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“Trade and foreign direct investment”

New Report by the WTO

In the face of the growing economic, institutional and legal interlinkages between trade and foreign direct investment, should WTO member governments continue to resort to bilateral FDI arrangements? Or should they create a multilateral framework that recognizes these close linkages, and takes into account the interests of all the members of the WTO - developed, developing and least-developed alike?

To assist the trade community in its evaluation of how the WTO should respond to the growing importance of FDI, the WTO Secretariat today (16 October) launched a 60-page report on "Trade and Foreign Direct Investment" focusing on the economic, institutional and legal interlinkages between FDI and world trade. The report examines the interaction of trade and FDI, including the impact of FDI on trade of home and host countries. It reviews the perceived costs and benefits of FDI, and considers the implications of competition for FDI among host countries. The report also contains a review of the regulations governing foreign investment, together with a brief discussion of existing investment-related WTO rules and disciplines. The report concludes with a review of the key policy issues facing WTO members. The full text of the report is attached.

Note to editors:

The co-authors - Richard Blackhurst, Director of Economic Research and Analysis Division, and Adrian Otten, Director of Intellectual Property and Investment Division - will hold a media briefing at 3.00 p.m. on Wednesday 16 October in Salle III at the UN Palais des Nations, Geneva. TV, radio and press representatives are invited to attend.

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Chapter four
Trade and foreign drect investment

There are many reasons why foreign direct investment (FDI) has become a much-discussed topic. One is the dramatic increase in the annual global flow between 1985 and 1995, from around $60 billion to an estimated $315 billion (Chart 1), and the resulting rise in its relative

importance as a source of investment funds for a number of countries. Stocks of FDI, in turn, have been growing and estimates suggest that the sales of foreign affiliates of multinational corporations (MNCs) exceed the value of world trade in goods and services (the latter was $6,100 billion in 1995), that intra-firm trade among MNCs accounts for about one-third of world trade, and that MNC exports to non-affiliates account for another third of world trade, with the remaining one-third accounted for by trade among national (non-MNC) firms.

The keen interest in FDI is also part of a broader interest in the forces propelling the ongoing integration of the world economy, or what is popularly described as "globalization". Together with the more or less steady rise in the world's trade-to-GDP ratio, the increased importance of foreign-owned production and distribution facilities in most countries is cited as tangible evidence of globalization.

Foreign direct investment is also viewed as a way of increasing the efficiency with which the world's scarce resources are used. A recent and specific example is the perceived role of FDI in efforts to stimulate economic growth in many of the world's poorest countries. Partly this is because of the expected continued decline in the role of development assistance (on which these countries have traditionally relied heavily), and the resulting search for alternative sources of foreign capital. More importantly, FDI, very little of which currently flows to the poorest countries, can be a source not just of badly needed capital, but also of new technology and intangibles such as organizational and managerial skills, and marketing networks. FDI can also provide a stimulus to competition, innovation, savings and capital formation, and through these effects, to job creation and economic growth. Along with major reforms in domestic policies and practices in the poorest countries, this is precisely what is needed to turn-around an otherwise pessimistic outlook.

At an institutional level, the growing importance of FDI, coupled with the absence of binding multilateral rules on national policies toward FDI, has created what in many quarters is viewed as an obstacle that could slowdown the pace of further integration of the world economy. The perceived need for multilateral rules on investment is not new - indeed, the Havana Charter for the stillborn International Trade Organization (origin of the GATT and "spiritual ancestor" of the WTO) contained provisions on foreign investment - but attempts to reach a comprehensive multilateral agreement with binding rules have thus far not been successful.

Renewed interest in FDI within the trade community has been stimulated by the perception that trade and FDI are simply two ways - sometimes alternatives, but increasingly complementary - of servicing foreign markets, and that they are already interlinked in a variety of ways. The 27 OECD countries (plus the EC Commission) are negotiating an investment agreement, scheduled to be completed in time for the 1997 OECD Ministerial meeting. On a multilateral level the WTO's General Agreement on Trade in Services, by including rules on "commercial presence", recognizes that FDI is a prerequisite for exporting many services (there are no corresponding rules on commercial presence in the General Agreement on Tariffs and Trade, which governs trade in goods).

It is important to recognize that not everyone is enthusiastic about these developments. Critics are concerned about the possible negative effects of FDI. In "home" countries (where the outflow of capital originates), there are claims that FDI exports jobs and puts downward pressure on wages. In "host" countries (which receive the FDI), there are worries about the medium-term impact on the balance of payments, about potential monopolization of the domestic market, and more generally about the impact of FDI on the government's ability to manage the economy. Critics are also worried about the implications of having a multilateral agreement that lays down common standards for national FDI rules and requires each

signatory to bind its rules under the agreement. Having to bind national FDI policies under a multilateral agreement would be viewed by critics as going even further in pre-empting a country's right to manage inflows of FDI.

Answers to these concerns are developed below, along with a careful documentation of the many benefits which FDI brings to host countries and which must be considered in formulating a country's overall attitude toward FDI inflows.

The focus of this report

There is, by now, a fairly extensive academic literature on the general topic of the economics of FDI. In addition, UNCTAD's annual World Investment Report regularly analyses a variety of aspects of FDI, and extensive statistics on FDI are provided by the IMF, UNCTAD and the OECD. Together this material offers a comprehensive introduction to many FDI-related issues on both a conceptual and empirical level.

From a WTO perspective, the most interesting and relevant aspect of FDI is its interlinkages - economic, institutional, legal - with world trade. With this in mind, it was decided to focus this report on the interlinkages between FDI and trade, rather than on FDI per se. The goal is to help to fill a modest lacuna in the literature, and to assist the trade community in its evaluation of various proposals on how the WTO should respond to the growing importance of FDI.

This introductory section is followed by an examination in Part II of the inter-action of trade and FDI, including the impact of FDI on the trade of home and host countries. Part III reviews the perceived costs and benefits of FDI, and considers the implications of competition for FDI among host countries. Regulations governing foreign investment (other than those in the WTO) are reviewed in Part IV, followed by a brief discussion in Part V of existing investment-related WTO rules and disciplines. Part VI concludes the report with a review of the economic, institutional and legal interlinkages between FDI and trade, and their implications for the options facing WTO members.

Before turning to the main body of the report, however, it would be useful to review briefly a few basic statistics on FDI in order to put the subsequent analysis in perspective (see Box 1 on the definition and measurement of FDI).

Box 1: Defining and measuring foreign direct investment

Foreign direct investment (FDI) occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. The management dimension is what distinguishes FDI from portfolio investment in foreign stocks, bonds and other financial instruments. In most instances, both the investor and the asset it manages abroad are business firms. In such cases, the investor is typically referred to as the "parent firm" and the asset as the "affiliate" or "subsidiary".

There are three main categories of FDI:

• Equity capital is the value of the MNC's investment in shares of an enterprise in a foreign country. An equity capital stake of 10 per cent or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. This category includes both mergers and acquisitions and "greenfield" investments (the creation of new facilities). Mergers and acquisitions are an important source of FDI for developed countries, although the relative importance varies considerably.

Recent trends in FDI

Chart 1 above spans a little more than two decades. By the end of the 1970s, the annual outflow of FDI from OECD countries to all destinations (including one another) had doubled from around $25 billion to nearly $60 billion (the OECD countries currently are host to 73 per

cent, and home to 92 per cent of the world's stock of FDI). These are nominal figures, however, and recalling that the OECD countries went through two periods of double-digit inflation in the 1970s, it is clear that in inflation-adjusted real terms there was little or no increase in the annual outflow. After declining sharply in the early 1980s, it began once again to increase. During the years 1986 to 1989 annual FDI flows increased at a phenomenal rate, multiplying fourfold in four years. In the second half of this four-year burst of activity, the global total was given a further boost, albeit a minor one, by a tripling (from a very low base) of FDI outflows from non-OECD economies, in particular from Hong Kong. More specifically, the share of non-OECD countries in worldwide outflows of FDI increased from 5 per cent in 1983-87 to 15 per cent in 1995.

In the OECD countries, this period of high growth for FDI was followed by five years (1990-94) of stagnant or declining annual outflows, no doubt reflecting in part the widespread economic slowdown. Then, in 1995, there was another dramatic turn-around, with outflows of FDI from the OECD area estimated to have increased by 40 per cent.

A commonly asked question is whether FDI is growing more rapidly than world trade. The answer depends on the period. During 1986-89 and again in 1995, outflows of FDI grew much more rapidly than world trade. In contrast, during 1973-84 and 1990-94, FDI growth lagged behind trade growth. Over the entire period 1973-95, the estimated value of annual FDI outflows multiplied more than twelve times (from $25 billion to $315 billion), while the value of merchandise exports multiplied eight and a half times (from $575 billion to $4,900 billion).

A comparison of flows of FDI and flows of international portfolio investment for the period 1988-94 reveals that the average annual flows of the two types of international investment were more or less equal during 1988-90, after which portfolio investment began three years of rapid growth that brought it to a level ($630 billion in 1993) more than double that of FDI. A sharp slowdown in the growth in portfolio investment in 1994 then narrowed the gap somewhat (data on portfolio investments for 1995 are not yet available). A third category of financial flows, and one of particular importance to many developing countries, is official development finance. In 1994, when the flow of international portfolio investment was about $350 billion and the flow of FDI $230 billion (in both cases to all destinations), the OECD countries provided about $60 billion of official development finance, of which about $50 billion went to developing countries and the remainder to the transition economies.

In 1995, inflows of FDI into the non-OECD area totalled an estimated $112 billion. Of this, approximately $65 billion went to Asia, and another $27 billion to Latin America (including Mexico). The remaining $20 billion was divided almost equally between transition economies in Europe on the one hand, and Africa and the Middle East on the other.

The share of the non-OECD countries in world FDI inflows, which decreased in the 1980s, increased from nearly 20 to about 35 per cent between 1990 and 1995. China as a host country played a major role in this increase, but other developing countries, in particular in Asia and Latin America, have also benefited from a sharp increase in FDI. At the same time, FDI flows to non-OECD countries are highly concentrated. In 1995, China accounted for about one-third of all FDI inflows into non-OECD countries ($38 billion out of $112 billion), and another nine countries for another 35 per cent. The remaining 31 per cent or $36 billion was divided (not equally) among the approximately 135 remaining developing and transition countries. The least-developed countries attracted throughout the 1990-95 period on average $1.1 billion of FDI inflows which corresponds to about one-half of 1 per cent of global FDI flows.

Switching to cumulative inflows, Table 1 presents figures on aggregate cumulative inflows into the leading host economies for the period 1985-95. Seven out of the twenty are developing economies. China is in fourth place, with Mexico, Singapore, Malaysia, Argentina, Brazil and Hong Kong, also on the list. Table 1 also calls attention to the fact that the leading host economies for FDI are, for the most part, also the leading home economies for FDI (the names of the latter are in bold). The first nine host economies, plus seven of the remaining eleven host countries, are on the list of the twenty leading home economies.

Table 1
Leading host economies for FDI based on cumulative inflows, 1985-95

Rank	Country	FDI billion $	FDI per capita $	
1	**United States**	477.5	1820	(13)*
2	**United Kingdom**	199.6	3410	(7)
3	**France**	138.0	2380	(10)
4	**China**	130.2	110	(20)
5	**Spain**	90.9	2320	(11)
6	**Belgium-Luxembourg**	72.4	6900	(2)
7	**Netherlands**	68.1	4410	(3)
8	**Australia**	62.6	3470	(6)
9	**Canada**	60.9	2060	(12)
10	Mexico	44.1	470	(17)
11	**Singapore**	40.8	13650	(1)
12	**Sweden**	37.7	4270	(4)
13	**Italy**	36.3	630	(16)
14	Malaysia	30.7	1520	(14)
15	**Germany**	25.9	320	(18)

16	**Switzerland**	25.2	3580	(5)
17	Argentina	23.5	680	(15)
18	Brazil	20.3	130	(19)
19	**Hong Kong**	17.9	2890	(9)
20	**Denmark**	015.7	3000	(8)

*Figures in parentheses indicate the ranking of the leading host economies on per capita basis.

Note: Economies in bold are also among the 20 leading home economies for FDI (note that definitions of FDI vary considerably across the economies). Excluding Bermuda, for which cumulated FDI inflows, largely in the financial sector, amount to $21.5 billion.

