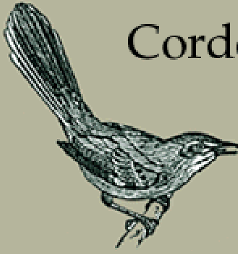

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Trade Policy Analyses

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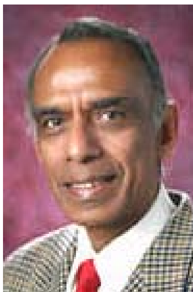
The Cordell Hull Institute's Trade Policy Roundtable met on 29 November 2001, to discuss the WTO system's extension to foreign direct investment.

The meeting convened at the Washington, DC office of Akin Gump Strauss Hauer & Feld LLP, near Dupont Circle (pictured above).



Reproduced opposite is the paper presented by **V.N. Balasubramanyam** (above).

About the Authors

V.N. Balasubramanyam is Professor of Development Economics at the University of Lancaster, England, where he has taught since 1969.

Prior to post-graduate studies in the United States, he was at the

SINGAPORE ISSUES...

Extending the WTO System to Foreign Direct Investment

V.N. Balasubramanyam and David Sapsford

WHEN A GROUP of businessmen in New York asked Prime Minister Nehru about the Indian Government's policy towards foreign investment, he is reported to have looked out of the window and commented on the weather. There is a similar reaction from most influential writers and commentators when it comes to the question of extending the World Trade Organization (WTO) to foreign direct investment.[1]

This is unfortunate not so much because foreign direct investment and its principal agencies, multinational enterprises, are the targets of attack by opponents of globalization on the streets of Seattle, where the third WTO ministerial conference was held, and in London, Genoa and other cities where political leaders have gathered in subsequent years. It is unfortunate more because they are intimately intertwined with trade, especially with international commercial transactions in services. Investment is already subject to rules in the WTO system through the agreements reached in the Uruguay Round negotiations of 1986-94 on trade in services, trade-related investment measures and the trade-related aspects of protecting intellectual property rights.[2]

In the Doha Round negotiations, which were launched at the fourth WTO ministerial conference in Doha, Qatar, in November 2001, the major developed countries wanted investment regulations addressed, along with other "Singapore issues", but this was resisted by developing countries. At the first WTO ministerial conference, held in Singapore in December 1996, working parties were established in investment regulations, competition policies, "transparency" in government procurement and "trade facilitation" (the streamlining of customs administration procedures). At the Doha ministerial it was decided to take up the Singapore issues at the fifth WTO ministerial conference, which was held in Cancun, Mexico, in September 2003, but the conference broke down, the question was put off and in July the WTO General Council decided

to proceed only with trade facilitation in the Doha Round negotiations.

The fact of the matter remains though that trade rules, bearing on the production structures of economies, are about trade-related investment. Sooner or later the investment issue will be taken up in the multilateral trading system. In the meantime, the United States and others are pursuing investment issues at bilateral and regional level.

Why is there reluctance, then, to admit that foreign direct investment belongs in the WTO system and that there is a case for framing a coherent set of multilateral rules on the subject? One explanation is that FDI is doing well, meaning that its volume has been increasing steadily over the years – and that which is not broke should not be fixed. The other explanation is that FDI involves issues of sovereignty – sacred turf, best left untouched. None of this makes sense.

In the absence of a coherent set of WTO rules on foreign direct investment, the liberalization of trade, with which it is intimately involved, will be impeded. And the reluctance of WTO member countries to discuss and debate FDI issues, much of which is scattered throughout the WTO system, will only fuel the flames of opposition to globalization. Such reluctance will be equated with the WTO's culpability in all the supposed sins of globalization. This essay examines the principal reasons for the reluctance to extend WTO rules to foreign direct investment and makes a case for doing so.

Is FDI Doing Well?

The belief that foreign direct investment is doing well is based on the observed growth in such investment flows in recent years. Inflows of FDI amounted to $865 billion in 1999 and the total stock was a sizeable $5 trillion. Save for 1996, annual average rates of growth of FDI flows were in excess of 20 percent, reaching 39 percent in 1998. Indeed, the volume of production of goods and services on account of FDI exceeds that supplied by international trade. Global sales and gross product associated with international production increased faster than global exports and GDP – by 3.2 percent and 4.1 percent, respectively, in the period 1982-99.[3] And much of international trade, around 50 percent, is on account of trade between affiliates of multinational enterprises – what is called intra-industry or intra-firm trade.

Judged by the volume of foreign investment crossing borders, and its relatively high rate of growth, FDI is indeed doing well. But it is a judgment that provokes hostility and opposition. It is doing well by multinational enterprises, but what has it achieved for host developing countries? The problem is that most discussion of FDI is centered on its volume, on the factors that propel these flows

Indian Statistical Institute, New Dehli.

Dr Balasubramanyam has consulted with the World Bank, the ILO and the British Government on foreign investment and has held visiting positions at Harvard, Yale and ANU, Canberra.

David Sapsford is a professor at the Management School, University of Liverpool, England. Prior to this position, he was a Guest Research Professor, University of Innsbruck, Austria.

