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MULTILATERAL DISCIPLINES AND NATIONAL INVESTMENT POLICIES

In the past 50 years, little has been done to negotiate multilateral disciplines on policies that affect factor movement. With the exception of the General Agreement on Trade in Services (GATS), there are no disciplines in the WTO on policies pertaining to labor and capital movement. Some WTO members have argued that there is a need to negotiate multilateral rules for investment policies, such as the right of establishment and national treatment for foreign investors. In part, these arguments have to do with market access objectives. In many sectors the preferred mode of supplying a market may be through foreign direct investment (FDI), not exports. If FDI is restricted by the host country, foreign firms have an interest in rules that enhance or guarantee their market access. Another line of argument emphasizes the potential payoffs to developing countries of signing on to multilateral rules as a commitment device—as a mechanism to implement rules that governments want to adopt but are constrained from adopting because of political-economy factors (Markusen 2001; Moran 1998). Yet another rationale for considering rules in this area is to ensure that investment policies do not distort the mode of supply choice of firms (Feketekuty 2000; Low and Mattoo 2000). For developing countries, a policy of great interest in this regard is locational subsidies (tax concessions) offered by high-income country governments to attract or retain FDI.

Bora, in Chapter 19 in this volume, discusses the implementation of the Agreement on Trade-Related Investment Measures (TRIMs) negotiated in the Uruguay Round. This agreement basically prohibits measures that are inconsistent with the GATT's national treatment principle (Art. III GATT) and its ban on the use of quantitative restrictions (Art. XI GATT). The GATS goes further by including establishment and national treatment for investors as commitments that signatories may decide to make for specific services industries. An important issue for WTO members is whether to extend the trading system through general rules regarding investment policies, and, if so, what form such rules might take. The 1996 WTO ministerial meeting in Singapore led to the creation of a working group on trade and investment with the mandate of examining the relationship between trade and investment policies. At the 2001 ministerial meeting, in Doha, agreement was reached to initiate negotiations on investment policies at the 2003 WTO ministerial meeting, if consensus exists on the modalities of such negotiations.

This chapter surveys the main arguments that have been suggested for why developing countries should support the creation of a multilateral agreement on investment. As in other areas, the answer may vary depending on country circumstances. A key challenge from a developing country viewpoint is to ensure that any agreement on domestic disciplines makes sense from the perspective of the national development strategy and that disciplines extend to policies that are harmful to developing countries.

A basic question is to identify the problem that international cooperation is supposed to resolve. It is important to bear in mind in this connection that the value of sales by foreign affiliates of multinationals has been growing rapidly, driven in part by declines in communication and transport costs and by unilateral actions in many countries to privatize state-owned enterprises and liberalize FDI regimes. Eagerness to attract FDI is reflected in the use of fiscal and financial incentives to investors and in the proliferation of bilateral investment treaties (BITs). UNCTAD reports that as of 2000, over 1,600 BITs had been negotiated, as against 400 at the beginning of 1990.

Conceptual Issues

Economic theory dictates that in the absence of domestic market failures and externalities, the optimal FDI policy ought to be no policy at all—that is, governments should allow for unfettered market transactions. A rationale for restricting FDI depends on the presence of domestic policy distortions or market failures. Since multinational firms typically arise in oligopolistic industries, the existence of imperfect competition is a possible motivation for intervention by host country governments. Multinational firms wield considerable market power and will typically use it to extract rents from the host economy. Theoretical analyses of content protection and export performance requirements under conditions of imperfect competition (Rodrik 1987; Richardson 1991, 1993) illustrate that the welfare effects of such policies can be positive under certain circumstances. In most situations, however, more efficient instruments than investment measures can be identified; for example, vigorous competition policies are better suited for encouraging competition (Bora, Lloyd, and Pangestu 2000).[1] Whatever the rationale of restrictive policies, the available empirical evidence suggests that local content and related policies (on transfer of technology and joint ventures) are ineffective and costly to the economy (Moran 1998).[2] Furthermore, protected industries may create problems for future liberalization because they have an incentive to lobby against a change in regime. In such a scenario, an international agreement may help overcome resistance to FDI liberalization by protected industries.