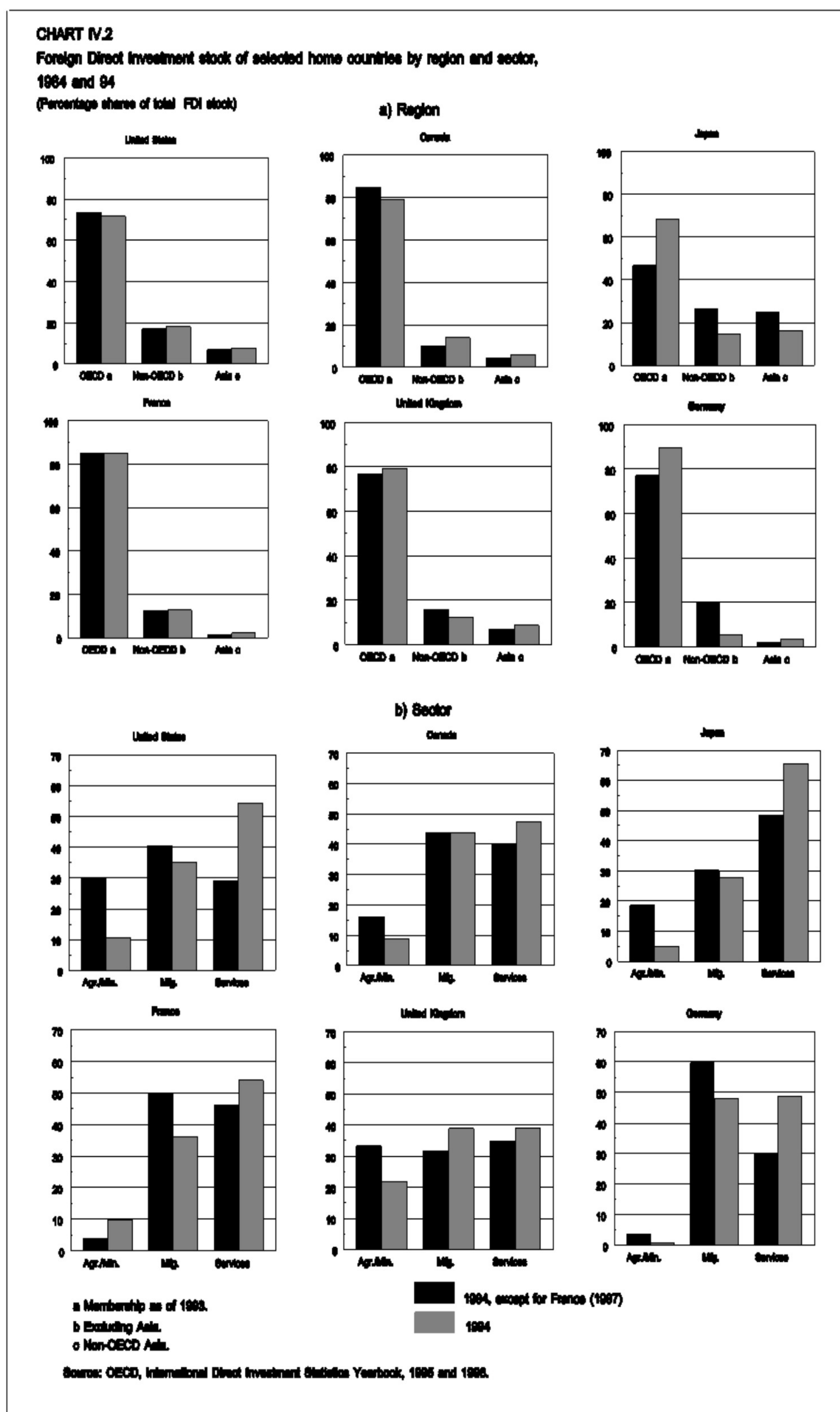
Source: UNCTAD, FDI database for the top 20 host economies, and United Nations (1996) for the population figures used to derive the per capita figures.

Cumulative inflows are also shown on a per capita basis in Table 1 (note that there is no reason to believe that these are the twenty leading countries on a per capita basis). In many instances the ranking is very different from that based on the aggregate figures. The most dramatic change is the drop in China's ranking from 4th on an aggregate basis to 20th on a per capita basis. The next largest declines are for the United States (from 1st to 13th) and France (from 3rd to 10th). The counterpart, of course, is that some economies - especially some of the smaller economies - rank higher on the basis of per capita figures: Denmark, Switzerland, Hong Kong and Singapore jump ten places (or more) each.

The upper half of Chart 2 indicates where the MNCs in six major home countries have been putting their FDI (the six countries were selected on the basis of data availability; together they accounted for about two-thirds of the global outflow of FDI during the past decade). In both 1984 and 1994, the dominant destination was other OECD countries. Even Japan, which had been the least focused on OECD countries in 1984, saw the share of its FDI stock in the OECD area jump by more than one-third between 1984 and 1994. Of the three European countries in the Chart, only the United Kingdom had more than a very minor share of its stock of FDI in non-OECD Asia in either year.

For the most part, empirical work on the linkages between FDI and trade has not tried to establish causation - that is, to determine, for example, whether inflows of FDI cause exports to be greater than they would otherwise be or if, instead, expanding exports attract increased FDI. The focus, rather, has been on the more modest goal of seeking to determine whether an increase in one is systematically associated with an increase or decrease in the other - in other words, whether they are correlated. This is commonly referred to as testing whether trade and FDI are substitutes (negatively correlated) or complements (positively correlated).

When the focus is on interlinkages, the question of whether FDI and trade are substitutes or complements is of secondary importance. A substitute relationship can create just as strong an interlinkage as a complementary one. And if they are interlinked, it means that trade policy affects FDI flows, and FDI policies affect trade flows, and therefore that both sets of policies



would benefit from being treated in an integrated manner.

This section provides an overview of the results of research on the relationship between FDI and trade, beginning with a brief review of current thinking on the driving forces behind FDI at the level of the individual firm. As will become clear, an awareness of the motivations behind FDI is an important part of understanding the interlinkages between FDI and trade. The focus in the remaining part is on the empirical evidence on interlinkages between FDI

and trade, first from the viewpoint of the home country, and then from that of the host country.

Why do firms expend the effort required to invest abroad, rather than staying home and producing for export and/or licensing their technology to foreign companies? Researchers have examined this issue for almost forty years. There is now a degree of consensus that an MNC typically is the outcome of three interacting circumstances. First, the firm owns assets that can be profitably exploited on a comparatively large scale, including intellectual property (such as technology and brand names), organizational and managerial skills, and marketing networks. Second, it is more profitable for the production utilizing these assets to take place in different countries than to produce in and export from the home country exclusively. Third, the potential profits from "internalizing" the exploitation of the assets are greater than from licensing the assets to foreign firms and are sufficient to make it worthwhile for the firm to incur the added costs of managing a large, geographically dispersed organization.

The assets of MNCs

It is often observed that the assets possessed by MNCs include many that are “intangible”, consisting primarily of intellectual property, including technology, brand names and copyrights, plus the “human capital” (employee skills) associated with these assets. Much of the literature on MNCs emphasizes technology as a driving agent for the internationalization of the operations of such firms. The technology may center on products (the firm might produce a product variety that is, by virtue of technology embodied in it, preferred by consumers over variants of the same product produced by rival firms) or on processes (the firm might be able to produce standardized products at a lower cost than its rivals). At the same time, however, technology-based competitive advantages of firms often tend to become obsolete with the passage of time. Hence the real advantage possessed by certain firms may be not a given technology, but rather the capacity to consistently innovate such technologies.

As powerful as technology might be in driving the internationalization of firms, it is not the only intangible asset that firms may seek to exploit worldwide. Patents and copyrights can impart obvious competitive advantages to the firm that holds them. In some industries, the assets are in the form of brand names for which consumers worldwide are willing to pay a premium (for example, cola beverages). Firms owning such assets can, of course, license country-specific production rights, rather than deciding to invest in foreign production facilities.

Why produce in more than one country?

The fact that a firm owns assets that can be exploited on a large scale and that make it competitive internationally, still does not explain the international character of the MNC. After all, managing assets located in foreign countries entails extra costs, such as those associated with obtaining information about local laws and regulations, managing local labour relations, increased management travel, and the need to manage operations in different languages and cultures. Why not produce in one location and serve foreign markets through exports?

For many service industries, the answer is very simple. In order to be competitive in foreign markets, the service provider must have a physical presence in those markets. Indeed, the fact is that most cross-border trade in services has been propelled by FDI. Whereas with manufactured goods, FDI often follows trade, in services it is more often the other way around. This was explicitly recognized in the Uruguay Round when the participants agreed to include rules on “commercial presence” in the General Agreement on Trade in Services.

There are several reasons why multinational operations also may be superior for industries producing goods, many of which fall into one of two broad categories. First, there are those which tend to emphasize vertical FDI, where a firm locates different stages of production in different countries. These types of investment are typically seen as the result of differences across countries in input costs. An MNC involved in an extractive industry, where the endowment of natural resources is concentrated in certain countries, is an obvious example. Another is the case in which a firm locates a certain labour-intensive stage of its production chain in a country with low labour costs, while at the same time locating production stages requiring substantial amounts of “human capital” in a nation where highly skilled workers are in relatively abundant supply. In other words, the firm, in an effort to minimize production costs, establishes production sites in a number of nations, and uses trade as a means of supplying demand for particular products - including inputs - in particular markets.

The other main category of advantages from multinational operations gives rise to horizontal FDI, where similar types of production activities take place in different countries. Motivations behind this type of FDI are, for instance, that transport costs for products with high weight/value ratios may render local production more profitable; that certain products need to be produced in proximity to consumers; that local production makes it easier to adjust to local product standards; and that local production yields better information about local competitors. The FDI may also be driven by trade barriers, either existing measures - “tariff-jumping” FDI - or with the intention of reducing the probability of future protectionist measures, the so-called "quid pro quo" FDI.

Why not license?

The possession of intangible assets, and differences across countries in production costs, cannot by themselves explain why a firm undertakes the production itself. Many intangible assets, including technology, can be - and in practice often are - licensed to foreign firms. When a firm decides to engage in FDI, there must be reasons why it prefers to “internalize” the use of its assets rather than to exploit them through licensing.

Many benefits from internalization have been identified in the literature. One category are those that stem from the avoidance of the transaction costs associated with arm's length market transactions. Such costs include those of contracting and quality assurance in dealing with suppliers, with export/import firms and with foreign licensees. These and other costs can be reduced, perhaps significantly, by internalizing the transactions within a single firm. A closely related consideration is whether the legal environment in the host country, especially for the protection of intellectual property, gives an MNC that licenses its technology an amount of control over the use of the technology that is equivalent to the control it would have if it set-up an affiliate and undertook the production itself.

Another motivation is that the external market for technologies may undervalue technologies relative to their value to the firm that developed them. For example, to fully exploit a particular technology might require that other, complementary, technologies be present, or that the organization employ persons with certain specific knowledge and skills not easily available elsewhere. In such cases, the technologies are likely to be of greater value inside the organization responsible for their creation than to outside organizations, which means that the organization cannot receive this value by licensing the technology on the open market. The greater the discrepancy, the more likely it is that the firm's managers will decide to internalize the use of the technology.

Trade polices can affect the incentives for FDI in many ways, two of which were just mentioned. A sufficiently high tariff may induce tariff jumping FDI to serve the local market.

Other types of import barriers can have the same effect, of course. It is no coincidence that Japanese automobile manufacturers began producing in the European Union and the United States following the imposition of so-called "voluntary export restraint" agreements (VERs) limiting the number of automobiles that could be shipped from Japan. FDI may also be undertaken for the purpose of defusing a protectionist threat. Such quid pro quo investments are motivated by the belief that the added cost of producing in the foreign market is more than compensated by the reduced probability of being subjected to new import barriers on existing exports to that market. There is evidence, for example, that the perceived threat of protection had a substantial impact on Japanese FDI in the United States in the 1980s, and that these investments reduced the subsequent risk of being subjected to contingent protection resulting from anti-dumping and escape clause actions.

While some host countries intentionally use high tariffs as an incentive to induce investment, the gains from doing so may be limited. FDI attracted to protected markets tends to take the form of stand-alone production units, geared to the domestic market and not competitive for export production. Indeed, high tariffs on imported raw materials and intermediate inputs can further reduce international competitiveness, especially if local inputs are costly or of poor quality (as suggested by the need to protect the domestic producers of those goods in the first place). To counteract the negative effects of high input tariffs, host countries often provide duty drawback schemes for foreign inputs entering into production for export. This is part of the standard incentive package offered to foreign investors, particularly in export processing zones.

A low level of import protection - especially if it is bound - can be an even stronger magnet for export-oriented FDI than duty drawback schemes. Comparing FDI flows to the relatively open markets of certain Asian countries with the (until recently) relatively protected Latin America markets, a recent study found that the former tended to attract export-oriented FDI, while the latter tended to attract local market-oriented FDI. These results are supported by another study which found that in 1992 the ratio of exports to total sales of Japanese affiliates in the manufacturing sector in Asia was 45 per cent, while the corresponding figure for Japanese affiliates in Latin America was just 23 per cent.

