linkages over and beyond those generated
by local firms they displace. Thus, merely documenting extensive linkages between multinational
and local suppliers or buyers is insufficient to argue that net external benefits accrue to the local
economy as a result of FDI.

Markusen and Venables (1999) have argued that the entry of multinationals might help
resolve a coordination failure in the host economy. By creating demand for intermediate goods,
entry by multinationals encourages their production. Consequently, local firms gain access to
hitherto unavailable inputs since these are not produced in the absence of the demand generated
by multinationals. Such an argument is probably most relevant for the least developed countries
that have very little industrial activity of their own. Countries like India and Brazil that have
adequate indigenous industry are unlikely to enjoy substantial linkage effects of the kind
discussed by Markusen and Venables.

To recapitulate, an economic rationale for providing fiscal and financial incentives to
FDI might exist in the presence of domestic distortions or positive externalities from FDI. The
empirical evidence regarding the latter has not been clear cut but part of the difficulty lies in the
very nature of externalities. Furthermore, a true evaluation of the extent to which there are
spillovers from FDI requires a dynamic study since immediate productivity improvements in local firms are unlikely. Nevertheless, suppose one accepts the notion that there indeed exist solid economic grounds for promoting inward FDI via incentives. Even so, the case for incentives must contend with the real problem that arises once the existence of other countries with a similar interest is recognized. Suppose two potential host countries foresee positive externalities from an investment project that is being considered by a multinational firm. The two potential hosts could easily find themselves in a bidding war for attracting FDI that is to the detriment of both parties. Thus, even in the presence of externalities, a policy of offering incentives to multinational firms seems counter-productive.

Yet another damaging criticism of a policy of offering incentives to inward FDI comes from direct empirical evidence on this issue. Most studies (Morck and Yeung 1991, and Wheeler and Mody, 1992) fail to find any significant impact of such incentives on FDI, once the other more important determinants of FDI are taken into account. This line of research implies that determinants of FDI are much more fundamental than incentives; the available evidence suggests the latter basically end up as transfers to multinationals. However, this conclusion has been contested by a number of countries in the WTO Working Group on Trade and Investment (WTO, 1998). Representatives from these countries (who are not identified in the reports of the Group) remain unconvinced by the evidence. For example, Loree and Guisinger (1995) find that investment incentives do have a positive effect. In part the differences of opinion may reflect measurement difficulties, as it may be difficult to separate fiscal and/or financial incentives from more general policies that promote business activity. That the latter matter a lot is uncontested. In a recent empirical analysis of the effect of state policies on the location of manufacturing,
Holmes (1998) finds that the share of manufacturing in employment in states with pro-business regulatory environments increases by one third compared to a bordering state without such policies. This result is noteworthy not only in indicating that state policies appear to matter, but also in suggesting that differences across states are relatively stable. The measure of policy chosen (whether a state had a law banning requirements that all employees of a firm join a union) has not changed significantly since 1958; in the last two decades only two states passed such laws; while none repealed them.

4. The Regional Integration Experience

The extent to which market access barriers are removed and the reach of the national treatment principle as circumscribed in a trade agreement are important determinants of the magnitude of liberalization (integration) that is pursued by governments. In the case of the WTO, national treatment does not apply to investment policies. It is often claimed that RIAs can and do go further, allowing governments to abolish market access barriers (e.g., by granting the right of establishment) and performance requirements. Clearly the RIA experience is relevant in assessing the need for and payoffs associated with a possible MAI. A first question to ask is what RIAs have in fact achieved to date over and above what countries have been willing to do unilaterally or through the WTO.

Some RIAs have extended the reach of national treatment to investment, in the process abolishing performance criteria and related policies such as local content and trade balancing requirements. Examples include the EU, where freedom of investment is a basic principle, NAFTA, and various association agreements the EU has concluded with Central and Eastern
Europe neighbors. Other RIAs with investment liberalization provisions include Mercosur, the G3 (which is closely modeled on NAFTA), and the Canada-Chile FTA. Agreements vary in the extent to which barriers to entry are removed; with the exception of the EU, most RIAs tend to maintain restrictions on market access and entry by foreign firms.