About the Meeting

The meeting was held soon after the launch of the first WTO round in Doha, in the Gulf state of Qatar, in November 2001.

The Doha Round mandate provided for governments to prepare for negotiations on the Singapore issues – investment, competition, trade facilitation and transparency in government procurement – which working groups were established at the first WTO Ministerial Conference, held in Singapore in December 1996.

Other speakers at the meeting were **Isaiah Frank**, of the School of Advanced International Studies at Johns Hopkins University, Washington, DC, and **Theodore Moran**, of the School of Foreign Service at Georgetown University, Washington, DC.

Trade Policy Roundtable

The Cordell Hull Institute's Trade Policy Roundtable is sponsored by seven international law firms in Washington, DC: Akin Gump Strauss Hauer & Feld, Arnold & Porter,

Hogan & Hartson, O'Melveny & Myers, Sidley Austin Brown & Wood, Steptoe & Johnson and Wilmer Cutler Pickering.

and on ways and means of removing obstacles to its continued growth. The attempt in the Organization for Economic Cooperation and Development (OECD) to negotiate a multilateral agreement on investment, which came to grief in 1997, is a case in point. There were a number of reasons for its demise, including the vast range of topics it attempted to cover,[4] but the main one was the widespread perception that its sole concern was with FDI liberalization and growth.

Foreign direct investment is admittedly a potent ingredient in the development process. It is an acknowledged conduit for the transfer of technology and human skills. It is a purveyor of new ideas. It is a source of capital. Policy makers in most developing countries are aware of FDI's contribution to the development process. Indeed, most developing countries, for a variety of reasons (including the decline in bank credit and aid flows), have eagerly sought foreign investment from major enterprises around the world. Whilst they may not have embraced FDI with open arms, most of them now accept it as "a necessary evil", especially since the collapse of the Soviet empire and the success of the East Asian economies. Even so, the OECD's draft multilateral agreement, which intentionally or otherwise appeared to take the virtues of FDI as holy writ and preached it to the developing countries, was bound to come unstuck.

Foreign direct investment is not a panacea for the development problem. It functions efficiently and contributes to the social product, given certain pre-conditions, among them a stable macroeconomic environment (including price and exchange-rate stability), the presence of distortion-free product and labor markets and the availability of a threshold level of human capital and infrastructure facilities. It is well established that FDI is much more effective in promoting growth and technical change in economies open to competition from both external and internal sources.[5] Furthermore, the rates of growth of economies pursuing a neutral development strategy, those which do not provide artificial incentives for either domestic or export markets, appear to converge on the growth rates of developed countries, whilst the growth rates of economies still pursuing import-substitution strategies appear to show no such convergence. Such convergence is promoted by the efficient utilization of FDI in the countries pursuing a neutral strategy.[6]

In short, foreign direct investment is a superb catalyst of development, but it is not the prime mover. It functions most effectively as a catalyst only in the presence of the right kind of ingredients in sufficient volumes. Very few developing countries, however, are able to provide all those ingredients. It is for that reason that about three quarters of FDI flows to developing countries, around $180 billion per annum in recent years, are concentrated in a dozen countries or so, ones with the kind of environment that investment requires.

Thus the claims that "FDI is doing well" send mixed messages. It is doing well, judged by the growth in its volume; and it is doing well in developing countries that are well placed to provide the environment it requires. But FDI is also doing well in a number of countries that provide an array of artificial and transient incentives such as tax concessions and subsidies of various sorts. In these countries, it is doing well in the sense that private rates of return to investment are relatively high, but its contribution to the social product is at best marginal and at worst negative. It is true to say that FDI responds to market forces, but if the markets are distorted its response is not the sort that augments the development objectives of recipient countries.

Should governments then rest contently in the knowledge that FDI is a rich-country good, as it were, and is of little significance for the many developing countries that either receive insignificant amounts of FDI or, from a social point of view, squander what little they do receive? The "do nothing" philosophy suggests as much. More to the point, would a multilateral agreement on investment under the aegis of the WTO facilitate the utilization of FDI in promoting the development objectives of developing countries, especially the objectives of those that now receive relatively low FDI volumes? This can be dismissed as a tall order.

All the same, a framework of multilateral rules that removes or delimits various kinds of distortions in product and factor markets, and improves the investment climate in general, should go a long way in promoting the efficacy of foreign direct investment. It should also provide the least developed countries with an opportunity to compete for increased FDI flows. It could be argued, though, that the development of poor countries is not the WTO's mandate, explicit or otherwise. In fact, its implicit mandate, strictly speaking, may not even be the liberalization of trade and investment, but the promotion of a stable institutional environment through rules-based trade and trade-related investment. Surely this would be defeatist.