The evidence supports the view that low tariffs is the preferred strategy for host countries with ambitions to integrate themselves more fully into the global economy - and those tariffs need to be bound in order to give the tariff regime credibility. Investment decisions are by their very nature long-run, and investors are certain to be affected by uncertainty about the durability of duty drawback schemes and other incentive packages that can be withdrawn or altered at the discretion of the government.

Regional trade agreements and FDI

Market size is an important consideration for an MNC contemplating a particular FDI. By removing internal barriers to trade, a free trade area or customs union gives firms the opportunity to serve an integrated market from one or a few production sites, and thereby to reap the benefits of scale economies. This can have a pronounced impact on investment flows, at least while firms are restructuring their production activities. The single market program of the European Union stimulated substantial investment activity, both within the Union and into the Union from third countries, and similar effects on FDI flows have been observed for other regional trade agreements.

The most common form of regional trade agreement is a free trade area, which differs from a

customs union in that each member retains its own external tariff schedule. This creates a need for "rules of origin" to determine whether a product that has been imported into one of the members, and undergoes further processing, is entitled to free trade treatment between member states (in other words, is it still a product of the third country from which it was purchased, or is it now a product of the partner country?). Because rules of origin can have a protectionist effect (if not an intent), they can affect the location of FDI. For example, under NAFTA rules of origin, clothing produced in Mexico gains tariff-free access to the United States market, provided it meets the "yarn forward" rule, which for many products requires virtually 100 per cent sourcing of inputs in North America. Mexican clothing manufactures face a choice between sourcing all inputs beyond the fibre stage in North America to obtain free trade area treatment, or sourcing inputs outside NAFTA at potentially lower cost, but foregoing duty free access to its most important market. As MFN tariffs on clothing are still high, they may choose to source inside the area rather than outside. This obviously creates greater incentives for third country textile producers to invest in production facilities inside the NAFTA area to regain lost customers, than would less restrictive rules of origin.

Some regional integration agreements have evolved into "hub-and-spoke" systems. This can happen, for example, if members of a customs union sign individual free trade agreements with country X and country Y, but there is no free trade agreement linking X and Y - in which case the customs union is the "hub" and countries X and Y are the "spokes". Such trade arrangements distort the pattern of FDI because there is an added incentive to locate FDI in the hub, from which there is duty free entry to all three markets, rather than in one of the spokes, since goods do not move duty-free between the two spokes.

These examples indicate that trade policy can have a significant impact on FDI flows. The opposite relation also holds, as is shown in the next section.

It is frequently alleged that FDI reduces home country exports and/or increases home country imports, and thus has negative consequences for the home country's employment and balance of payments. The counterpart is the belief that FDI reduces host country imports and/or increases host country exports. The origin of these views is the traditional thinking about FDI, which has focused on the possibility of using foreign production as a substitute for exports to foreign markets.

Two developments explain much of this traditional view that FDI and home country exports are substitutes. An influential theoretical article published in 1957 demonstrated that, under certain restrictive (simplifying) assumptions, the free movement of capital (and labour) was a substitute for free trade - that is, that the completely free movement of factors of production would produce the same results as the completely free movement of goods and services. A substitute relationship between capital flows and trade obviously is at the heart of this analysis. The other development was the popularity of import-substitution policies in large parts of the developing world until the early 1980s. As has already been noted, high import barriers encouraged - often at the explicit wish of the governments imposing the barriers - tariff-jumping FDI, with the result that local production replaced imports.

Whatever its origin, this traditional view of trade and FDI as substitutes ignores the complexity of the relationship in the contemporary global economy. To begin with, just because FDI causes the displacement of certain home country exports by production in the host country, it does not necessarily follow that the home country's total exports to the host market decline. To see why, consider a firm which is initially prevented from undertaking FDI, and instead serves the foreign market through exports. If the firm is then allowed to invest in the foreign country, the total effect on the home country exports is the result of several forces.

First, at given levels of sales in the foreign market, and with the same productive activities taking place within what is now an MNC as prior to the liberalization, there could be a replacement of previous exports of the final product by the new production in the foreign (host) country. This could stimulate exports of intermediate goods or services from the home country, but with the MNC's total production of the final good or service unchanged, that would not be sufficient to prevent an overall decline in exports.

However, the raison d'être of the investment is presumably to improve the firm's competitive position vis-a-vis other firms in the industry at home and abroad. This gain in competitive position may be due to access to cheaper labour or material inputs, but it may also stem from lower transactions costs, closer proximity to local customers, and so forth. Total sales are likely to increase as a result of the investment, which would imply increased demand by the affiliate for intermediate inputs. This will increase home country exports, to the extent that the affiliate continues to purchase intermediate goods and services from the parent company, or from other firms in the home country. Depending on the extent to which the affiliate relies on the home country for inputs, and the extent to which the MNC's total sales increase (in the host country's market and/or in third countries) there could be a net increase in total exports from the home country (the composition of exports, of course, is likely to shift toward intermediate goods and services). In addition, if the FDI stimulates economic growth in the host country, as appears to be the case (see below), the result will be an increase in demand for imports, including from the home country.

Now consider the impact of the FDI on home country imports. Some portion (perhaps all) of the inputs that were imported before the FDI for use in the production that is relocated abroad, will not be imported into the home country after the FDI has been undertaken. On the other hand, the foreign affiliate may begin serving the home country market, and in which case imports of the final product would increase. Again, because of these and other possibly off-setting effects, there is no reason per se to expect FDI and home country imports to be either substitutes or complements.

The discussion so far has been concerned with the complexities of the relationship between FDI and home country trade. But it should be clear that, for many of the same reasons, it is no easier to determine a priori the relationship between FDI and host country trade. Again the question of the relationship between FDI and trade can only be settled by looking at the empirical evidence. This is particularly true because the wider and largely dynamic effects of FDI in the host country - such as the stimulus to competition, innovation, productivity, savings and capital formation - can be important. Since these and other FDI-related dynamic effects are likely to affect the level and product composition of the country's imports and exports - including its trade with the home country - it is evident that the relationship between trade and FDI is considerably more complex than is often suggested.

Before turning to the empirical evidence, four points should be emphasized. First, the theory has only provided limited guidance to the empirical work. This in turn makes it very risky to draw policy conclusions from individual studies. Second, because data problems are particularly acute with regard to service industries, most research on FDI focuses on goods. This lack of empirical research on FDI in the services sector is increasingly troublesome, considering the growing importance of services in production, trade and investment. Third, the theoretical literature is largely focused on analysing the impact of an individual (marginal) investment. At the margin, incremental investment may have a very different set of implications from those related to the entire trade and FDI regime. Finally, empirical work on FDI is generally plagued by the limited availability and quality of the data (see Box 1 above). As a result, empirical research on MNCs is largely limited to firms from just a few countries,

notably the United States, Sweden and Japan.

The relationship between outflows of FDI from the United States and exports from the United States has been examined in a number of studies. Early work, based on data from the 1970s, found a positive relation between United States exports in a given product category to a country, and the level of production in that country by United States MNCs, with the effect being more pronounced for affiliates located in developing countries. Tests of the effect of affiliate production on the total exports of parent firms to all destinations, suggested that the displacement of United States exports to third countries, if it existed, was not large enough to offset the positive effects on parents' exports to host countries. In each industry, United States MNCs whose foreign production was above the industry average also had above-average exports from the United States. Another study reported that in about 80 per cent of the industries, production by majority-owned United States affiliates was either unrelated or positively related to exports by United States firms in the same industry.

A more recent examination of the relationship between the stock of United States FDI abroad and United States exports, using data for 1980, 1985 and 1990, concluded that United States exports were positively and significantly related to United States FDI stocks in all three years. In 1990, for example, each 1 per cent rise in the stock of FDI in a host country was associated with 0.25 per cent higher United States exports to that country. Using a different statistical procedure, designed to correct for (among other things) the possibility that United States MNCs have a greater tendency to export to and invest in larger markets than in smaller markets, an even more recent study confirmed a complementary relation between FDI and exports for the world, as well as for East-Asian and European countries. The apparent opposite or substitute relationship for the Western hemisphere countries could be explained by the Latin American countries' import substitution policies in the 1970s and early 1980s.

The overall conclusion from studies of Swedish MNCs is that sales by foreign affiliates, to the extent that they affect exports from Sweden at all, contribute positively to home country exports. Similar results have been reported for Germany, Austria and Japan.

There has been relatively little empirical testing of the impact of outward FDI on imports by the home country. There is evidence that United States imports are not materially affected by the extent of United States investment abroad. In contrast, a given amount of outward Japanese FDI appears to have promoted about twice as much Japanese imports as exports, while German FDI outflows probably promoted German imports at the beginning of the 1980s, but not necessarily at the end of the decade. A more recent study found that, in the case of United States, there was weak evidence for a positive relationship between FDI stocks and imports in the manufacturing sector, whereas for Japanese FDI the results were inconclusive.

To sum up, empirical research suggests that to the extent there is a systematic relationship between FDI and home country exports, it is positive but not very pronounced. Certainly, there is no serious empirical support for the view that FDI has an important negative effect on the overall level of exports from the home country. There is less evidence on the relationship between FDI and home country imports, but what exists tends to suggest a positive but weak relationship.

Detailed studies of FDI in mining and other natural resource-based industries have confirmed the expected strong positive correlation between FDI and the host country's exports. Several studies covering a broader range of industries have also found a high positive correlation between aggregate inflows of FDI and the host countries' aggregate exports.

Indirect evidence based on sectoral studies indicates that FDI is often undertaken by companies that are already significant exporters. These findings are supported by studies which have found that foreign owned firms tend to export a greater proportion of their output than do their locally owned counterparts. Presumably foreign firms typically have a comparative advantage in their knowledge of international markets, in the size and efficiency of their distribution networks and in their ability to respond quickly to changing patterns of demand in world markets. Foreign affiliates can also have "spillover" effects on the propensity of local firms to export. Empirical evidence from South East Asia strongly suggests that there has been such a learning process by local firms, and there is evidence that Mexican firms located in the vicinity of foreign MNCs tend to export a higher proportion of their output than do other Mexican firms.

There can also be policy-based linkages between FDI and host country exports. Performance requirements that require MNC affiliates to export a part of their production, and FDI incentives that are limited to or favour export-oriented sectors, are examples of policies that can produce (or strengthen) a positive correlation between inflows of FDI and exports.

A conspicuous example of such policies is export processing zones (EPZ). Many foreign firms have established operations in these zones, which have been set up by the host governments with the goal of stimulating exports, employment, skill upgrading and technology transfer. While the evidence about the benefits from export processing zones to host countries remains mixed, particularly as regards the linkages with the rest of the host country's economy, there seems to be a fairly broad agreement that EPZ have played a positive role in stimulating the countries' exports, particularly in the early stages of encouraging the development of labour-intensive exports.

Turning to the interlinkages between FDI and host countries' imports, some studies indicate that the impact of inward FDI on the host country's imports is either nil or that it slightly reduces the level of imports. However, most of the empirical research suggests that inward FDI tends to increase the host country's imports. One reason is that MNCs often have a high propensity to import intermediate inputs, capital goods and services that are not readily available in the host countries. These include imports from the parent company of intermediate goods and services that are highly specific to the firm. Concerns about the quality or reliability of local supplies of inputs can also be a factor.

In summary, the available evidence suggests that FDI and host country exports are complementary, and that a weaker but still positive relationship holds between FDI and host country imports. Except for the apparently stronger complementarity between FDI and host country exports (than between FDI and home country exports), these results are very similar to those reported for the relationship between FDI and home country trade.

The impact of FDI on the trade of the host and home countries was considered in the previous section and found to be generally positive. The main purpose of this section is, first, to explore in more detail two topics that were touched on briefly in that section, namely the "technology transfer" and "employment" aspects of FDI, and then to consider the implications of competition between countries in the use of incentives to attract FDI. Before turning to those topics, however, the "costs" most often stressed by critics of FDI are examined very briefly.

Historically, the significance of the benefits and costs of FDI has been a matter of fierce controversy. On one side, supporters praise it for transferring technology to the host countries, expanding trade, creating jobs and speeding economic development and integration into global markets. On the other side, critics charge it with creating balance-of-

payments problems, permitting exploitation of the host country's market, and in general reducing the host country's ability to manage its economy. While the debate has increasingly favoured the pro-FDI view in recent years, as more and more countries have adopted development strategies based on increased integration in the global market, the critics continue to voice concerns.