*Services Liberalization: A Litmus Test*

A key indicator of the “seriousness” of RIAs is the extent to which they go beyond the WTO in liberalizing market access restrictions and subject governments to disciplines regarding the use of incentives and performance requirements. As far as market access is concerned, a litmus test from an investment point of view is what is done in nontradable sectors, i.e., many services. As mentioned earlier, tradables can be supplied through trade: in these sectors the focus of negotiations should first and foremost be on elimination of trade barriers. What have RIAs achieved in liberalizing access to service markets?

In the EU, there is full freedom to provide services, with the exception of transportation services for which the primacy of national policies was recognized until a common EC-wide regime was established. Little progress was made to do so, with the result that intra-EC competition in transportation services remained limited. In the financial services sector, Article 61 of the Treaty of Rome stated that liberalization was to be effected in step with the progressive liberalization of capital movements—in the absence of progress on the latter, the former was also constrained. Liberalization of the medical and pharmaceutical professions was made contingent upon the harmonization of licensing and certification requirements. Despite rulings by the European Court of Justice in the mid-1970s that, as of the end of the transitional
period (1970), all other services in principle were tradable, differences in national regulations proved to be major barriers to market access.

Much of the Single Market program aimed at integrating EU services markets, and many of the Directives that were issues by the Commission related to specific service industries. For example, the second Coordinating Banking Directive made home countries responsible for prudential supervision (e.g. setting and enforcing liquidity and solvency standards), subject to the requirements of other EC Directives that establish minimum standards in this regard, thereby allowing any credit institution authorized in a Member State to establish branches and provide banking services anywhere in the EU (the so-called single passport). Directives were also developed dealing with investment services, mutual funds, insurance, road and air transport, telecommunications (broadcasting as well as value-added services), professional services (accounting, legal and medical), and the mutual recognition of diplomas related to pharmacy and higher education related to `regulated' professions.

The NAFTA has comprehensive coverage of services activities, and liberalizes both cross-border trade and investment in services. It includes several sector-specific trade liberalizing rules and/or timetables (for financial, telecommunications and transportation services) and establishes work programs on standards harmonization for land transportation (bus, truck and rail services) and telecommunications equipment. A negative list approach is taken towards determining sectoral coverage. All non-conforming measures at both the national and sub-national levels not scheduled within prescribed time limits automatically become null and void. Although Mexico lodged the largest absolute number of reservations, it also undertook significant liberalization commitments in a large number of service sectors. Most transportation
modes—land, maritime and some air services, telecommunications, and financial services are included. Mexico agreed to open up financial markets to international competition over a six-year period, during which market share limits—both aggregate and firm-specific—apply. Thereafter, temporary safeguard provisions may be invoked in banking and securities, but not beyond January 2007, and only if prescribed foreign market shares reach their upper limits.

Services were included in the Australia-New Zealand Closer Economic Relations (CER) trade agreement in 1988. All service sectors were covered except “sensitive” ones such as basic telecommunications, broadcasting, air transport, maritime cabotage and postal services. In 1992 Australia removed its reservations relating to banking and government preferences for Australian companies in construction, engineering and general consultancy. New Zealand removed its reservations for radio and television broadcasting, short-wave and satellite broadcasting, stevedoring and part of the reservation relating to airways services. Subsequently, the two governments agreed to integrate their aviation markets through conclusion of a bilateral agreement.