Promotion of rules-based trade or multilateralism is a means to an end, the end being the economic growth and development of the participating countries, especially that of countries where peoples are suffering. Whatever the legal nuances and interpretations of the WTO mandate, the pursuit of liberal trade polices or multilateralism is not just an end in itself. There is a voluminous literature that attests to the benign impact of liberal trade policies on economic development.[7] Advocacy of a WTO agreement on foreign direct investment should not be grounded, or seen to be grounded, in the objective of paving the way for unrestrained FDI flows. An agreement on FDI has to take on board "the impact of FDI" issue and not just ways and means of expanding the volume of investment that crosses borders.

Sovereignty Issue

Any type of commercial transactions between two or more distinct jurisdictions give rise to issues of sovereignty, broadly defined as the legitimate right of one jurisdiction to protect its citizens against encroachment by others on their general interests, as opposed to sectional or "special" interests. The colorful controversies over free trade in Britain during the nineteenth century and the debates there on Imperial Preference during the early part of the twentieth century involved issues of sovereignty. Admittedly, issues related to the protection of indigenously owned factors of production against competition from foreign-owned factors of production are much starker, principally because of the presence and establishment of foreign-owned factors of production within the borders of the host country.

In the case of foreign direct investment, foreign firms are intimately involved in the operations of the local economy, which is not the case with trade and licensing agreements. When the scale and size of operations of the foreign-owned or controlled entity and its endowments of money and skills are relatively large, as with affiliates of multinational enterprises, its involvement in the local economy is conspicuous and perceptions concerning its threat to the political and economic sovereignty of nation states are heightened.

Such fears were routinely expressed during the 1960s and 1970s when both the advocacy and opposition to foreign direct investment went to extremes. Those debates, though, were not entirely vacuous. They resulted in a substantial body of academic research that served to identify the costs and benefits of FDI and sift the emotion-ridden arguments from those based on facts.[8] The studies also served to allay the fears of developing countries at a time when, for reasons stated earlier, they were being compelled to turn increasingly to FDI for their requirements of capital, technology and know-how.

The old debates have re-surfaced in recent years in the context of "globalization" (the catchword covering the integration the world economy), with multinational enterprises and foreign direct investment being the targets of attack from the anti-globalization brigade. These are not confined to the slogan-mongering protesters against globalization. Academics, too, have pitched in. Alas, there is nothing new in the arguments deployed, for they are just old wine in new bottles.

(a) The familiar refrain is that multinationals are big, their sales exceed the GDP of some African countries, there are no "trickle down" effects, multinationals pay abysmally low wages and the freedom of policy makers in developing countries is increasingly constrained by the need to cater to the interests of big business.[9]

> (b) The *riposte* to these arguments from the pro-globalization lobby is equally familiar. The relevant statistic to assess the size of multinational enterprises relative to that of the countries in which they operate is not their global sales, but their value added. Multinationals pay higher wages than comparable locally owned firms in developing countries. And it is the electorate, not the multinationals, which dictate the tax and expenditure policies of nation states.[10]

The different camps can produce facts and figures in support of their contentions. But these academic jousts do little to progress the debate. There is ample scope to do so, given that even the most caustic critics of FDI concede the potential of FDI to promote development objectives, broadly defined to include the transfer of technology and skills and the creation of employment opportunities with adequate remuneration. The dispute relates to the reasons for the failure of foreign direct investment to deliver much more than what it has done. Noorena Hertz, of University of Cambridge, a critic of globalization, sums up the issue when she writes:

> "[T]he point is not that inward investment cannot make people of recipient countries better off. It is why there is not a bigger 'trickle down effect'. Why is globalization – to quote James Wolfensohn, head of the World Bank – 'not working at the level of the people?' Why has the number of people living on less than $1 a day increased in every developing country outside East Asia."?

Dr Hertz's answer to the question she poses is that the political process, captured by big business, is unable to protect the interests of the public realm. This may be so, but is it because politicians and policy makers are captured by corporate giants? Or is it because the political process in most developing countries is flawed for reasons that have nothing to do with the multinationals? How come, on Dr Hertz's own admission, the East Asian countries are able to reduce levels of poverty and prosper, whilst the others are not able to do so? It may be far fetched to argue that democracy thrives in most East Asian countries and hence their acknowledged success in combating poverty and promoting development goals.

The fact of the matter is that policy makers in these countries have instituted the kind of policies that not only attract sufficient volumes of FDI but also promote its efficient utilization. The benefits of FDI can hardly trickle down if countries are unable to attract sufficient volumes in the first place and fail to utilize efficiently whatever they attract. As the British economist I.M.D. Little wrote several years ago, "FDI is as good or as bad as your policies".

None of this is to say that multinational enterprises are entirely blameless in all they do. Admittedly wage rates paid by

multinationals in certain areas of activity in some developing countries are abysmally low. Indeed, they do seek low-wage locations for many of their processing activities. But why do multinationals get away with paying abysmally low wages in certain countries but not in others? Here again it is the failure of policy, or the absence of it, that allows profit-maximizing multinationals to take advantage of low-wage labor.