The essence of the view that an inflow of capital benefits the host country is that the increase in the income of the host country resulting from the investment will be greater than the increase in the income of the investor. In other words, as long as the FDI increases national output, and this increase is not wholly appropriated by the investor, the host country will gain. These benefits can accrue to domestic labour in the form of higher real wages, to consumers by way of lower prices and/or by better quality products, and to the government through increased tax revenue. Beyond this, there are other benefits via externalities associated with the FDI, some of which are discussed below in connection with the transfer of technology.

For the critics of FDI, this is a misleading, or at best incomplete picture because it ignores costs they believe are often associated with inflows of FDI. These include:

Balance of payments effects. Critics argue that while the initial impact of an inflow of FDI on the host country's balance of payments may be positive, the medium-term impact is often negative, as the MNC increases imports of intermediate goods and services, and begins to repatriate profits. The analysis in the previous section, which pointed to a stronger complementarity between FDI and host country exports than between FDI and host country imports, is relevant here. So is the finding that FDI in countries with high levels of import protection tends to be less export-oriented than FDI in countries with low levels of protection. The repatriation of profits, of course, must also be taken into account.

Suppose that, in a particular situation, the demand for foreign exchange associated with an inflow of FDI ultimately exceeds the supply of foreign exchange generated by that FDI. Is this a sufficient reason to reject the FDI?

The answer obviously depends on a comparison of the "costs" of dealing with the impact on the foreign exchange market, and the "benefits" of the FDI, for example from technology transfers and dynamic effects, such as increased domestic savings and investment. The latter are considered in more detail below. As regards the "costs", it is important to remember that the impact of FDI on the balance of payments depends on the exchange rate regime. Under flexible exchange rates, any disturbance to the balance between the supply and demand for foreign exchange is corrected by a movement in the exchange rate, in this case a depreciation.

If the country instead has a fixed exchange rate, a net increase in the demand for foreign exchange by the FDI project will result in a reduced surplus or increased deficit in the balance of payments. It is important however, to keep this in perspective. First, the previously mentioned evidence strongly suggests that, on average, an inflow of FDI has a bigger positive impact on host country exports than on host country imports. Balance-of-payments problems, therefore, if they occur, are likely to be small. Second, FDI is far from unique as a source of fluctuations in the demand and supply of foreign exchange, and governments regularly use monetary, fiscal and exchange rate policies to keep the current account balance at a sustainable level in the face of a variety of disturbances. Finally, the FDI is likely to bring a number of gains whose net benefit to the economy can exceed the cost of any possible balance-of-payments problems.

Domestic market structure. Because they generally have more economic power than

domestic competitors, it is argued that MNCs are able to engage in a wide variety of restrictive practices in the host country which lead to higher profits, lower efficiency, barriers to entry, and so forth. If the FDI was induced by host country tariffs, this could lead to an influx of foreign firms on the "follow-the leader" model, leading to excessive product differentiation and a proliferation of inefficient small-scale plants (automobile production in Latin America in the 1960s and 1970s comes to mind). Alternatively, of course, the entry of a MNC may have the effect of breaking up a comfortable domestic oligopolistic market structure and stimulating competition and efficiency. And, of course, account must be taken of the host country's domestic anti-trust policies, which are as applicable to MNCs as they are to national firms. In short, the effect of FDI on market structure, conduct and performance in host countries is not easy to predict a priori. The empirical evidence, however, points strongly to pro-competitive effects.

National economic policy and sovereignty. Critics have also raised concerns about the effects of FDI on public policy, vulnerability to foreign government pressure, and host country national interests. They argue that, because of its international connections, the subsidiary of a MNC enjoys alternatives not open to domestically-owned firms, and that this makes possible, among other things, the evasion of compliance with public policies. For instance, confronted with new social or environmental legislation in the host country that raises production costs, the MNC can more easily shift its activities to another country. Its ease of borrowing internationally may frustrate the use of direct macroeconomic controls for internal or external balance. The concern for vulnerability to foreign government pressure and its impact on the host countries' national interests stems the fact that the subsidiary of an MNC is answerable to two political masters - the host country government and the government of the home country where the parent is incorporated.

These are understandable concerns. But, again, it is important to keep them in perspective. The costs associated with these concerns (admittedly a very subjective calculation) have to be compared with the costs of foregoing the benefits that would come with FDI. Moreover, many of the concerns could be addressed in the course of negotiating a multilateral agreement on FDI. For example, multilateral disciplines are an option for dealing with regime "shopping" by multinationals seeking to avoid national regulations. Similarly, a multilateral agreement would provide a forum for the settlement of disputes over MNC behaviour involving home and host governments. In addition, judging from existing bilateral, regional and plurilateral investment agreements, it is likely that a multilateral agreement would allow signatories to claim exceptions for "sensitive" sectors.

Among the reasons which explain the change of attitude towards FDI on the part of many developing and transition countries is the belief that it can be an important channel for technology transfers, with technology being broadly defined to include not only scientific processes, but also organizational, managerial and marketing skills. This section first considers the ways in which FDI can enhance the efficient use of local resources through technology transfers, and then the empirical evidence on such efficiency-enhancing effects of FDI. While the focus is on FDI's impact on the efficiency of locally owned firms, it should be noted that the host country will also benefit from the fact that the subsidiary of an MNC is itself likely to use host country resources more efficiently because of its superior technology.

How FDI improves the efficient use of host country resources

As suggested by the discussion of the motivations behind a decision to engage in FDI, there are good reasons to think that MNCs are important vehicles for the direct and indirect transfer of technology between countries. Superior technology or capacity to innovate figure

prominently among the attributes a firm engaging in FDI relies on to compensate for the cost disadvantage, relative to local firms, associated with foreign operations. This technological superiority of many MNCs has led researchers to emphasize the efficiency-enhancing characteristics of their foreign investment.

FDI is very often associated with secondary benefits through the diffusion of technology to firms in the host country. This diffusion may be deliberate, such as when technology is licensed by the affiliate to a domestic firm, or it can be in the form of a technological spillover which occurs when the activities of the multinational firm yield benefits for local economic agents beyond those intended by the multinational.

An example of a deliberate diffusion is the upgrading of the technological capabilities, by the MNC, of local firms doing business with the MNC, for example when such upgrading is required to meet specifications demanded by the MNC. Technological spillovers can be horizontal or vertical. A horizontal technological spillover occurs, for example, when the affiliate has a new technology that is subsequently copied or learned by competing firms. A vertical spillover occurs when the affiliate transfers, free of charge, technology to firms supplying inputs or servicing "downstream" operations (for example distribution or retailing). The distinguishing feature of technological spillovers, which are an example of what economists term "positive externalities", is that the benefits they bring to the host country are not taken into consideration in the MNC's investment decision. Such benefits will be captured in full by the host country unless they are "competed away" in a bidding process to attract the FDI, in which case a part - perhaps all - of these indirect benefits will be captured by the MNC (more on this below).

Apart from the diffusion of MNC technology through spillovers, FDI may also produce other unintended efficiency-enhancing effects, as when local rivals are forced to upgrade their own technological capabilities as a consequence of competitive pressure from the local affiliate of the MNC. In the United States, for example, the entry of Japanese automobile manufacturers into the local market via FDI caused the major domestic automobile producers (themselves multinational firms) to upgrade their own products and to increase the efficiency of their domestic production facilities. This has benefited all consumers in the United States, whether they purchased Japanese or United States brand automobiles. There is considerable evidence that similar benefits occur in developing countries. Korean FDI, for example, contributed to the development of a locally-owned garment exporting industry in Bangladesh.

In many circumstances, FDI may result in a greater diffusion of know-how than other ways of serving the market. While imports of high-technology products, as well as the purchase or licensing of foreign technology, are important channels for the international diffusion of technology, FDI provides more scope for spillovers. For example, the technology and productivity of local firms may improve as foreign firms enter the market and demonstrate new technologies, and new modes of organization and distribution, provide technical assistance to their local suppliers and customers, and train workers and managers who may later be employed by local firms. Foreign subsidiaries may themselves conduct research and development activities aimed at adapting the parent firm's innovation to local conditions. Clearly FDI leads to more extensive personal interaction with foreigners and exposure to new ways of doing things than does trade.

What the empirical evidence shows

Empirical studies of FDI's role in the process of transfer and diffusion of technology approach the issue in various ways. Most of them provide evidence that FDI exerts an efficiency-enhancing effect on locally owned firms without, however, allowing the authors to

disentangle the particular channels through which it has its impact.

During the first five years after their commercialization, evidence suggests that new technologies are introduced abroad primarily through foreign MNC subsidiaries rather than exports. Moreover, it appears that in most instances the average age of technologies transferred to affiliates was lower than the average age of technologies sold to outsiders through licensing or joint ventures. This is consistent with the results of a study that found that flows of technology to MNC affiliates dominate all other types of formal technology transactions between countries. Another study considered the effects on economic growth of two variables related to technology transfer: imports of machinery and transport equipment did not seem to have any impact, whereas the inflow of foreign direct investment had a significant positive influence on income growth rates, at least for the higher-income developing countries.

Studies of manufacturing in several host countries provide evidence that FDI exerts a positive effect on the productivity of local firms. In the Mexican case, for example, it has been shown that the larger the presence of foreign MNCs in an industry, the higher the level of labour productivity and the faster the rate of productivity convergence toward the level on the corresponding industry in the United Sates. These results are consistent with earlier studies of Mexico, Australia and Canada. However, other empirical studies have found much weaker and sometimes even negative correlations between the presence of MNCs and the productivity of domestically-owned manufacturing plants. A possible reason for these apparently contradictory findings could be that various host industry and host country characteristics may influence the impact of FDI. For example, there is evidence that a higher educational level of the labour force, a higher level of fixed investment, a higher level of local competition and fewer requirements affecting local affiliates of foreign firms increase affiliate imports of parent company technology.

Other evidence on the effects of FDI in developing countries confirms that FDI had a positive overall effect on economic growth, that the magnitude of this effect depended on the stock of human capital (skills) in the host country, and that FDI also exerted a positive effect on domestic investment. An important role for human capital is consistent with the idea that in order for spillovers to occur, the host economy must have trained people able to learn from multinational firms and to apply their knowledge in local firms. These results, while not conclusively demonstrating the existence of technological spillovers, nevertheless provide strong circumstantial evidence of their presence. The evident complementarity between FDI and local investment is consistent with the idea that even if affiliates of multinational firms displace domestic rivals, this effect is more than compensated for by the investment activity of other local firms whose operations expand along with those of the multinational enterprise.

Research on urban areas in China has shown, first, that foreign-owned firms grew faster than other firms, and that even after controlling for other influences, FDI appeared to be a factor behind growth differences between regions; and second, that the amount of FDI in an area explained differences in locally owned enterprises' growth rates. Other studies tend to confirm that MNCs in developing countries generally extend their vertical linkages over time, which could be a consequence of technological transfer. Two related studies of the consumer electronics industry in southeast Asia showed that while vertical linkages between multinational firms and local suppliers in this very export-oriented industry were not significant at the time of the first study, they had grown substantially five years later. The fact that multinationals turned increasingly to local suppliers suggests that these suppliers became more competitive, at least in part as a result of technological spillovers from the

multinationals.

Conclusions

Despite the difficulties associated with the measurement of the efficiency-enhancing effects induced by FDI, let alone with the assessment of the specific channels by which a transfer of technology affects local productivity, the empirical literature offers some important conclusions. First, there appears to be a wide consensus that FDI is an important, perhaps even the most important, channel through which advanced technology is transferred to developing countries. Second, there also seems to be a consensus that FDI leads to higher productivity in locally owned firms, particularly in the manufacturing sector. Third, there is evidence that the amount of technology transferred through FDI is influenced by various host industry and host country characteristics. More competitive conditions, higher levels of local investment in fixed capital and education, and less restrictive conditions imposed on affiliates appear to increase the extent of technology transfers.

FDI and employment in the home country

In home countries - which means principally the OECD countries - the public debate over FDI has focused in large part on the impact of FDI on wages and employment. During the negotiation and final approval process for the North American Free Trade Agreement (NAFTA), concerns were expressed in the Congressional debate about the potential for this agreement, through increased investment (and trade) links with Mexico, to put downward pressure on United States wage levels, especially for unskilled labour. Similar concerns have been voiced in Western Europe over investment and trade linkages with Eastern Europe and Asia. Given projected demographic trends, the relationship between foreign investment, trade and employment is likely to remain a source of debate in the evolution of the global trading system.

Empirical research on home country employment effects has taken an indirect approach, focusing on linkages between FDI and trade, on the assumption that a net expansion in exports will translate into a net increase in employment, and vice versa for a net increase in imports. The basic presumption is that exports create employment, while imports destroy employment, and that production in foreign affiliates replaces home country production for export and domestic consumption. The latter assumption is largely contradicted by the empirical evidence. With regard to the former, it should be emphasized that the meaning of job creation and destruction is not so simple. The relevant question is not whether a particular FDI project creates or destroys employment, but whether FDI in the aggregate increases or decreases domestic employment.