CER does not include a right of establishment; FDI remains subject to review policies in each country. The common trans-Tasman labor market obviates the need for provisions on temporary entry and the removal of citizenship and/or permanent residency requirements associated with the licensing of service providers found in the NAFTA. The agreement only contained "best efforts" language regarding licensing and certification requirements, which was all that was feasible given the sovereignty of Australian states with respect to numerous licensing

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Moreover, Australia reserved restrictions on establishment of foreign-owned banking branches, subsidiaries or representative offices, as well as legislative limits on shareholdings in Australian banks.
and certification matters. In a 1992 review of the CER New Zealand and Australia committed themselves to exploring the potential benefits of concluding a trans-Tasman agreement applying mutual recognition principles to Australian and New Zealand regulatory standards for goods and occupations. As noted above, negotiations were concluded in 1997.

No specific commitments are made in the Euro-Mediterranean agreements (EMAs) on liberalization of cross-border supply of services (i.e., trade), nor is there a right of establishment. Liberalization in these areas are an objective that is to be pursued in the future. The EMA simply refers to the obligations of each Party under the General Agreement on Trade in Services (GATS). These do not imply much, if any, liberalization (Hoekman and Primo Braga, 1997). Mediterranean countries made very limited commitments under the GATS, subjecting some 6 percent of their service sectors to the national treatment and market access principles, as compared to 26 percent for the EU.\(^8\)

Other RIAs vary in their coverage of services. In the case of ANDEAN, CACM, and SADC, little services liberalization has occurred. In SACU and CARICOM certain service sectors have been integrated more for historic than for deliberate policy reasons. In CARICOM national treatment applies to banking, health, education, tourism and transport services, and many of these services are provided jointly. The G3 is similar to NAFTA, although sectoral coverage is less (e.g., transport remains the subject of negotiation). In MERCOSUR, free circulation of services is a long term objective to be achieved by 2007. Progress towards

\(^8\) The share of the service sector where commitments were made—even if not guaranteeing national treatment and market access also differed substantially. The EU scheduled 57 percent of its services; the Middle East and North African Members of the WTO only 16 percent.
liberalizing service markets has been slow, with members still engaged in a process of negotiating a framework agreement for liberalization in this sector. ASEAN members have until recently restricted services liberalization to the GATS. In 1997 they agreed to attain full liberalization (on a preferential basis in most services by 2020.

With the exception of the EU, in practice it appears that the multilateral GATS process is either leading liberalization of services, or that GATS commitments of RIA members do not differ significantly from RIA commitments. RIAs also do little to effectively constrain the ability of governments to provide incentives for FDI. The most far-reaching RIAs are those involving the EU as a partner. They seek to apply common disciplines in areas such as antitrust, state aids, and state monopolies; indeed, increasingly what appears to be required by the EU is the full adoption of the EC’s internal market rules and the adoption of national legislation that is consistent with EC norms. But the periodic disputes regarding the use of incentives by local governments to attract FDI illustrate that even these far-reaching disciplines are insufficient to defuse tensions. Moreover, recurring claims of “social dumping” reveal that even far-reaching disciplines on subsidies will not be enough to constrain the ability of governments to adopt the regulatory regimes they believe will be most conducive to stimulating investment, be it foreign or domestic.

5. Towards a WTO-based MAI?

Starting in 1995, the OECD initiated talks to create a Multilateral Agreement on Investment (MAI) that would further liberalize investment and establish binding dispute settlement
procedures. Investment has also been proposed as a subject for future WTO negotiations. A recent WTO report on investment in the global economy concludes that:

“WTO members are confronted with a basic policy choice: Do they continue to approach the FDI issue as they have until now, that is bilaterally, regionally and plurilaterally, and on an ad hoc basis through sectoral and other specific WTO agreements; or do they seek to integrate such arrangements into a comprehensive and global framework that recognizes the close linkages between trade and investment, assures the compatibility of investment and trade rules and, most of all, takes into account in a balanced way the interests of all the members of the WTO--developed, developing and least developed alike. Only a multilateral negotiation in the WTO, when appropriate, can provide such a global and balanced framework” (WTO, 1996, p. 59).