In addition to trade-related investment measures, many countries apply licensing and approval regimes and impose related red tape costs on foreign investors. They may also prohibit entry through FDI altogether or may impose equity ownership restrictions. Such policies may reflect welfare-enhancing attempts to shift foreign profits to the domestic economy, or welfare-reducing rent-seeking activities by domestic industries or government bodies. (See the section and readings on FDI in the CD-ROM that accompanies this Handbook.) The TRIMs agreement does not apply to such non-trade-related policies, nor does it affect service industries. The latter, however, are covered by the GATS. As mentioned, the GATS extends to FDI policies, in that countries can make specific market access and national treatment commitments for this mode of supply for any or all services.

The current situation suggests a number of questions. What is the payoff to seeking general investment rules, as opposed to expanding the coverage of the GATS? Much can already be achieved via the GATS, as the agreement includes FDI as a mode of supply, and services tend to be subject to higher FDI restrictions than do manufacturing sectors. How significant are existing barriers to entry through establishment (FDI) in nonservices sectors? What is the effect of these barriers? Taking into account that restrictive FDI policies can be eroded in tradable industries by contesting the market through exports, what is the relative payoff for trade liberalization compared with investment liberalization? If the former is higher, this would suggest that priority should be given to trade liberalization and related trade facilitation efforts. If trade barriers are low, domestic industry will not have as large an incentive to support restrictive FDI regulations. (Restrictions on inward FDI may be motivated in part by the existence of high trade barriers, as this provides an incentive for tariff wall–hopping FDI.) Perhaps most important is the question of why governments do not reform FDI policies unilaterally. As explained in Box 42.1, reducing restrictions on foreign entry through FDI can have very beneficial effects for developing countries. A key issue is how a multilateral agreement could help achieve this if domestic forces are blocking FDI liberalization and a reduction in red tape. Another key question concerns the magnitude and effects of policies that seek to attract or retain FDI.

BOX 42.1 WTO RULES ON FDI: A POSITIVE VIEW

FDI has been subject to various types of policies on the part of both host and parent countries, from extremely negative ones such as nationalization or expropriation to positive incentives such as tax holidays, as shown in the table. Relatively common negative incentives include restrictions on foreign equity share, domestic content requirements, production or export requirements, and restrictions on remittances of profits. Many countries use screening, negative lists (sectors in which FDI is not permitted or is restricted), foreign equity caps, and limitations on landownership.

Examples of FDI Policies

Positive incentives

1. Tax holidays
2. Tax treaties to avoid double taxation
3. Exemptions on import duties on capital goods and raw materials
4. Other exemptions or relaxations of rules in priority sectors

Negative incentives

1. Nationalization or appropriation
2. Double taxation
3. Domestic content requirement for intermediate inputs
4. Domestic employment restrictions
5. Export requirements
6. Screening
7. General foreign equity limits
8. Sectoral foreign equity limits
9. Landownership restrictions
10. Joint-venture requirement
11. Restrictions on remittance of profits
12. Limitations on transfer of shares or liquidation of the company

There is, in principle, a fundamental similarity between the case for freer trade in goods and the case for freer FDI. From a rule-making perspective, what is needed is to apply two sensible principles that have been used in the trade policy setting. First, distortions should be handled by the appropriate policy instruments that *most directly* deal with the respective distortion. Second, if there is no forceful theoretical support for the welfare-enhancing effects of a policy intervention, the benefit of the doubt is given to the market, not to policy activism. That is, the preferred choice is no intervention.

These principles should apply to FDI policy, as well. Perhaps the single most important reason for resistance to a more open FDI policy is the presumed market power effect of multinational corporations. A more open and transparent FDI policy, however, would invite not just one multinational but many and would thereby foster competition among the multinationals themselves as well as between domestic and foreign firms. Hence, the scope for exercising market power will be self-constraining. If there is evidence of predation, the remedy is competition or antitrust policy. Lack of an effective institutional framework for competition policy should not be a justification for imposing restrictions on FDI. A more open FDI policy may itself act as a catalyst for the development of these institutions. In any event, the first policy principle applies.