There are studies for the United States that estimate a net loss of jobs due to the relocation of production from the United States, even after allowing for employment gains linked to home exports of intermediate goods to affiliates. However, other economists have been highly critical of the methodology and resulting estimates (which in any case represent one-tenth of one per cent or less of total employment in the United States). A recent survey of the linkages between outward FDI and employment concludes that no firm conclusion can be drawn regarding FDI/employment linkages in the home country.

An assessment of trade-related linkages between outflows of FDI and employment in France found that outward FDI by French firms for the period from 1989 to 1992 was mainly carried out by industries in which increased exports brought about job gains rather than losses. Other studies of foreign investment, focusing on the motivations for FDI, conclude that most such investment is motivated by a desire to serve regional markets, rather than by a desire to shift

production between regions.

On net, therefore, the effect of FDI on home country employment appears to be slight at most.

FDI and employment in the host country

What about the employment effects of FDI in host countries? Historically, perceptions regarding the potential employment effects of FDI flows to host developing countries have ranged from very negative to very positive. On the negative side, it has been argued that "the management, entrepreneurial skills, technology, and overseas contracts provided by MNCs may have little impact on developing local sources of these scarce skills and resources and may in fact inhibit their development ... as a result of the MNCs dominance of local markets." This view, however, is overwhelmingly rejected by the empirical evidence. An alternative view, supported by the recent evidence discussed above, is that MNCs can fill critical management gaps, facilitating employment of local labour and transferring skills to local managers and entrepreneurs. Clearly, effects in individual cases will depend on the practices of the MNCs themselves, on the regulatory environment in which they operate, and on the initial skill level of local employees. This calls attention to the fact that many labour market effects of FDI are closely related to the technology transfer aspects of FDI, particularly as regards the upgrading of skills.

Inflows of FDI also increase the amount of capital in the host country. Even with skill levels and technology constant, this will either raise labour productivity and wages, allow more people to be employed at the same level of wages, or result in some combination of the two (of course, if the inflows are negligible relative to the size of the labour force, the productivity and wage effects for the average worker will also be negligible). For a few developing countries, the ratio of inflows of FDI to gross fixed capital formation has been substantial in recent years (for example, 37½ per cent for Singapore, 24½ per cent for Malaysia and 10½ per cent for China). In Mauritius, it was FDI that fuelled the past decade of export-led growth and employment gains.

An appreciation of the benefits that FDI can bring, together with the widespread adoption of development strategies based on increased integration in the world economy, have resulted in most countries actively seeking FDI, often with the use of incentives. As competition for FDI intensifies, potential host governments find it increasingly difficult to offer less favourable conditions for foreign investment than those offered by competing nations.

Investment incentives can be classified into:

- **Financial incentives**, involving the provision of funds directly to the foreign investor by the host government, for example, in the form of investment grants and subsidized credits.

- **Fiscal incentives**, designed to reduce the overall tax burden for a foreign investor. To this category belong such items as tax holidays, and exemptions from import duties on raw materials, intermediate inputs and capital goods.

- **Indirect incentives**, designed to enhance the profitability of a FDI in various indirect ways. For example, the government may provide land and designated infrastructure at less-than-commercial prices. Or it may grant the foreign firm a privileged market position, in the form of preferential access to government contracts, a monopoly position, a closing of the market for further entry, protection from import competition or special regulatory treatment.

A number of governments have voiced concern with the proliferation of investment

incentives perceived to distort investment patterns in favour of countries with “deep pockets”. At the same time, the bilateral and regional investment agreements discussed below in Part IV reveal a reluctance on the part of governments to extend policy disciplines to investment incentives. The closest governments have come to a collective effort to limit the use of investment incentives is the inclusion of certain provisions in the WTO Agreement on Subsidies and Countervailing Measures (see Part V below).

In a very simplified model of the world economy, where information is costless, there are no special interest groups and policy decisions are guided only by a desire to use resources more efficiently, a case could be made for using investment incentives. This follows from the fact that the positive effects of FDI on host countries, such as the technological spill-overs and other positive externalities outlined above, are not fully captured by the investing firms. In the absence of investment incentives, there is no reason why an MNC would take such spillovers into account in deciding where to locate the FDI. In such a world, incentives would be a policy mechanism for allocating FDI efficiently by “internalizing” at least a portion of the spillover benefits accruing to host countries.

However, the situation in the real world where competition for FDI actually takes place is very different - so different, in fact, that the case for using investment incentives must be heavily qualified, if not totally rejected. The arguments can be broadly grouped into four categories.

Distributional considerations. Investment incentives transfer part of the value of FDI-related spillovers from the host countries to MNCs. The more intense the competition among potential hosts, the greater is the proportion of potential gains which is transferred to the MNCs. If the total stock of FDI available for investment in a region is largely insensitive to the amount of incentives being offered, host countries may find themselves providing incentives that simply neutralize other countries' incentives, without actually increasing the amount of FDI they obtain. Such incentives are nothing more than a transfer of income from these countries to the investing firms.

Knowledge considerations. Arguments in favour of incentives rely heavily on the assumption that governments have detailed knowledge of the value/size of the positive externalities associated with each FDI project. In practice, it would be an almost impossible task to calculate these effects with any accuracy, even with the aid of well-trained specialists. In reality, getting drawn into competitive bidding for an FDI project is like sending government officials to an auction to bid on an item whose actual value to the country is largely a mystery. As the winning host country generally is the one with the most (over-) optimistic assessment of the project's value to the country, incentive competition can give rise to over-bidding, the so-called “winner's curse”. If a country offers $185 million in incentives to obtain an FDI project that brings $135 million in total benefits, the country as a whole is $50 million worse off with the FDI.

Political economy considerations. Lack of knowledge is not the only reason a government might offer an amount of incentives that exceeds the benefits of the FDI. The benefits from a particular FDI project are likely to accrue to certain groups within the economy - for example, to a particular region or to workers fortunate enough to get jobs with the affiliate - while the costs of the investment incentives are likely to be spread more equally across the society. This different incidence of benefits and costs among groups in the host country opens the door for politically influential special interest groups to lobby the government to provide investment incentives which primarily benefit them, but which are largely paid for by other groups. The previously mentioned knowledge limitations simply open this door even wider.

Introducing new distortions. The discussion has assumed that the cost to a host country of

providing a million dollars worth of incentives is just a million dollars. This is overly optimistic. Financial incentives must be financed, and taxes create their own inefficiencies. Fiscal incentives are no better, and non-pecuniary (indirect) incentives can be even worse. For example, granting a monopoly position to a foreign firm allows the host government to escape direct budgetary outlays by shifting the cost onto consumers in the form of higher than necessary prices. Developing countries, in particular, may for budgetary or balance-of-payment reasons feel compelled to utilize highly distorting incentives, such as monopoly rights and guarantees against import competition to foreign investment projects. In contrast, developed countries with "deeper pockets" may offer straightforward financial grants with less distorting effects. This asymmetry puts developing countries at an extra disadvantage when competing for FDI, beyond a simple lack of deep pockets.

In summary, once the realities of using investment incentives to compete for FDI are taken into account, it is very difficult not to conclude that the world economy - and the vast majority of individual countries - would be better off with a multilateral agreement that included limitations on the use of investment incentives. Such incentives are no different from any other kind of subsidy program and, as with most other kinds of subsidies, developed countries (and in this case the largest developing countries) can out-spend the vast majority of other countries. Under very stringent conditions, investment incentives can correct for market imperfections. But the reality is that the necessary knowledge is missing, the programs are very vulnerable to political capture by special interest groups, and there is considerable scope not only for introducing new distortions, but also for redistributing income in a regressive way. The latter effect is a particular concern since developing countries as a group are net recipients of FDI.

Existing intergovernmental arrangements on foreign investment include a wide diversity of bilateral, regional, plurilateral and multilateral instruments that differ in their legal character, scope and subject-matter. Binding agreements exist mainly at the bilateral, regional and plurilateral levels, while instruments at the multilateral level are mostly of a non-binding nature. Some arrangements are devoted exclusively to foreign investment. Others treat foreign investment as part of a wider set of issues relating to economic cooperation and integration. The subject-matter of existing arrangements covers a broad spectrum of issues, including admission and treatment of foreign investment, promotion of foreign investment, investment insurance, aspects of corporate conduct, taxation, competition and jurisdictional matters, and dispute settlement procedures.

The recent evolution of international rule-making in the field of foreign investment is marked by the growing prominence of bilateral, regional and plurilateral arrangements which aim at encouraging foreign investment by providing substantive standards relating to the admission and treatment of foreign investment by host states. This is in contrast to the greater emphasis in the past on host country rights to control foreign investment and on norms for corporate conduct. Many recent arrangements are legally binding, but as illustrated by the APEC Non-Binding Investment Principles, other approaches are also being followed.

As regards the norms and concepts in the more recent instruments, there is a general tendency to accept the view that the protection of foreign investment should encompass certain general standards of treatment, coupled with norms on specific matters such as expropriation, compensation and the transfer of funds, and a mechanism for international settlement of disputes. In contrast, significant differences continue to exist regarding the admission of foreign investment and legally-binding commitments on admission are found only in some agreements.

Developments at the intergovernmental level are influenced by developments at the national level. It is helpful, therefore, to begin with a very brief look at recent developments in national regulations governing foreign investment.

The period since the early 1980s has witnessed a widespread tendency towards liberalization of national laws and regulations relating to foreign investment, especially in developing and transition countries. In many cases, this liberalization of foreign investment policies and regulations has been part of broader, market-oriented reforms of economic policy and has proceeded in parallel with trade liberalization, deregulation and privatization.

The recent trend to more open investment policies has been particularly evident in the removal or relaxation of regulatory barriers to the entry of FDI. Screening procedures involving prior authorization have been eliminated or reduced in scope. Closely related is the liberalization of sectoral restrictions on the entry of foreign investment and of limitations regarding foreign shareholding in local companies. There has also been a shift away from the imposition of performance requirements and a liberalization of regulations concerning the transfer of funds. In addition, there has been increasing acceptance of standards of non-discriminatory treatment of foreign investors and of international standards on matters such as compensation in case of expropriation. Finally, international arbitration mechanisms for the settlement of disputes between foreign investors and host states have gained widespread acceptance.

At the same time, there are several qualifications to this liberalization trend. First, the trend has not been homogeneous and significant differences between foreign investment regimes persist. Second, virtually all countries maintain some restrictions, often of a sectoral nature, on the entry of foreign investment. In this connection, an issue that has attracted attention is the existence of reciprocity requirements with regard to the entry and treatment of foreign investment.

The liberalization of national laws and regulations has been accompanied by a rapid proliferation of intergovernmental arrangements dealing with foreign investment issues at the bilateral, regional and plurilateral levels. Unilateral liberalization of national legal frameworks has not been found sufficient, and states around the world have increasingly recognized the crucial importance of international commitments to securing a stable and predictable legal environment for FDI.

Because postwar attempts to establish a binding multilateral agreement containing comprehensive rules on foreign investment have not been successful (more on this below), bilateral treaties for the promotion and protection of foreign investment have emerged as the predominant source of rules for the treatment of foreign investment. An exclusive focus of such bilateral investment treaties (BITs) on the regulation of foreign investment is their major distinguishing feature in comparison with earlier Treaties of Friendship, Commerce and Navigation which were common in the immediate postwar years.

The growth in the number of BITs has been especially significant since the late 1980s. UNCTAD reports that some two-thirds of the nearly 1,160 BITs concluded up to June 1996 were concluded during the 1990s. This evolution reflects three broad trends. First, until the late 1970s, the conclusion of BITs by OECD countries was confined to a relatively small number of mainly European countries. Then during the 1980s the negotiation of such treaties by OECD countries became more generalized and by 1994 there were 18 OECD countries which had concluded at least ten BITs. Second, the geographical orientation of the BITs concluded by OECD countries, initially characterized by a heavy emphasis on developing countries in Asia and Africa, changed markedly after the mid-1970s as treaties were

concluded with countries in Central and Eastern Europe, China, Latin America, and the Soviet Union and its successor republics. Third, beginning in the 1980s a considerable number of BITs were concluded between non-OECD countries.

The importance of BITs stems not only from the sharp increase in their use, but also from the fact that many recent regional and plurilateral investment arrangements incorporate concepts and standards derived from these treaties. BITs tend to be relatively brief and broadly comparable in structure. Virtually all contain provisions on scope of application, admission of investments, general treatment standards, standards of treatment on specific matters, and dispute settlement. Despite this similarity in structure and areas of substantial convergence, there are also areas characterized by wide variation in the substantive provisions. BITs are usually reciprocal in nature, setting forth rules applicable to investments made by investors of either party in the territory of the other party. While designed to promote and protect foreign investment, BITs seldom contain positive obligations for home countries to take measures to foster investments by their nationals in the territory of the other party. The promotion of foreign investment is sought, instead, through reductions in various types of uncertainty peculiar to such investments.