With the demise of the OECD-based efforts to negotiate a MAI, it appears that the WTO is the only game in town for those seeking to negotiate general rules on FDI. In this connection RIAs are a second-best instrument, as they may distort the pattern of FDI flows, either by discriminating against investors located in non-members, or by creating incentives for FDI from any source to locate in a specific country. The latter can arise in so-called “hub and spoke” free trade agreements, where a country has a series of bilateral FTAs, but the various partner countries do not have FTAs with each other. In such situations investors may choose to locate in the “hub” country simply because this gives them access to all the “spoke” countries, not because it is the optimal location on economic fundamentals.

Given the possible distortions created by RIAs, if an agreement is to be pursued, this is clearly best done in a multilateral setting like the WTO. A number of WTO agreements already embody or imply disciplines on investment-related policies (see WTO 1996 for a review). A central question, however, is whether the net gains of negotiating an effective MAI under WTO auspices are large enough. Returning to the key issues identified in the Introduction, what would
a MAI do for developing countries in terms of fostering “good” FDI-related policies; in terms of generating better access to foreign markets; and in terms of addressing the potential for negative spillovers due to lack of international cooperation?

Most FDI takes place between high-income countries that have similar factor endowments. The fact that these flows of FDI occurred in the absence of any MAI raises questions regarding the relevance of such an agreement. It could be argued that FDI flows would have been still higher if there existed a MAI. Furthermore, the policy environment across the developed world is on the whole more uniform than it is across developing countries. Thus, the value of implementing common rules governing FDI is potentially higher for developing countries. FDI flows into such countries have increased substantially in the last decade; they now attract some thirty percent of the total (UNCTAD, 1996). It is worth recalling here that what matters in terms of attracting FDI is political stability, geography, an efficient infrastructure, adequate human capital, and liberal trade policies. An investment treaty will do little to attract FDI if these fundamental requirements are not in place. On the other hand, when such conditions do exist, a country’s policy with respect to trade and FDI does not seem to be pivotal. Consider China for example – it has been the biggest recipient of FDI in recent years and it is not even a member of the WTO, let alone subject to international disciplines on investment policies. Large countries such as China will be able to continue attract FDI even if they do not join the MAI and continue to pursue policies that violate national treatment. Of course, the cost of foreign capital may rise at the margin, but it is worth recalling that China
attracted some $130 billion in FDI during 1985-95, the fourth highest in absolute value after the United States, United Kingdom and France (UNCTAD, 1996).

From a national perspective, a MAI may help countries that seek FDI as a signaling device or instrument through which the perceived credibility of a set of policies intended to foster FDI can be enhanced. However, much of what might be embodied in a MAI can be pursued and implemented by a government unilaterally.⁹ Indeed, many countries that are looking for FDI already have done so. For example, great weight was put upon the fact that the OECD effort to negotiate a MAI would include strong enforcement provisions including investor-State arbitration, and the OECD draft agreement required Parties to accept arbitration of disputes under the ICSID, ICC, or UNCITRAL rules,¹⁰ depending on the preferences of the investor (see Baldi, 1996). But any country already has the option of doing this. Indeed, countries that are “in the market” for credibility can use the existing WTO disciplines as well to schedule market access opening policies for services (including granting of the right of establishment), and can also lock in low tariff regimes by binding these under GATT rules. There is still huge scope for developing countries to use the existing WTO as a credibility enhancing instrument if government wish to do so—the coverage of services commitments is very limited, and tariff bindings for merchandise imports are often significantly higher than applied rates.

⁹ Developing countries may for example use the facilities of the Multilateral Investment Guarantee Agency (MIGA), pass legislation that allows investors to invoke the arbitration services of the International Center for Settlement of Investment Disputes (ICSID) and commits the government to abide by such arbitration decisions, negotiate bilateral investment treaties with the major home countries of FDI, etc.