Countries that have failed to institute trade and investment policies designed to create jobs and employment opportunities are also the ones that seek low-wage jobs from multinationals. If the opportunity cost of labor is negligible in these countries, it is the overall framework of economic policy that is to be "blamed", that provides the explanation. There is little point in railing against multinationals for seeking low-wage locations. It is wishful thinking to expect profit-maximizing firms to behave as social service agencies, especially when the domestic market environment is riddled with distortions. Low-wage locations, such as the "export processing zones" in some countries, are no more than a feeble attempt by governments to offset distortions elsewhere in their economies.

All this is familiar landscape dating back to the 1970s. The concern today is with the efficient utilization of foreign direct investment in the promotion of national economic objectives whilst preserving the economic sovereignty cherished by nation states. What is the nature of the threat to their sovereignty from the operations of foreign-owned firms that developing countries perceive? This perception of loss of economic sovereignty differs between various influential groups in the host countries.

Raymond Vernon, the American trade official who, in a second career at Harvard University, became in his time the leading international authority on the operations of multinational enterprises, identified three influential groups in public discussion of foreign direct investment: the government bureaucrats, the local businessmen and the elite sections of opinion.

(a) The *bureaucrats* perceive a threat to their power and control over the local economy from the operations of foreign firms. As Vernon put it, "the indigenous bureaucrats are torn between two powerful needs. At times, they have felt the need to safeguard the companies from the untenable demands of their colleagues, in order not to kill the egg-laying goose; at other times, they have felt the need to take a leading role in extracting added benefits from the companies in order to strengthen their claim to continued power ".[11]

(b) The stance of the *local businessmen* has changed over time. With the growth in their ability to compete with foreign firms they have attempted to cut back the scope of foreign

firms. Those businessmen, however, whose activities complement that of the foreign firms, seem to tolerate the presence of foreign firms, if not actively encourage their growth.

(c) The *elite* is a complex group, consisting of those who are opposed to any form of private enterprise (be it foreign or domestic), those who wish to determine the limits of dependence on foreign firms and those who see foreign firms as a part of the Establishment and a threat to their power and influence.

For the most part, the game plan of the bureaucrats is to voice their concern and opposition to foreign firms in public fora, but in private negotiations with foreign firms recognize their contribution to development objectives and seek ways and means of attracting foreign direct investment. Businessmen, in general, lobby for stringent regulation of foreign firms where they perceive them as a threat; and where they see them as an aid to their power and profits, they seek joint ventures and other avenues of rent sharing. The elite does what they do best, position themselves as critics of foreign firms in the media and provide intellectual support to activists, such as non-governmental organizations.

The attitude and perceptions of the bureaucrats and local businessmen in general towards foreign firms are not entirely unreasonable. At the heart of the matter is the control over operations that multinationals exercise. Economic sovereignty is all about delimiting the control over operations or power over decision making which foreign firms exercise. The name of the game is to extract the maximum possible gains from the operations of foreign firms without killing the goose that lays the golden egg. And if the goose does threaten their interests, it is natural to attempt to circumscribe its sphere of activity. Control over operations is one of the essential features of foreign direct investment.

It is this aspect which theories of the multinational enterprise style as the ability of the firm to internalize operations or bypass the market. And it is internalization that enables the enterprise to preserve and exploit the so-called ownership advantages it possesses. It is again the ability to internalize and exercise control over operations that the multinational enterprise to transfer technology and "know how" across borders efficiently. But it is internalization that creates tensions between multinational enterprises and host countries. Internalization or the exercise of control over operations and ownership of production facilities by foreign firms is perceived as a threat to their sovereignty by the developing countries.

In other words, they face a trade off between increased gains from FDI to the host economy and loss of economic sovereignty, as they perceive it. But any dilution of control over operations limits the

efficiency of operations of foreign firms. The higher the degree of control they cede to local interests, by conforming to the rules and regulations imposed on them, the less is their ability to transfer technology and know how to the local economy. Here the trade off the foreign firms face is between the loss of control over operations and efficient operations. Multilateral rules governing FDI should assist in arriving at a compromise and resolving the dilemma that both groups face.

The problem arises when the interests of the bureaucrats and the businessmen do not coincide with national objectives. If they are intent on safeguarding their private profits and their power base at the expense of the social good that foreign firms, given the appropriate climate, are capable of promoting, they play into the hands of ideologues and the elite. Their actions and the policies they advocate and institute may do more harm than good. It is this group of businessmen and bureaucrats who, seeing a threat to their power and profits from foreign firms, play the sovereignty card for all it is worth.

The posturing takes a number of forms. Foreign direct investment involves issues of sovereignty and therefore nothing should be done. Or whatever is done must be gradual. Or "the time is not ripe" for dealing with the issue. These all fail to identify the specific problem that should be addressed, which is that entrenched interest groups invoke sovereignty as an excuse to preserve and perpetuate their interests. In the name of sovereignty, they institute rules and regulations that impair the efficient operations of foreign firms, determining the limits of their contribution to the social product. The challenge is to identify and eschew policies designed only to promote the narrow self-interest of these groups and to devise rules and regulations that promote efficient operations of foreign firms, which in turn bestows on the host economy the maximum possible gains from their operations.