Crowding out or scaling down of domestic entrepreneurship is another concern. Although such effects do arise, it is equally true that downsizing of *inefficient* domestic firms is welfare improving because of the associated rationalization and the increase in the choice of quality that would be available to consumers. Those domestic firms that are unable to undertake technological innovation would be relegated to serving the lower end of the market, whereas firms that are willing and able to innovate would serve the high end, along with the foreign firms. Moreover, through mergers and acquisitions, and by infusing new technology, FDI can prevent some domestic industries from being wiped out.

(*continued*)

BOX 42.1 (CONTINUED)

FDI is a direct instrument of development and growth. Since growth strategy should vary from country to country depending on factor endowment, technology, and so on, FDI policy ought to be country-specific to some extent. In the Indian context, for example, this translates mostly into sectoral prioritization. Infrastructural problems continue to be India's biggest bottleneck, followed by the poor quality of the services sector and shortcomings in the agriculture sector—lagging modernization and availability of critical inputs. The priorities for FDI in India are, accordingly, relatively straightforward: the infrastructure sector (energy, transport and communications, cement, and so on) comes first, followed by the services sector (including the financial and insurance industries) and agricultural machinery, chemicals, and fertilizers.

An effective prioritization scheme does not require a complex system of regulations and incentives. Reform should aim for simplicity—for example, the removal of many of the arbitrarily set caps on foreign equity in different sectors. Any prioritization scheme carries the danger of allowing costly discretion for too long, and a timetable must be set for removal of the restrictions. This is where multilateral rules can help. There is a yawning gap between FDI approvals and actual inflows in India. Since liberalization in 1991, the ratio of actual to approved FDI has been no more than 25 percent An alarming absolute decline in FDI in India since 1998 suggests that the existing incentive packages and vows of commitment are not enough to attract foreign investors. Further assurance and security for foreign investors are needed and might be obtained from WTO rules.

Such rules should revolve around a most-favored-nation (MFN) code of conduct aiming at gradual, time-bound removal of restrictions on FDI, with defined prioritization deadlines for different developing countries and with safeguard provisions that allow for well-defined temporary deviations from free foreign entry, but on grounds of industry-specific ills only, not on account of balance of payments or other problems.

Source: Prepared by the volume editors, based on Das (2000).

International Spillovers

Investment-related policies may rationally attempt to shift rents (profits) from source to host countries through measures that effectively tax investors. The opportunity for this arises because FDI usually occurs in imperfectly competitive markets, and such policies can therefore give rise to spillovers. The same is true for policies that encourage FDI. Clearly, both types of policies can provide a basis for international cooperation. What follows focuses primarily on incentive policies, as these are most obviously potentially detrimental to developing countries. Distortions created by imperfect competition call for competition policies (see Chapter 43, by Holmes, and Chapter 44, by Evenett, in this volume).

From an individual country's perspective, incentives to attract FDI may be justified if FDI generates positive externalities. An example is when FDI generates technological spillovers for local firms, thereby making more efficient use of national resources.[3] There exists a large literature that tries to determine whether host countries enjoy such spillovers. Spillovers may arise when local firms adopt technologies introduced by multinational enterprises through imitation or reverse engineering; when workers trained by a multinational transfer information to local firms or start their own firms; and when derived demand (both upstream and downstream) from multinationals leads to local provision of services or inputs that are also used by local firms.

The empirical support for positive spillover effects is ambiguous (see Chapter 34, by Saggi, in this volume). Nevertheless, if governments believe that there exists a solid economic case for promoting inward FDI via incentives because of positive externalities, countries may find themselves in a bidding war for attracting FDI.[4] This can be to the detriment of the parties involved if it leads to excessive payment to the investor—that is, transfers that exceed the social value of the expected spillovers. The proliferation in the use of incentives for FDI suggests that this is an important possibility and that there may be a case for international cooperation to ban or discipline the use of fiscal incentives.