¹⁰ International Center for the Settlement of Investment Disputes (operating under World Bank auspices); the International Chamber of Commerce (which has a Court of Arbitration); and the United Nations Committee on International Trade Law, respectively.
An important question is whether a MAI can help to reduce or offset the political impediments that constrain adopting better policies. To do so, the process of negotiating the MAI must allow issues to be brought to the table that are of sufficient interest to domestic constituencies for them to invest resources to fight for a more liberal FDI regime. Clearly necessary conditions for a government to go down this path is that there are restrictive policies that have proven impossible to eliminate unilaterally, and that there are issue linkages that can break the deadlock. The RIA experience suggests that as far as developing countries are concerned it may not be easy to devise such an agreement; the OECD experience illustrates that limiting attention to investment policies only is a recipe for failure—the agenda needs to be broader to allow tradeoffs and issue linkages.

Increasing access to foreign markets through FDI does not appear to be a priority issue for most developing countries. Here again the question will be what they can gain in other areas from making commitments regarding FDI policies. This is an important issue, and should be the subject of careful analysis by each government.

Finally, turning to the systemic issue (international spillovers), perhaps the strongest argument in favor of a MAI is that it may help avoid mutually destructive policies from the viewpoint of developing countries eager to attract FDI via the use of incentives. In our view, to be effective in this regard a MAI would need to be very comprehensive. It would need to cover investment incentives, taxation, performance requirements, and deal with the discrimination that is created by RIAs. If an agreement is not comprehensive, countries can side-step the disciplines through the use of other policies, including their competition policies. The GATT/WTO negotiating and implementation history illustrates that subsidy disciplines are very
hard to obtain, and are easily circumvented. Even RIAs such as the EU—which go much further than the WTO in this area—have encountered recurrent difficulties associated with government policies intended to attract FDI. NAFTA does not even try to tackle this issue. The recent report issued by the WTO Working Group on investment (WTO, 1998) illustrates that there are widely divergent views on the efficacy and need of incentives. The report also fails to indicate there is any consensus regarding the existence of a compelling case that there are large benefits to be obtained for the trading system (and for individual WTO members) through the establishment of multilateral disciplines on investment-related policies.

6. Concluding Remarks

Competing for FDI via incentives and imposing performance requirements on foreign investors are dubious policies for developing countries. The evidence indicates that fundamental factors such as infrastructure, geography, a labor force with appropriate skills, secure property rights, an effective legal regime and political stability are much stronger determinants of FDI. In principle, a major potential rationale for a multilateral investment agreement is that it can help avoid wasteful competition for FDI. This would be especially beneficial to developing countries since resources are scarce in such countries. However, it is difficult to see how any MAI could impose effective disciplines on the use of incentives. Both the regional and the GATT/WTO experience with disciplining subsidies does not suggest there is great cause for optimism in this regard.

Rationales for a MAI that rest on the role international agreements can play as credibility enhancing instruments are also not compelling, as governments have not used
available instruments to anything close to the full extent possible, and many of the dimensions of a MAI that have been touted in this connection can be employed through unilateral decisions to use existing institutional mechanisms to reduce uncertainty.

Negotiating a MAI may prove useful in arriving at a “grand bargain” that extends beyond liberalization and binding of investment regimes. This is an issue that must be considered carefully, as there may be significant scope for obtaining large returns in other areas as a quid pro quo for participating in a MAI. Indeed, for developing countries the gains associated with international agreements in other areas are likely to far outweigh anything that could emerge from a MAI alone.

In our view priority should be given to the pursuit of “classic” trade liberalization to ensure markets for tradable goods are contestable through exports. This should include efforts to liberalize access to service markets on a nondiscriminatory basis, an area where establishment (FDI) is often crucial. Further nondiscriminatory liberalization of trade barriers for goods and services will also help reduce possible locational distortions for FDI resulting from RIAs. Given that there is already in place a General Agreement on Trade in Services under the WTO that includes establishment as a mode of supply on which commitments can be made, there does not appear to be a compelling case for seeking to negotiate a stand-alone investment agreement.
References