What of the elite and their perceptions? They have to be accepted as a fact of life. At best, they may serve the purpose of engineering a reasoned debate; and at worst, they continue to muddy the waters.

The issue of sovereignty, as interpreted here, is one that will not disappear in time. It is an inescapable fact that is likely to grow in complexity with the growth of globalization. But if one were to shy away from formulating a compact on FDI, because it involves issues of sovereignty, it would only strengthen the hands of the ideologues and weaken the efforts of those who wish to utilize FDI efficiently in the promotion of development objectives.

A Multilateral Framework of Rules

The task of devising multilateral rules on foreign direct investment under the aegis of the WTO is much more complex than devising

multilateral rules on trade. All the same, the gains from such a compact are likely to be substantial, both for the recipients and for FDI providers. The problem is that any suggestion of such a compact is immediately seen as one-sided, a set of rules designed to pave the way for unrestrained flows of capital from the developed to developing countries. So the framework of rules should recognize the concerns of developing countries, principally the dilemma they face, as discussed earlier, and shift the emphasis away from the objective of easing the passage for multinational enterprises.

Before discussing the form and nature of the compact, which is likely to be acceptable to the recipients of foreign investment, especially the developing countries, several objections to its inclusion on the WTO agenda require discussion.

The first of them is that the WTO is not the appropriate forum for framing a compact on FDI because its mandate does not extend to investment. It is concerned with trade. This was one of the objections to the inclusion of services on the GATT agenda. This has no basis in fact because a substantial proportion of world trade is on account of multinational enterprises. In 1999, exports of foreign affiliates of multinationals accounted for more than 45 percent world exports, totaling about $7 trillion. If rules can be devised for trade, there is no reason why they should not be extended to the entities that generate trade. The latter is unlikely to flourish in the absence of the former. It is established that trade and FDI are complements for one another and not substitutes. A set of rules that facilitate both the flows of FDI and its efficient operations is more than likely to promote the growth of trade.

In any case, trade and investment in the services sector are on the WTO agenda and, except in the case of so-called long-distance services, efficient delivery of most services requires the presence of the producer in the locale of the consumer. Here production and trade are coterminous. More often than not the presence of the service producer in the locale of the consumer is established through foreign investment. Again, the Agreement on Trade-related Investment Measures (TRIMs), a product of the Uruguay Round negotiations, is about the policies of host countries towards foreign firms. Trade-related investment measures have an impact on the production decisions of foreign firms, including the sourcing of inputs. Admittedly, the justification for the inclusion of TRIMs in the WTO is that all such measures, at one remove or the other, have an impact on trade. But then there are very few policy measures that do not have an impact on trade in one way or the other. To repeat, foreign direct investment in one form or the other is already being addressed in the WTO system, but the regulations relating to it are haphazard and scattered throughout in agreements relating to services, TRIMs, subsidies and government procurement.

What can a compact on foreign direct investment achieve? As argued earlier, the twin objectives of the compact should be to

(a) provide access to FDI for developing countries that receive relatively low volumes and

(b) help resolve the economic sovereignty dilemma the developing countries face in utilizing FDI.

The first of these requires not only increased volumes of FDI in toto but also much more widespread distribution of FDI than that prevails now. Both of these objectives, especially the second one, essentially involve creating competitive market conditions that foster efficient operations of foreign firms.

The first of the objectives poses much more of a challenge than the second. The literature on the determinants of foreign direct investment identifies (i) macro-economic stability, including exchange-rate stability, distortion-free product and labor markets that allow for the play of comparative advantage in resource allocation, (ii) a stable policy framework and (iii) resource endowments, including a threshold level of human capital. No compact on FDI, however ingenious it may be, can promote macro-economic stability or the provision of human capital. These belong to domestic policy in the host countries.

A compact on foreign direct investment, though, may serve to promote the establishment of a stable policy framework and the elimination of distortions in product and labor markets. There is a strong suggestion in the literature that when foreign firms seek political stability, what they look for is policy stability. In fact, economic stability may more often than not promote political stability. Here the enshrined principles of the WTO relating to trade, notably most-favored-nation treatment, transparency and national treatment, may serve to promote policy stability. Non-discrimination between differing FDI providers, explicit regulations that are agreed and bound and the guarantee that there would be no discrimination in the policy framework between foreign and local firms should achieve the policy stability that foreign firms seek.

Some of these factors relating to determinants also influence the efficient utilization of FDI, which in turn are intimately related to the economic sovereignty issue, as discussed earlier. The first of these is the presence of distortion-free markets, defined as markets where prices of factors of production and products reflect social opportunity costs. In most developing countries, especially those that receive relatively low FDI volumes at present, there are pervasive distortions in factor and product markets. These last arise from tariffs and quotas on trade, stringent labor laws designed to protect jobs or, more specifically, appease labor unions (as in the case of India), and assorted subsidies including

export subsidies. It is now the received wisdom that such distortions do not attract large FDI volumes and that which is attracted, such as the tariff-jumping type, serves to bolster rents and the private returns to foreign investments. And they also impair efficiency of operations.