Bilateral investment treaties typically contain a broad, flexible concept of “investment”. It is viewed as a form of property and is usually defined through an open-ended (illustrative) list of assets, including movable and immovable property, ownership rights in companies, claims to money and intellectual property rights. The scope of the investments covered by the BIT in some cases has been expressly limited to investments made in accordance with the domestic law of the host state or to investments approved or duly registered by the host state. Another important aspect concerns the definition of the persons and companies which will be treated as investors of one of the parties. In this respect, BIT practice is marked by relatively important discrepancies, especially in regard to the definition of corporate nationality.

There are two main approaches to the admission of foreign investment. Most BITs require that, subject to their domestic laws, parties shall encourage and admit in their territories investments by nationals and companies of the other party. The reference to domestic laws means that the commitment to encourage foreign investment is subject to any existing or future restrictions on the entry of foreign investment contained in domestic legislation. The priority accorded in these BITs to domestic laws reflects the fact that historically these treaties have been designed primarily to regulate the treatment of foreign investment after admission. A fundamentally different approach to the admission of foreign investment is found in most BITs concluded by the United States. They require application of MFN and national treatment with respect to both admission and to subsequent treatment of investments, subject, however, to the right of each party to make or maintain exceptions in sectors or matters specified in an annex to the BIT.

General standards of treatment commonly found in BITs require that covered investments be accorded fair and equitable treatment, full protection and security, and that the parties refrain from impairing by unreasonable or discriminatory measures the management, maintenance, use, enjoyment or disposal of covered investments. In addition, many treaties contain a requirement for each party to observe any obligations it may have undertaken in respect of investments by investors of the other party. Most BITs also contain MFN and national treatment requirements, although there is a significant number which specify only MFN treatment. Practice regarding the precise formulation of MFN and national treatment clauses tends to vary considerably. In addition to exceptions for specified sectors or measures, BITs normally provide for exceptions to MFN/national treatment in respect of benefits accorded to investors of a third state by virtue of membership in a regional integration agreement and

benefits accorded to investors of third states under bilateral agreements to avoid double taxation. Virtually all BITs contain requirements related to the transfer of funds related to investments, expropriation and compensation, and protection from losses due to war and other extraordinary circumstances. Most also address certain matters arising from the operation of national insurance schemes. Other less common provisions, found mainly in treaties concluded by the United States, deal with performance requirements, temporary entry of certain personnel in connection with the establishment or management of an investment, and the right of foreign investors to hire top managerial personnel without regard to nationality.

Dispute settlement mechanisms contained in BITs provide for binding arbitration of disputes regarding the application and interpretation of the treaty which the parties have not been able to resolve through diplomatic efforts. Arbitration of intergovernmental disputes is regulated by specific rules laid down in each BIT concerning such matters as the method of appointing the arbitrators, rules of procedure, the time-limits for the completion of the arbitration proceedings, liability for costs and applicable law. In addition, there often are provisions for binding international arbitration of disputes between one of the parties and a national of another party. Such provisions normally refer to pre-existing arbitration rules, notably those under the International Centre for Settlement of Investment Disputes (ICSID) Convention. Although the recent trend towards widespread acceptance of this type of clause marks a significant shift in attitude, there is great diversity of treatment in these clauses of such issues as the unconditional nature of the right of a foreign investor to have recourse to international arbitration and the application of the principle of exhaustion of local remedies. Experience with these BIT dispute settlement mechanisms is rather limited, and no inter-governmental arbitration has yet been instituted pursuant to a BIT. The first case taken to an ICSID arbitration tribunal, on the basis of an investor-state arbitration clause in a BIT, occurred only in 1987.

There are other bilateral agreements that can have indirect effects on FDI. One example, is the Bilateral Investment Incentives Agreements between the United States and a number of developing countries, which deal with the provision of investment insurance by the United States Overseas Private Investment Corporation (OPIC). Such agreements provide that host states shall recognize OPIC's rights of subrogation in case of payment of a claim, and establish a mechanism for the settlement of disputes through binding international arbitration. Another example is the large number of bilateral treaties dealing with double taxation.

At the regional and plurilateral level, a distinction can be made between, on the one hand, arrangements that cover only foreign investment and, on the other, arrangements that integrate rules on foreign investment into a broader framework of rules aimed at economic cooperation and integration, (Tables 2 and 3). Examples of the latter include the Treaty establishing the European Community, the North American Free Trade Agreement and the European Energy Charter Treaty. The former type of agreement has been used in the case of OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations, the Colonia Protocol on the Promotion and Reciprocal Protection of Investments within MERCOSUR and the APEC Non-Binding Investment Principles. In regard to their objectives and coverage, these arrangements show greater diversity than BITs. For example, some aim primarily at the removal of investment barriers between the parties, while others are more inspired by the promotion and protection approach typical of BITs. Also, while most regional and plurilateral arrangements focus on questions relating to the admission and treatment of investment, the OECD Declaration on International Investment and Multinational Enterprises

addresses certain subjects not typically dealt with in investment agreements, such as norms for corporate conduct and procedures for the resolution of jurisdictional conflicts.

Table 2
Regional instruments

Instrument	Date	Instrument	Date
I. Separate Instrument			
Common Convention on Investments in the States of the Customs and Economic Union of Central Africa	1965	Agreement for the Establishment of a Regime for CARICOM Enterprises	1987
Agreement on Investment and Free Movement of Arab Capital among Arab Countries	1970	Revised Basic Agreement on ASEAN Industrial Joint Enterprises	1987
Convention Establishing the Inter-Arab Investment Guarantee Corporation	1971	Agreement Among the Governments of Brunei Darussalam, the R Republic of Indonesia, Malaysia, the Republic of the Philippines, the Republic of Singapore and the Kingdom of Thailand for the Promotion an Protection of Investments	1987
Joint Convention on the Freedom of Movement of Persons and the Right of Establishment in Central African Customs and Economic Union	1972	Charter on a Regime of Multinational Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States	1990
Agreement on the Harmonization of Fiscal Incentives to Industry	1973	Decision No. 24 of the Commission of the Cartagena Agreement: Common Regulations Governing Foreign Capital Movement, Trademarks, Patents, Licenses and Licences and Royalties and Decision No.291 of the Commission of the Cartagena Agreement: Common Code for the Treatment of Foreign Capital and on Trademarks, Patents and Royalties	1970 1991

The Multinational Companies Code in the Custom and Economic Union of Central Africa	1975	Decision No. 292 of the Commission of the Cartagena Agreement: Uniform Code on Andean Multinational Enterprises	1991
Unified Agreement for the Investment of Arab Capital in the Arab States	1980	Colonia Protocol on Promotion and Reciprocal Protection of Investment within MERCOSUR	1994
Community Investment Code of the Economic Community of the Great Lakes Countries (CEPGL)	1987	Protocol on Promotion and Protection of Investments Coming from States non Parties to MERCOSUR	1994
II. Embedded in Broader Framework			
Treaty Establishing the European Community	1957	Treaty Establishing the Latin American Integration Association	1980
Agreement on Arab Economic Unity	1957	Treaty Establishing the Economic Community of Central African States	1983
Agreement on Andean Subregional Integration	1969	North American Free Trade Agreement	1992
Treaty Establishing the Caribbean Community	1973	Treaty Establishing the Common Market for Eastern and Southern Africa	1993

Table 3
Plurilateral instruments

Instrument	Date	Instrument	Date
Code of Liberalization of Capital Movements (OECD)	1961	Fourth ACP-EEC Convention of Lomé	1989
Code of Liberalization of Current Invisible Operation (OECD)	1961	APEC Non-binding Investment Principles	1994
Declaration on Investment and Multinational Enterprise (OECD)	1976	Final Act of the European Energy Charter Conference , the Energy Charter Treaty, Decisions with Respect to the Energy and Annexes to the Energy Charter Treaty	1994

Among the agreements dealing with foreign investment as one part of a comprehensive framework for regional cooperation, the most far-reaching approach is contained in the EC Treaty. It envisages the removal of restrictions on the right of establishment and movement of capital as one of the means of establishing a common market, something which distinguishes it from all other arrangements in the field of foreign investment. Articles 52-58 of the EC Treaty provide for the progressive elimination of restrictions on the freedom of establishment of natural and legal persons having the nationality of one member state in the territory of another member state, and Articles 67-73 address the progressive elimination of restrictions on the free movement of capital. These matters are also addressed in agreements concluded by the EC with third countries, including the recent association agreements with countries in Central and Eastern Europe. Other examples in which investment liberalization is an aspect of regional economic integration are the Treaty Establishing the Caribbean Community (1973) and the Treaty for the Establishment of the Economic Community of Central African States (1983).

In contrast, the investment provisions in Chapter 11 of the North American Free Trade Agreement are more comparable to BITs. In common with BITs, the provisions of Chapter 11 include a wide definition of the term "investment", general standards of treatment (including national treatment, MFN treatment, and treatment in accordance with international law), specific standards for compensation in the case of expropriation and in the case of losses suffered as a result of armed conflict or civil strife, transfers, and a mechanism for arbitration of disputes between an investor and a Party to the NAFTA. In important respects, however, the NAFTA investment disciplines go far beyond those contained in a typical BIT. For example, the requirements to accord national treatment and MFN apply both to the admission of investments and the treatment of investments and investors after admission, and the scope of the prohibition of performance requirements is unprecedented in international investment or trade agreements. Examples of other unique features of the NAFTA rules on investment are the inclusion of rules on environmental matters and the provision for consolidation of state-investor arbitration proceedings in case of multiple claims involving common questions of law or fact.

The European Energy Charter Treaty establishes a legal framework for the promotion of long-term cooperation in the energy sector and encompasses trade, competition, technology, access to capital, investment promotion and protection, and environmental matters. Although limited in its sectoral coverage, the large number of countries involved makes the Treaty unique among binding international arrangements containing substantive standards for the treatment of investment. As with the investment provisions of the NAFTA, the Treaty is comparable to BITs in regard to the substantive rules on the treatment of foreign investment (Articles 10-17) and the procedure contained in Article 26 for international arbitration of disputes between an investor and a Contracting Party. On the other hand, a notable difference between the Treaty and NAFTA is that, while in regard to the treatment of investments after admission the Treaty requires Contracting Parties to accord the better of national treatment and MFN treatment to investors from other Contracting Parties, in respect of the admission of investment it only requires Contracting Parties to "endeavour" to accord such treatment (the Treaty envisages the conclusion of a supplementary treaty by 1 January 1998 that would extend the national treatment/MFN obligation to the entry of foreign investment). The Treaty is also less far-reaching than NAFTA in respect of performance requirements, which it addresses by incorporating the provisions of the WTO Agreement on Trade-Related Investment Measures.

In addition to the rules on promotion and protection foreign investment, and on trade-related investment measures, the Treaty also deals with the question of access to capital. In this connection, Article 9 requires that Contracting Parties endeavour to promote access to their capital markets for the purpose of financing trade in energy and for the purpose of investment in the energy sector, on a basis no less favourable than that which it accords in like circumstances to its own companies and nationals, or to companies and nationals of any other Contracting Parties or any third state, whichever is the most favourable.

Several regional and plurilateral instruments deal with foreign investment matters by providing a framework for the conclusion of bilateral investment agreements between the parties to the instrument. An important example of this approach is the Fourth ACP (Lomé) Convention. Chapter 3 of the Convention, which is part of Title III on development finance cooperation, contains provisions on investment promotion, investment protection, investment financing, investment support, current payments and capital movements, and qualifications and treatment of business entities. The Chapter sets forth general principles regarding the treatment of foreign investment, such as the requirement to accord fair and equitable treatment, and envisages that more specific regulation of policies on foreign investment will be dealt with through the negotiation of bilateral agreements between the contracting parties. Article 260 affirms the importance of concluding bilateral investment promotion and protection agreements, and Article 261 provides inter alia that the negotiation and implementation of such agreements shall proceed on a non-discriminatory basis. With a view to facilitating the negotiation of such agreements, a Joint Declaration in Annex LIII of the ACP Convention provides that the Contracting Parties will undertake a study of the main clauses of a model bilateral investment agreement.