Clearly, a key issue here is whether fiscal incentives are effective. The empirical evidence on this issue, too, is far from clear. Many studies have concluded that incentives for inward FDI do not play an important role in altering the global distribution of FDI (Wheeler and Mody 1992; Caves 1996). Others conclude that incentives do have an effect on location decisions, especially for export-oriented FDI (see Guisinger and associates 1985; Hines 1993; Devereux and Griffiths 1998).[5] When incentives do not distort the global allocation of FDI, they basically end up as transfers to multinationals. It is precisely when such incentives fail to attract FDI that developing countries have the most to gain from committing to not using them. The case for cooperation under these circumstances is based mainly on distributional grounds.

If incentives do affect FDI, there may be an efficiency case against competition for FDI. It must be recognized, however, that competition for FDI via incentives may actually help ensure that FDI goes to those locations where it is most highly valued. Incentive competition may act as a signaling device that improves the allocation of investment across jurisdictions by ensuring that FDI moves to where it has the highest social return. It can do so in situations where investors locate in countries or regions in which the social return to FDI is lower. In such situations governments should apply incentive policies on a nondiscriminatory basis.

In practice, locational competition is generally not driven by information asymmetries that can lead to FDI not flowing to countries where social returns are highest. This is the case, in particular, for efforts by high-income countries to retain or attract FDI that would be more efficiently employed in developing countries. Labor unions and groups representing the interests of local communities may oppose plant closures and efforts by firms to transplant facilities. Similar motivations underlie the use of trade policy instruments such as antidumping by industrial countries. It is important, therefore, to distinguish between competition for FDI between developing countries, which may be efficient, and locational incentives used by industrial nations. The latter are much more likely to be inefficient because they attract or retain industries that otherwise would locate in developing countries. Such incentive policies, as well as complementary policies that protect industries which cannot compete (examples are restrictive rules of origin in regional agreements and antidumping), are prime candidates for discipline through international negotiations (Moran 1998).

The foregoing suggests there are valid reasons to question the rationale for a multilateral agreement that seeks to discipline all incentives. If incentives fail to alter the global allocation of FDI, restricting their usage has mainly distributional consequences. In this case unilateral action to cease granting incentives is the optimal policy. If incentives *are* effective in altering location decisions, a case may exist for subsidy freedom, since countries may be able to signal important information to potential investors. Developing countries, however, have an unambiguous incentive to push for multilateral disciplines on industrial country policies that have the effect of keeping firms from relocating to developing countries. A key need is to increase information on the use of incentives and analysis of their effects.

Spillovers due to Regional Integration

Some regional integration agreements (RIAs) extend the reach of national treatment to investors from partner countries. Examples include the European Union (EU), where freedom of investment is a basic principle; the North American Free Trade Agreement (NAFTA); and various association agreements that the EU has concluded with neighboring countries. Insofar as RIAs lead to discrimination between insiders and outsiders in FDI policies, they impose negative externalities over and above whatever investment “diversion” occurs because of the preferential liberalization of trade barriers (see Chapter 55, by Hoekman and Schiff, in this volume). Eliminating this discrimination can be a powerful argument in favor of multilateral rules. An important empirical question is whether such discrimination occurs and how large it is. This is difficult to determine, as doing so requires careful and detailed assessments of the applicable legislation on both a horizontal and a sectoral basis. Some agreements—for example, the EU and some of the agreements the

EU has in turn negotiated with neighboring countries—embody a right of establishment for nationals of parties. Most RIAs only have disciplines of the type found in bilateral investment treaties, which require national treatment (often subject to exceptions in the form of negative lists) and which discipline the use of performance requirements.

Given the role of regulation and the political sensitivity associated with foreign ownership of many services industries, one way of assessing whether RIAs have a discriminatory effect is to determine to what extent they go beyond the GATS in eliminating discrimination in services markets. Since FDI will be a major mode of supply, the more RIAs go beyond the GATS, the greater the potential negative spillovers.