What can a set of multilateral rules achieve to reduce if not eliminate these distortions? To the extent agreed rules pertaining to trade serve to lower artificial barriers to trade, they also serve to reduce product-market distortions. Especially relevant in the context of FDI are trade-related investment measures, which encompass not only local-content requirements but also equity regulations tied to exports and so-called incentives such as tax holidays, tax concessions and assorted subsidies. The economic sovereignty issue is also bound up with TRIMS. This complex beast is supposed to serve several objectives: garner the maximum possible benefits from the operations of foreign firms to the host countries, satiate the desire of bureaucrats to retain power and control, provide local businessmen with a complementary role in the operations of foreign firms and, in some cases, protect locals firms from foreign competition.

In other words, these measures ostensibly allow host countries to exercise economic sovereignty over the operations of foreign firms. In some cases, TRIMs are also designed to offset policy-induced distortions elsewhere in the economy. Export subsidies and equity regulations tied to exports are an attempt to offset the attractions of a protected domestic market and so, too, are the export-processing zones pervasive in many developing countries.

TRIMs were included on the Uruguay Round agenda on the grounds that they had an impact on trade. Initially, there was a push by the United States to negotiate multilateral rules on international investment, but this was resisted by developing countries and so they settled for a codification of existing GATT rules. So the Uruguay Round accord on TRIMs relates to local-content requirements and incentives such as tax concessions tied to exports. Domestic regulations in both areas violate the principle of national treatment, laid down in GATT Article III, and the prohibition of quantitative restrictions, laid down in GATT Article XI. Thus the TRIMs Agreement reaffirms the need for WTO member countries to conform to GATT rules within a specified period.

But the TRIMs Agreement was no more than a Pyrrhic victory. It only addresses local-content requirements and export obligations. It has nothing to say about other trade-related investment measures such as the subsidies and tax incentives that host countries offer foreign firms. Nor does it include regulations relating to employment of nationals and the requirement of some developing countries that foreign-enterprise participation has to be in the form of joint ventures with locally owned firms. The

agreement is much weaker than the one concluded in the North American Free Trade Agreement (NAFTA). Even so, the fact that an agreement of sorts was reached in the Uruguay Round negotiations, one involving developing countries, was a major achievement.

How best to build on what was achieved? A multilateral framework on foreign direct investment would inevitably reopen the issue of TRIMS. The developing countries would seek ways and means of preserving their economic sovereignty, as discussed above, and are unlikely to consent to a blanket ban on all TRIMS. But then any suggestion that each and every TRIM should be assessed for its trade-distorting effects, as was proposed by the developing countries in the run up to the Uruguay Round negotiations, would only serve to muddy the waters. The case-by-case approach, so dear to the hearts of bureaucrats, would only result in protracted negotiations, delay and red tape.

The alternative would be to formulate general rules designed to preserve those aspects of TRIMs that do promote development objectives. Instead of imposing a ban on all local-content requirements, developing countries could be allowed to require foreign firms to increase gradually their purchases of locally produced components over time. This would allow foreign firms time to search for indigenous suppliers and impart the technology required to such suppliers. In any case, most multinational enterprises would seek indigenous sources of supply of components, rather than incur heavy transport costs that imports involve, especially so if the former are cost competitive. The problem they face is the heavy search costs of locating competent local suppliers. Local-content requirements would act as a catalyst for the search process.[12]

Faced with local-content requirements in several of the host countries, Japanese firms have established competent suppliers in the automobile industry. The model they have adopted in India, in the case of the Maruthi car project, provides a good example of how trade-related investment measures can serve development objectives. The Japanese firm Suzuki contracts out a supply of components to local suppliers, provides them with the blueprints and required know-how and stipulates that the price paid for the components would be reduced over a specified time period to that prevailing in international markets. This scheme nourishes the infant suppliers with all that they need to grow up, but if they fail to do so, within a reasonable period of time, they are allowed to die.

This scheme is similar to the one endorsed by the WTO following the Uruguay Round Negotiations in 1995 that allowed developing countries five years, and the least developed countries seven years, to dismantle TRIMS in toto. Instead of requiring that all TRIMS should be dismantled, it suggests that they be allowed to

be geared to promoting development objectives, but with a time constraint.

TRIMS such as those that tie equity participation to exports are much more problematic. They are imposed for narrow balance-of-payments reasons and not for broader development objectives. In the presence of distortion-free markets, comparative advantage and market forces would guide the investment allocations of foreign firms. Equity-oriented export requirements are put in place to offset distortions elsewhere in the economy and provide artificial incentives for production oriented towards domestic markets.

These restrictions hardly fulfill development objectives. A foreign firm that does not wish to comply with equity restrictions may dilute its equity in favor of indigenous suppliers and opt to produce for the protected domestic market. And indigenous capital, whose social opportunity costs could be considerable, will also be oriented towards the protected domestic market. The net result is the creation of rents in protected markets for both the foreign-owned and the domestic-owned firms. And it would also result in a reduction in trade.