Among the regional and plurilateral arrangements devoted exclusively to foreign investment, mention should be made of the legally binding OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations. Adopted in 1961, they aim at the progressive non-discriminatory liberalization of restrictions on inward and outward capital and current payments, subject to the possibility of country-specific reservations, general exceptions and temporary derogations. The Capital Movements Code was amended in 1984 to include right of establishment. The implementation of these Codes is being reviewed by the OECD Committee on Capital Movements and Invisible Transactions. The treatment of investment after admission is subject to a separate OECD instrument, the National Treatment Instrument, which is part of the Declaration on International Investment and Multinational Enterprises. This Declaration and its annexes, originally adopted in 1976 and most recently revised in 1991, also contain guidelines for the conduct of multinational enterprises, procedures for cooperation to avoid or minimize the imposition of conflicting requirements on multinational enterprises, and procedures for cooperation in regard to investment incentives and disincentives. Although the Declaration itself is not legally binding, its implementation is reviewed in accordance with binding procedural decisions in the Committee on International Investment and Multinational Enterprises.

In May 1995, following several years of preparatory work, OECD members launched negotiations with the aim of concluding a Multilateral Agreement on Investment (MAI). The main features of the proposed agreement are as follows: the centrepiece is a "top down" approach to liberalization of investment regimes through the application of national treatment and MFN treatment standards to both the establishment and the subsequent treatment of investment; a broad, asset-based definition of investment; provisions on country specific reservations; standstill and roll-back obligations; provisions on transparency of domestic laws, regulations and policies; a limited set of general exceptions; standards for the

protection of investments (general treatment standards and specific standards on expropriation and compensation, transfer of funds, protection from civil strife, and so forth); and dispute settlement procedures through state-state arbitration and investor-state arbitration. In addition, consideration is being given to the possible inclusion of disciplines on investment incentives, performance requirements, movement and employment of key personnel, corporate practices, privatization and monopolies and state enterprises.

It has yet to be decided whether the MAI should provide for substantial liberalization commitments immediately upon entry into force, or should be more in the nature of a standstill agreement, coupled with a mechanism for progressive liberalization over time. The agreement is expected to be a free-standing international treaty, open to OECD members and the European Community and to accession by non-OECD countries. The aim is to conclude the negotiations by the time of the 1997 OECD Ministerial Meeting (they are traditionally held in May).

The Agreement among the ASEAN members for the Promotion and Protection of Investments (1987), and the Colonia Protocol on Promotion and Reciprocal Protection of Investments within MERCOSUR (1994), are examples of regional arrangements devoted exclusively to foreign investment that are similar in approach to the majority of BITs. The former adopts the approach to admitting foreign investment found in the vast majority of BITs, in that it provides that the parties shall encourage foreign investment from other parties, but subject to their domestic laws and objectives. Moreover, national treatment after admission is not a general obligation but a matter for negotiation between the parties to the agreement. By contrast, the Colonia Protocol requires parties to accord the better of national treatment and MFN treatment in regard to both the admission of foreign investment from other parties and the treatment of such investment after admission. This obligation is qualified by the right of each party to maintain during a transition period exceptions in sectors listed in the annex to the Protocol.

The APEC Non-Binding Investment Principles, adopted in November 1994, deal with transparency, non-discrimination between source economies, national treatment, investment incentives, performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes, entry and sojourn of personnel, avoidance of double taxation, investor behaviour and removal of barriers to capital exports. Apart from the fact that the principles are not legally binding, in most instances their formulation is considerably less specific and less stringent than in comparable recent investment arrangements.

Although several efforts were made in the decades following World War II to agree on a binding multilateral instrument containing comprehensive substantive rules on foreign investment, none were successful. Existing multilateral instruments of a legally binding nature tend to be narrow in scope and do not establish substantive norms, while multilateral instruments that set forth substantive norms are non-binding.

Within the World Bank Group, two multilateral instruments of a legally binding nature have been concluded specifically relating to foreign investment (Table 4). One is the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, which was concluded in 1965 and entered into force in October 1966. It establishes facilities for the resolution of disputes between investors and states through conciliation and arbitration in the International Centre for Settlement of Investment Disputes (ICSID). The number of Contracting States to the Convention has grown significantly in recent years and many bilateral and regional investment agreements refer to the ICSID Convention as the framework for the settlement of disputes between investors and states.

Table 4
Multilateral instruments

Instrument	Date	Instrument	Date
I. Binding Instruments			
Convention of the Settlement of Investment Disputes between States and Nationals of Other States (IBRD)	1965	Guidelines on the Treatment of Foreign Direct Investment (The World Bank Group)	1992
Convention Establishing the Multilateral Investment Grantee Agency (IBRD)	1985		
II. Non-binding instruments			
UN General Assembly Resolution 1803 (XVII): Permanent Sovereignty over Natural Resources	1962	Draft International Agreement on Illicit Payments (not adopted by the UN General Assembly)	1979
UN General Assembly Resolution 3201 (S-VI): Declaration on the Establishment of a New International Economic Order and UN General Assembly Resolution 3202 (S-VI): Programme of Action on the Establishment of a New International Economic Order	1974	The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (adopted as UN General Assembly Resolution 35/63) and Resolution Adopted by the Conference Strengthening the Implementation the Set	1980 1990
UN General Assembly Resolution 3281 (XXIX): Charter of Economic Rights and Duties of States	1974	Draft United Nations Code of Conduct on Transnational Corporations (not adopted by the UN General Assembly)	1983

ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy and Procedure for the Examination of Disputes Concerning the Application of the Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy by Means of Interpretation of its Provision	1977 1986	UN General Assembly Resolution 89/248: Guideline for Consumer Protection Draft International Code of Conduct on the Transfer of Technology (not adopted by the UN General Assembly)	1985 1985

Note: See Chapter 5 for the multilateral instruments in the WTO framework.

The other agreement concluded under the auspices of the World Bank Group is the Convention Establishing the Multilateral Investment Guarantee Agency, which was concluded in 1985 and entered into force in April 1988. Based on a belief that the flow of foreign investment to developing countries can be facilitated and promoted by alleviating concerns related to non-commercial risks, the principal aim of the Multilateral Investment Guarantee Agency is to provide a multilateral investment insurance mechanism as a complement to national, regional and private investment insurance schemes. The Convention also contemplates a role for the Agency with regard to substantive standards for the treatment of investment. Under Article 12(d) of the Convention the Agency must, in guaranteeing an investment, satisfy itself inter alia as to "the investment conditions in the host country, including the availability of fair and equitable treatment and legal protection for the investment". Article 23 of the Convention deals with investment promotion and stipulates that, in addition to research and technical assistance activities, the Agency is to facilitate the conclusion of agreements among members to the Convention on the promotion and protection of foreign investment.

Substantive multilateral norms for the treatment of foreign investment are contained in the non-binding Guidelines on the Treatment of Foreign Direct Investment, developed in the World Bank Group following an April 1991 request by the IMF-World Bank Development Committee for the preparation of a report on "an overall legal framework which would embody the essential legal principles so as to promote foreign direct investment". The Guidelines were "called to the attention" of the members of the World Bank Group by the Development Committee in September 1992 "as useful parameters in the admission and treatment of private foreign investment in their territories, without prejudice to the binding rules of international law". They differ in two main respects from the work initiated in 1977 in the United Nations on a Code of Conduct for Transnational Corporations. First, they only cover general principles to guide governmental behaviour toward foreign investors; rules of good conduct on the part of foreign investors are not included. Second, they do not purport to represent a codification of customary international law in regard to the treatment of foreign investment, but rather to formulate generally acceptable international standards which support the objective of promoting foreign investment. The five sections of the Guidelines address respectively, the scope of application, the admission of foreign investment, standards of treatment of foreign investment, expropriation and unilateral alterations or termination of contracts, and settlement of disputes.

Mention should also be made of other multilateral instruments that are somewhat different in scope but are nevertheless relevant in this context. Several United Nations General Assembly Resolutions adopted in the 1960's and 1970's include provisions on foreign investment mainly with a view to affirming certain rights of host states. Matters relating to social policy have been dealt with in the (non-binding) ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy which was adopted in 1977 and took effect in 1978. The Declaration contains principles commended to governments, employers' and workers' organizations of home and host countries and to multinational enterprises. These principles pertain to general policies, employment, training, conditions of work and life and industrial relations. Restrictive business practices are addressed in the United Nations Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices. The Set, adopted in 1980 in the form of a non-binding Resolution of the General Assembly of the United Nations, contains principles addressed both to states and enterprises for the control of restrictive business practices as well as provisions for consultations, cooperation and technical assistance in the framework of UNCTAD. Health and safety issues are dealt with in the United Nations General Assembly Resolution 39/248 on Guidelines for Consumer Protection.

Negotiations began in 1977 in the United Nations towards the formulation of a Code of Conduct on Transnational Corporations aimed at the establishment of a comprehensive framework of norms for corporate conduct and norms for the treatment of transnational corporations by host states. A principal objective of the envisaged Code was "to maximize the contribution of transnational corporations to economic development and growth and to minimize the negative effects of the activities of these corporations". In regard to the activities of transnational corporations, the draft Code contained certain general norms as well as more specific standards of conduct in respect of economic, financial and social matters and disclosure of information. The treatment of transnational corporations by host states was the subject of general principles and provisions on nationalization and compensation, jurisdiction and dispute settlement. Negotiations on the Code were terminated in 1992 and no one has suggested their revival.

The multilateral trading rules traditionally have contained very little that was directly relevant to the treatment of foreign investment. But, as the GATT progressively developed through successive rounds of trade negotiations and, in particular, through its transformation into the WTO, investment-related issues have increasingly been addressed. This reflects the greater intertwining of investment and trade in the operations of firms, and the increasing difficulty of separating those aspects of the conditions of international competition related to the trans-border movement of goods and services from those related to foreign investment.

At the outset, it should be recalled that the creation of the GATT stemmed from the failure to establish the International Trade Organization. The ITO would have covered, in addition to those matters covered by the GATT, restrictive business practices, commodity agreements and, in its Articles 11 and 12, foreign investment.

The question of investment was revisited in the context of the 1955 GATT review conference, undertaken when it became clear that the Havana Charter would not enter into force. This resulted in a Resolution on International Investment for Economic Development, which recognized that an increased flow of capital into countries in need of investment from abroad and, in particular, into developing countries would facilitate the objectives of the General Agreement. It recommended that contracting parties in a position to provide capital for international investment, and contracting parties who desire to obtain such capital, use their best endeavours to create conditions calculated to stimulate the international flow of capital.

These included, in particular, the importance of providing security for existing and future investment, the avoidance of double taxation and facilities for the transfer of earnings of foreign investments. It urged GATT contracting parties, upon the request of any contracting party, to enter into consultation or participate in negotiations directed to the conclusion of bilateral and multilateral agreements relating to these matters.

In the years that followed, the GATT came to deal increasingly with internal policy instruments that can distort the conditions of international trade. Prior to the Uruguay Round, this development was most marked in the Tokyo Round negotiations in the 1970s, when rules on such matters as subsidies, technical standards and government procurement were negotiated. Although, for the most part, these policy instruments were looked at in terms of their impact on the cross-border movement of goods, the rules developed are also, in many cases, relevant to the competitive conditions which foreign investors face. For example, as is explained in more detail below, GATT and now WTO rules on subsidies are relevant to investment incentives.

A second and, for investment, more directly relevant development in the GATT/WTO has involved establishing international rules governing the treatment of foreign companies. Originally, the GATT rules only put obligations on governments in respect of the treatment of foreign goods. They were not concerned with the treatment of foreign persons, legal or natural, operating in their territories, the issue at the heart of investment policy. However, as a result of the Uruguay Round negotiations, the WTO puts important obligations on governments in regard to the treatment of foreign nationals or companies within their territories - in the GATS and the TRIPS Agreement, as well as in the plurilateral Government Procurement Agreement.

The integration of investment and cross-border trade in the WTO is most evident in the General Agreement on Trade in Services (GATS). As has been noted, the supply of many services to a market is difficult or impossible without the physical presence of the service supplier. Article I:2 of the Agreement defines "trade in services" as encompassing four modes of supply, including the supply "by a service supplier of one member, through commercial presence in the territory of any other member". The term "commercial presence" is defined in Article XXVIII(d) as "any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a member for the purpose of supplying a service". As a consequence, the GATS covers forms of establishment which correspond to the notion of FDI. Another investment-related mode of supply covered by Article I:2 is the supply "by a service supplier of one member, through presence of natural persons of a member in the territory of any other member". This mode of supply is closely related to the commercial presence mode of supply in that it includes temporary entry of business visitors and intra-company transferees of managerial and other key personnel.