Hoekman (1998a) argues that with the exception of the EU, most RIAs do not go much beyond the GATS. Most RIAs also do little toward effectively constraining the ability of governments to provide incentives for FDI. The most far-reaching RIAs are those involving the EU, which seek to apply common disciplines in areas such as antitrust, state aid, and state monopolies. Periodic disputes regarding the use of incentives by local governments to attract FDI and recurring claims of "social dumping" illustrate that even the far-reaching EU disciplines are insufficient to constrain the ability of governments to adopt the tax and factor market policies they believe will be most conducive to stimulating investment, be it foreign or domestic.

Insofar as RIAs cause negative investment spillovers, these effects will be attenuated if the trade discrimination associated with RIAs is reduced by negotiating lower external tariffs and other trade barriers.

Reputation and Policy Credibility

As noted above, an important question is what a multilateral agreement can do that a government cannot do on its own. One possible answer is that a multilateral agreement may help countries that seek to attract FDI by acting as a signaling device or instrument through which the perceived credibility of a set of policies intended to foster FDI can be enhanced. It is sometimes argued, for example, that the countries of Central and Eastern Europe sought to conclude association agreements with the EU in part to overcome perceptions by foreign investors that these countries had a high risk of policy reversals and policy uncertainty.[6] To assess the relevance of the credibility argument for an investment agreement, it is necessary to identify how much of what might be embodied in such an agreement can be pursued and implemented unilaterally.

Countries that are seeking to attract FDI can already use a variety of existing credibility-enhancing institutions. One is to commit to accept arbitration of disputes under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States; by the International Chamber of Commerce (ICC); or by the UN Committee on International Trade Law (UNCITRAL), depending on the preferences of the investor. Sometimes such commitments are embedded in RIAs such as NAFTA. Another is to conclude bilateral investment treaties with the major source countries for FDI. Countries that are in the market for credibility can also use existing WTO disciplines to schedule market access–opening policies for services (including the right of establishment) and to bind low tariffs under GATT rules. There is great scope for developing countries to use the WTO as a credibility-enhancing instrument; the coverage of services commitments is often very limited, and tariff bindings for merchandise imports are frequently significantly higher than applied rates. Although credibility with respect to investment-related policies can certainly be pursued via a multilateral investment agreement, governments that are convinced they have a need to use external instruments to achieve such objectives could start by exploiting existing instruments much more fully.

Issue Linkage and the Grand Bargain

The WTO process allows countries to define a negotiating set that allows a variety of potential tradeoffs and deals to be crafted. Because countries are restricted to the equivalent of barter trade in multilateral trade negotiations, achieving a superior cooperative outcome may require that issues be linked (Hoekman and Kostecki 2001). Determining when such linkage is necessary and successfully designing globally beneficial packages is a difficult task, given that this occurs in the context of rent-seeking lobbying and often involves issues that are difficult to analyze. Insofar as developing country governments are confronted with domestic constraints that inhibit the abolition of welfare-reducing restrictive FDI policies, engaging in investment policy talks may come at zero cost and allow additional gains to be obtained through quid pro quo negotiations (see Box 42.1). Given that for most developing countries capital exports through outward FDI flows is largely a nonissue, a good case can be made that the quid pro quo for accepting investment-related disciplines should be sought outside the investment area. Within the investment policy area, however, there are also important potential gains for developing countries, most importantly in the area of disciplines on the use of incentives by high-income countries.

While there is certainly scope for gains to be obtained from an agreement on investment, the size of the negotiating chips developing countries can bring to the table will determine what is attainable. Developing country investment policies may not be regarded as a particularly valuable negotiating chip by other WTO members, especially nations that already have liberal regimes. If so, other policies are likely to be more powerful in inducing concessions from trading partners. Among these, further liberalization of trade under existing agreements (GATT and GATS) figures prominently. Investment policies may prove useful, but more may have to be brought to the negotiating table by developing countries. What determines the net payoff from agreement to negotiate on investment rules depends importantly on the constraints that developing country governments face in pursuing domestic reforms, whether these reforms are consistent with what major WTO members desire in terms of multilateral rules, and the extent to which industrial countries are willing to impose restrictions on locational incentives used by their local and provincial governments to attract and retain firms.