There are also instances where foreign-owned firms are allowed 100 percent ownership of equity if their entire output is exported. Suppose that export prices are lower than those prevailing in domestic markets and the foreign firm services both markets. In that case the foreign firm operating in the protected domestic market would have an incentive to bridge the price difference between the two markets by raising prices on the domestic market. In essence domestic consumers would provide an export subsidy to the foreign firm. All this and other distortions and social costs that these measures impose have been rehearsed often.[13] These are not measures that promote development objectives and have no place in a compact on foreign direct investment.

Then there are assorted incentives offered by developing countries to attract foreign investment. These include tax holidays, tax concessions and subsidies of various kinds. Most of them are tied to performance requirements of one sort or the other. It is doubtful if they weigh heavily in the investment decision-making process of foreign firms. The evidence on the issue is not conclusive. Developing countries may be compelled to offer such incentives only because their competitors offer them. If none of the countries offer such incentives, the location decision of FDI would be based on the resource endowments of host countries and the climate for efficient operations they provide. Given the nature of these incentives, and the fact that each of the host countries offer such incentives only because others do so, it is likely that they are yet another source of distortions in the market for FDI. It would be in the interests of developing countries to do way with

such incentives that only serve to transfer incomes to foreign firms. At the very least, they should consent to a set of WTO rules that would limit the distortions that incentives generate and eliminate competition between developing countries based on artificial incentives.

Although local-content requirements, equity and export regulations and investment incentives are frequently seen as instruments devised to transfer rents from multinational enterprises to host countries, they often extend into other areas such as competition policy. Regulations that limit the operations of foreign firms to designated regions and areas of host countries prohibit them from entering designated areas of economic activity and stipulate conditions governing joint-ventures, acquisitions and mergers all fall into the arena of competition policy. These policies go beyond the objective of transferring rents from multinationals to host countries. Here the objective is the preservation of economic sovereignty or the retention of national control over production facilities.

This is the principal issue that policy makers are reluctant to discuss and opponents of globalization like to emphasize. Admittedly debate on these issues cannot be confined to narrow economic considerations such as their impact on resource allocation and economic efficiency of operations of FDI. The concerns of the developing countries have to be heard and rules and regulations devised with a view to preserving the economic sovereignty of developing countries. Whilst exceptions to the general principles of national treatment may have to be conceded, there is no reason why such policies should not be subjected to rules relating to transparency and stability of policy regimes.

In developed countries, such as Britain, there are tried and tested procedures for the adjudication of disputes concerning mergers and acquisitions, including cross border mergers and acquisitions. Cases referred to the Competition Commission in the United Kingdom are adjudicated on the basis of the impact of mergers on consumer interests and, lately, on whether they interfere with competition in the market place. Admittedly when the concern of the policy makers is not so much with consumer interests or with the impact on competition, but with loss of control exercised by national governments over the operations of foreign firms, the problem is much more complex. In such cases, exceptions to the general framework of rules governing FDI have to be allowed, albeit in the knowledge that host countries may be sacrificing economic objectives for the sake of non-economic objectives.

It is worth noting, though, that much of the FDI flows to developing countries are for green-field investments, cross border mergers and acquisitions are, as yet, very much a developed-country phenomenon. Mergers and acquisitions of locally owned firms by foreign firms account for around one-third of all FDI flows to

developing countries. These are mostly in East Asia and the Latin American countries. Some developing countries, such as Malaysia and Korea, have guidelines on mergers and acquisitions, but some read much like local-content requirements. It is worth considering whether a generalized framework of regulations on mergers and acquisitions, as opposed to individual country regulations, would be more effective in promoting both increased flows of FDI to developing countries and efficient utilization.

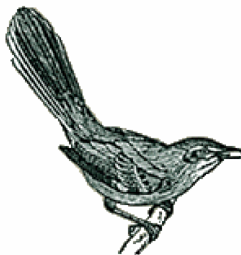
It is further worth noting in this context that the General Agreement on Trade in Services (GATS), which is essentially an agreement related to foreign direct investment, since services necessarily entail presence and establishment, provides a framework for a multilateral agreement on foreign direct investment more generally. The GATS takes account of many of the concerns of developing countries whist, at the same time, subjecting trade in services to Most Favored-Nation (MFN) treatment, national treatment, market access and transparency.

Perhaps the next step would be to extend GATS to cover foreign direct investments in other sectors. In the past, suggestions for a separate agreement on FDI have been made but it may be judicious to aim at one cohesive set of rules and regulations on FDI that encompasses the GATS accord. The new set of rules to be incorporated could include TRIMS and other national regulations relating to FDI discussed earlier. It would be neither necessary nor practical to establish a separate framework of rules for foreign direct investment when one already exists in the form of GATS framework.

Conclusion

This brief essay has argued the case for an agreement on foreign direct investment in the WTO system. It rejects the argument that the WTO is not the forum for such an agreement on the grounds that FDI is already very much a part of the WTO system in the form of the GATS, TRIPs and TRIMs agreements. Furthermore, much of international trade that the WTO oversees is generated by foreign direct investment. It makes little sense to deny that which already exists in the WTO system. But that which exists is patchy and haphazard. The various agreements do no more than tinker at the edges of the problem. A coherent compact that incorporates TRIMS and GATS under one umbrella should be much more efficient and manageable than that which exists.