Conclusion

Negotiating a WTO agreement on investment policies may prove useful in arriving at a grand bargain that extends to issues of particular interest to developing countries. This possibility must be considered carefully. A broader agenda will be necessary in any event, both for countries that confront domestic political-economy constraints on the adoption of better FDI policies and for those that seek to use FDI policies strategically. In both cases, addressing investment issues in a broader context can help mobilize interest groups that have an incentive to engage groups which benefit from the status quo.

Account must be taken, however, of the potential downside—issue linkage can be a two-edged sword. Efforts to expand the agenda to investment may allow groups in society to seek cross-issue linkages in areas that could be detrimental to developing countries. Bhagwati (1998) has argued that this Pandora's box possibility provides a powerful justification for leaving general investment rules off the WTO agenda. The failure of the OECD to reach consensus on a multilateral agreement on investment (MAI) illustrates the practical difficulties that will arise.[7] If OECD countries, with their much more uniform policy environment and similar goals, could not reach an accord, agreeing to a common set of multilateral principles on investment can be expected to be difficult. It should also be noted that in the MAI negotiations no progress was made in disciplining the use of investment incentives—one of the primary issues where developing countries stand to gain substantially.

The fact that the GATS includes establishment as a mode of supply on which commitments can be made should also be considered, given that FDI in services is more important in contesting markets than is FDI in goods (since goods can be traded). Much remains to be done in liberalizing access to services markets through establishment. Governments may also be able to achieve much of what is beneficial unilaterally, by applying national treatment and MFN principles and by adopting the right of establishment in national law.

That said, it is the case that the current architecture of the WTO is asymmetric; there is no a priori rationale for incorporating FDI as a mode of supply in the GATS while excluding FDI in manufacturing and primary sectors. It is often emphasized that trade and investment have increasingly become complementary.

This suggests that there is a case for negotiating on investment. As is always the case in trade agreements, the devil is in the details. Much depends on country-specific circumstances and on the objectives of the government. These will differ significantly across countries.

In some cases the primary issue may be to improve FDI regulatory policies and to reduce red tape. In some countries incentives may be needed to attract FDI, and these may be beneficial because of FDI-induced positive externalities. In others the key issue may be to eliminate inefficient tax incentives. Determining the impact of prevailing policies on

FDI is therefore critical in identifying reform priorities and determining how multilateral rules and agreements may assist in meeting the objectives that are defined. Undertaking such analysis will require information on existing policies—including policies in partner countries—and assessments of their effects.

Notes

1 In the case of other domestic policy distortions, the optimal policy is well known: remove the distortions at the source, if necessary through appropriately designed regulatory intervention that is applied on a nondiscriminatory basis (i.e., that applies equally to foreign and domestic firms). Thus, the adoption of low and uniform tariffs is preferable to the use of investment policies to offset the effects of high protection. This point of view is implicit in the WTO, which not only aims at progressive liberalization of trade but also prohibits the use of most TRIMs.

2 Investment measures have tended to be concentrated in specific industries, with automotive, chemical and petrochemical, and computer industries leading the list (Moran 1998). Local content requirements are most important in the auto industry; export requirements are more important in the computer industry. In chemicals and petrochemicals, local content requirements and export requirements are employed extensively.

3 The use of the word "spillovers" is somewhat unfortunate, since productivity improvements are unlikely to be costless and automatic.

4 Government officials are often not convinced of the inefficacy of incentives, as illustrated by the use of such instruments by many countries.

5 Fiscal incentives are found to be unimportant for FDI geared toward the domestic market. This type of FDI is more sensitive to the extent to which it will benefit from import protection.

6 See Markusen (2001) for a discussion of the credibility case for an investment agreement and Fernandez and Portes (1998) for an analysis of how international agreements may support credibility.

The International Centre for the Settlement of Investment Disputes (ICSID), which operates under the aegis of the World Bank, is responsible for applying the convention. The ICC has a Court of Arbitration. UNCITRAL has adopted a set of arbitration and conciliation rules that can be used in the settlement of commercial disputes.

7 See Henderson (1999) for a comprehensive analysis of the OECD-based MAI negotiations.