The argument that FDI is doing well by market forces cannot be sustained. It may be doing well in terms of the steady growth in the volume of FDI, but it is unevenly distributed among the developing countries and there is no reason to believe that it contributes to development objectives everywhere and anywhere. It is an excellent catalyst of economic growth, has the potential to be a major force in economic development and is perhaps the one



The **mockingbird** is the state bird of Tennessee.

Cordell Hull represented a district of Tennessee in the Congress of the United States, and was elected a senator from there, before becoming U.S. Secretary of State (1933-44).

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and only tested and tried conduit for the transfer of technology and managerial know-how. But it falls far short of its full potential for reasons outlined in the paper. A compact on FDI under the aegis of the WTO should create the necessary investment climate for FDI to fulfill its full potential.

The arguments that FDI involves issues of sovereignty and therefore a multilateral framework should not be discussed, or that the time is not yet ripe, does not hold water either. Any sort of international commerce involves issues of sovereignty. It is unavoidable and the time will never be ripe. The ostrich can't bury its head in the sand forever. The issue has to be addressed head on.

The essay has argued that economic sovereignty can be interpreted in many ways and there is more than one group in developing countries for which the issue is of interest. The challenge the developing countries face is one of a trade off between economic sovereignty and the fruits that FDI yields. A compact on FDI on the lines suggested in the essay should help resolve this trade off to a large extent.

Finally and most importantly any attempts at forging a compact on FDI based on the thesis that it would facilitate increased flows of FDI and protect the interests of multinationals are unlikely to succeed. The agreement, or the argument for an agreement, has to be couched in terms that reflect developing-country interests, recognizes the trade off between sovereignty and gains from FDI they face and emphasizes the potential of FDI for development. A blanket ban on TRIMS will not be acceptable to developing countries; nor should a discussion on TRIMS be confined to those TRIMS that impact on trade. The discussion has to be centered on the role of TRIMS in promoting development objectives including rent transfers to developing countries from the foreign firms. Any of the TRIMS that do not satisfy these criteria, irrespective of their trade effects, have to be abolished. In any case, with the growth in the liberalization of international trade, the rationale for TRIMS will fade. Most TRIMS are in existence to counter factor-market and product-market distortions caused by trade policy in developing countries. The compact on FDI should explicitly recognize the interdependence between trade and FDI and this is the most powerful rationale for a compact on FDI under the WTO. Forging multilateral rules on FDI will extend the WTO beyond the traditional role of the rules-based multilateral trading system, but such is the nature of the beast that a wider role for the WTO system has to be accepted.

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[1] At the first WTO Ministerial Conference, held in Singapore in December 1996, a working group was established to explore the question.

[2] An earlier version of this essay was presented at an international conference on International Institutions and Development, University of Innsbruck, on 7 November 2001.

[3] *World Investment Report, 2000* (New York and Geneva: United Nations, 2001).

[4] David Henderson, *The MAI Affair: a Story and its Lessons*, Pelham Paper No. 5 (Melbourne: Melbourne Business School, 1999), later published by the Royal Institute of International Affairs, London, the Groupe d'Economie Mondiale, Institut d'Etudes Politiques de Paris, and the Brookings Institution, Washington, D.C.

[5] V.N. Balasubramanyam, David Sapsford and Mohammed Salisu, "Foreign Direct Investment and Growth in EP and IS Countries", *Economic Journal*, Cambridge, Vol. 106, 1996.

[6] Kyriaki Silverstraidou and Balasubramanyam, "Trade Policy, Foreign Direct Investment, and Convergence", *Review of Development Economics*, Oxford, Vol. 4, No. 3 , 2000

[7] David Greenaway and David Sapsford, "What Does Liberalisation Do for Exports and Growth", *Weltwirtschaftliches Archiv*, Kiel, Vol. 130, No. 1, 1994.

[8] Surveyed at the time in Alasdair I. MacBean and Balasubramanyam, *Meeting the Third World Challenge*, second edition (London: Macmillan, for the Trade Policy Research Centre, 1978), ch. 8.

[9] Noreena Hertz, "Decrying Wolf", *Prospect*,London, August-September 2001 (reply to Martin Wolf, "The Infantile Leftist", *Prospect*, July 2001, review of Noreena Hertz's book, *The Silent Takeover*; *Global capitalism and the Death of Democracy*, Heinemann, London 2001).

[10] Martin Wolf, *op. cit.*

[11] Raymond Vernon, *Sovereignty at Bay* (Hamondsworth: Penguin Books, 1971).

[12] Balasubramanyam, "Putting TRIMs to Good Use ", *World Development*, London, Vol.19 No. 9, 1990.

[13] David Greenaway, "Trade Related Measures and Development Strategy", *Kyklos*, Basle, Vol. 45, No.9. 1992.