All WTO members have established specific commitments under GATS in relation to the four modes of supply. These commitments bind governments to guaranteed conditions of market access in respect of the modes and sectors indicated in schedules of specific commitments. In the absence of specifications to the contrary, members guarantee both the right of market entry (Article XVI) and the right to national treatment (Article XVII) in scheduled sectors. A list of six conditions that may be imposed on market access is contained in Article XVI. Four of these relate to different kinds of quantitative limitations that may apply to foreign services or service suppliers. The other two conditions are relevant only to commercial presence. They involve measures which "restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service" and "limitations on the participation of

foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment." Limitations on national treatment are not similarly defined, and may encompass any form of discrimination, as indicated in a member's schedule.

The GATS embodies a framework of rules establishing the context in which the schedules of specific commitments must be read, including those relating to investment. Some of these rules are of general application, while others apply only in the situation where a member has assumed a specific sectoral commitment. The most important rule of general application is most-favoured-nation treatment. Thus, GATS requires that members extend MFN treatment in all service sectors. Certain transparency obligations are also of a general nature. But many other provisions, covering such matters as domestic regulation, monopolies and exclusive service suppliers, payments and transfers, and balance-of-payments measures are only relevant in the context of specific commitments.

When considering GATS as a framework for international rules on investment, two points in particular are noteworthy regarding the content and structure of the Agreement. These are relevant to any consideration of how a broad-based international investment agreement might be structured. First, the GATS is not an investment agreement as such. It addresses investment as one of several different ways of gaining access to a market. The GATS does not contain the kind of investment protection provisions commonly found in many of the bilateral and regional investment arrangements discussed previously. Nor does it embody such features as a mechanism allowing private investors direct access to an international dispute settlement mechanism. On the other hand, by treating investment as one element of trade in services, the GATS addresses not only the terms and conditions upon which a foreign investor may enter the market, but also deals with "establishment trade" -- or in other words, the conditions of operation in the post-investment phase. The latter is also a feature of many of the bilateral and regional investment agreements referred to above.

Second, in defining national treatment as an obligation that relates only to scheduled commitments, the GATS departs from a number of other intergovernmental investment agreements in which national treatment has the same status as MFN, namely a principle of general application (but subject, in many cases, to reservations). Moreover, the GATS sets up a structure in which it is possible for governments, in agreement with trading partners, to condition national treatment, or grant it partially. Similarly, the market access concept contained in Article XVI of GATS permits governments to condition the extent to which entry by foreign suppliers will be permitted. This capacity to open domestic markets to competition from foreign suppliers by degree is achieved in other agreements through exceptions and reservations.

A distinction can be made between a "negative" list and a "positive" list approach to defining the scope of an agreement. Under the negative list approach, governments must specify the sectors or measures to which obligations do not apply. Under the positive list approach, by contrast, the requirement is to list those sectors or measures in respect of which obligations are to be assumed. In discussions of the best approach to identifying the extent of commitments, it has been argued that the negative list approach provides more transparency and encourages governments to be more forthcoming in negotiations in respect of their commitments. It has also been pointed out that under a negative list approach, new activities arising from technological advances will automatically be covered, whereas explicit provision would have to be made for such activities to be covered under the positive list approach. A number of the international agreements discussed previously rely on a negative list approach. In fact, the GATS is a hybrid of the two approaches, containing a positive listing of sectors and

a negative listing to limitations on market access and national treatment.

Finally, two more general points regarding the GATS are worth noting. First, it is a new agreement, having entered into force in 1995, and governments were well aware when they were negotiating the GATS that much remained to be done. Like the GATT before it, the GATS is a framework designed to permit the progressive liberalization of trade in services through further negotiations. Indeed, the GATS contains a built-in commitment in Article XIX to continue to negotiate liberalization through successive rounds of negotiations with the first such negotiation scheduled to begin before the year 2000. Second, the GATS is one of the few agreements covering foreign investment which is both multilateral and binding. Because of the multilateral nature of GATS, both existing and future bilateral and regional investment agreements will need to take its provisions fully into account, including in particular the strong MFN commitment.

The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is another important example of the evolution of the multilateral trading system from a set of rules primarily aimed at regulating policies affecting cross-border trade in goods to a set of rules also covering host country treatment of foreign companies. Although the TRIPS Agreement does not directly address foreign investment, its provisions on minimum standards for the protection of intellectual property, domestic enforcement procedures and international dispute settlement are directly relevant to the legal environment affecting foreign investment (the definition of "investment" in many intergovernmental investment agreements expressly includes intellectual property).

Under the TRIPS Agreement, each WTO member is required to accord in its territory the protection required by the TRIPS Agreement to the intellectual property of the nationals of other WTO members. The Agreement covers all the main areas of intellectual property rights - copyright and related rights, trademarks, geographical indications, industrial designs, patents, layout-designs of integrated circuits and undisclosed information or trade secrets. In respect of these areas the Agreement contains two main sets of substantive obligations.

First, it lays down minimum standards of substantive protection for each category of rights that must be available in the national law of each member, at a level which approximates that found in the main industrial countries today. It does this by requiring that the substantive obligations of the main WIPO Conventions, the Paris Convention for the Protection of Industrial Property and the Berne Convention for the Protection of Literary and Artistic Works, must be complied with and by adding a substantial number of additional obligations on matters where these Conventions are silent or seen as being inadequate. For each area of intellectual property, it sets out what subject matter must be protectable, what are the minimum rights that must flow from such protection and the permissible exceptions to those rights, and what is the minimum duration of protection.

The second major characteristic of the Agreement is that, for the first time in international law, it specifies in some detail the procedures and remedies that each member must provide within its national law so that the nationals of other members can effectively enforce their intellectual property rights - whether through the normal civil judicial process, through customs action against imports of counterfeit and pirated goods or through criminal procedures in respect of wilful counterfeiting and piracy on a commercial scale.

The Agreement on Trade-Related Investment Measures (TRIMs) has, as stated in its preamble, the aims not only of promoting the expansion and progressive liberalization of world trade but also the facilitation of investment across international frontiers. The Agreement has three

main features. First, it clarifies that certain types of investment measures applied to enterprises, which appear on an Illustrative List, are inconsistent with the GATT. These essentially concern local content and trade-balancing requirements, and include not only mandatory measures but also those measures which are not mandatory but create advantages if observed. While such measures frequently arise in the context of FDI, the TRIMs rules apply equally to measures imposed on domestic enterprises. The rules also apply both to measures affecting existing investments and to those covering new investments.

Second, the Agreement requires that all TRIMs inconsistent with GATT Articles III and XI, and which cannot be justified under an exceptions provision under the GATT, be notified within 90 days of entry into force of the WTO. Such measures are to be eliminated within a certain period of time - namely two years in the case of developed countries, five years for developing countries and seven years for least-developed countries. To avoid distortions of the conditions of competition between new investments and established enterprises already subject to a TRIM, members may apply the same TRIM to new investments during the transition period, subject to certain conditions.

The third important feature of the TRIMs Agreement is that it provides for a review within five years, in the context of which consideration will be given to whether the Agreement should be complemented with provisions on investment policy and competition policy.

The Agreement on Subsidies and Countervailing Measures (ASCM) defines the concept of "subsidy" and establishes disciplines on the provision of subsidies. In the taxonomy of investment incentives set forth in Part III above, at least some types of measures in each of the three categories (fiscal incentives, financial incentives and indirect incentives) are subsidies as defined in the ASCM. That is, they can involve a financial contribution by a government or public body, and would confer a benefit. Fiscal incentives, for example, would generally fall within the ASCM definition of "government revenue ... otherwise due [that] is foregone or not collected (e.g., fiscal incentives such as tax credits)". Financial incentives, such as the direct provision of funds through grants and subsidized credits, would generally meet the ASCM definition of "a government practice [that] involves a direct transfer of funds (e.g., grants, loans and equity infusion...)". Finally, at least some kinds of indirect incentives would appear to be subsidies as defined by the ASCM. In particular, the provision of such items as land and infrastructure at less than market prices would appear to fall within the definition of "a government provid[ing] goods or services other than general infrastructure, or purchas[ing] goods".

A range of multilateral disciplines would apply under the ASCM to investment incentives meeting these definitions. Investment incentives meeting the definition of a subsidy, and granted contingent upon exportation of goods produced (or to be produced) by an investor, or contingent upon use of domestic over imported goods, are prohibited under the ASCM. As well, investment incentives other than those meeting the definition of prohibited subsidies also are subject to the disciplines of the ASCM. That is, even if not prohibited, incentives that cause "adverse effects" as defined by the ASCM potentially are subject to compensatory action, either multilaterally or under WTO members' national legislation. In the multilateral context, the ASCM's provisions pertaining to serious prejudice refer directly to investment incentives. In particular, Annex IV, which provides guidance for calculating whether the total ad valorem rate of subsidization of a product is sufficient to give rise to a presumption of serious prejudice, includes subsidies to firms in "start-up situations", that is, where financial commitments have been made for product development or construction of facilities, but where production has not yet begun.

This being said, the underlying concepts of the ASCM are oriented toward trade in goods, and as such, may not in all cases be easily applied to investment incentives. This issue would become relevant in the context of a multilateral investment code, to the extent that such a code aimed in part at disciplining the uses of incentives. As discussed above, competition among different countries' investment incentives, which can be a key determinant of the ultimate location of an investment, can easily give rise to economic distortions. Because they are concerned with goods flows, which by definition occur only after the investment has been made, the ASCM's disciplines on subsidies by themselves do not appear capable of fully addressing such distortions.

The first important evolution of the GATT/WTO system into the area of the treatment of foreign companies by host countries was the 1979 Agreement on Government Procurement. In respect of the covered procurement operations, this Agreement required not only that there must be no discrimination against foreign products, but also no discrimination against foreign suppliers and, in particular, no discrimination against locally-established suppliers on the basis of their degree of foreign affiliation or ownership. A new Agreement on Government Procurement, the negotiation of which was concluded along with the Uruguay Round, has now entered into force. This retains the basic non-discrimination rule referred to above and expands procurement covered by some tenfold, including now services as well as goods, and procurement at the sub-central and public utility levels as well as central government level. The new Agreement also contains a number of important new rules, for example the right of suppliers to challenge through national tribunals the conformity of procurement decisions with the international rules themselves - the so-called “challenge procedures”.

Future disputes involving FDI-related WTO rules and disciplines will be resolved in the context of the integrated dispute settlement mechanism of the WTO, contained in the Understanding on Rules and Procedures for the Settlement of Disputes. It is a reinforced and unified mechanism for the settlement of disputes between member governments that will apply to disputes brought under all aspects of the Agreements attached to the Agreement Establishing the World Trade Organization, including those in the areas of TRIMs, GATS, TRIPS, subsidies and countervailing measures, and government procurement referred to above. The dispute settlement system has been substantially reinforced compared to the earlier GATT dispute settlement system, notably by the elimination of the means by which it had been possible for individual members to delay or block the dispute settlement process. There are now stricter time limits for completing the different stages of the dispute settlement process and, panel reports will be considered adopted unless there is a consensus against adoption. Another change compared to the old GATT system is the addition of an appeal stage, in the light of the more binding and automatic nature of the system.

There can be no question that foreign direct investment and international trade generally are mutually supportive, and that together they are playing the central role in the ongoing integration of the world economy. Through investment and trade, firms in each country are able to specialize in producing what they can produce most efficiently. Trade facilitates this process by allowing an economy to specialize in production, and then to exchange part of that output abroad in order to achieve the particular mix of goods and services its citizens want to consume. FDI facilitates this process by increasing the international mobility of - and thus the efficient use of - the world's supplies of capital and technology, including organizational, managerial and marketing skills. This joint process is central to development strategies and, more generally, to world-wide efforts to increase wealth and raise living standards.

This final section begins with a summary of the main findings, first in the form of selected highlights, and then with an overview of the principal economic, institutional and legal interlinkages between FDI and trade. It concludes with a review of the key policy issues facing WTO members with respect to foreign direct investment.

The preceding analysis touched on a large number of issues and points related to FDI and, especially, to the interlinkages between FDI and trade. Among the more important findings in this report are:

The growing importance of FDI

• During 1986-89 and again in 1995, outflows of FDI grew much more rapidly than world trade. Over the period 1973-95, the estimated value of annual FDI outflows multiplied twelve times (from $25 billion to $315 billion), while the value of merchandise exports multiplied eight and a half times (from $575 billion to $4,900 billion).

• Sales of foreign affiliates of multinational corporations (MNCs) are estimated to exceed the value of world trade in goods and services (the latter was $6,100 billion in 1995).

• Intra-firm trade among MNCs is estimated to account for about one-third of world trade, and MNC exports to all other firms for another third, with the remaining one-third accounted for by trade among national (non-MNC) firms.

Geographical distribution

• Developed countries account for most of the worldwide FDI outflows and inflows, but developing countries are becoming more important as host and home countries.

• The share of the non-OECD countries in worldwide FDI inflows, which decreased in the 1980s, increased from nearly 20 to about 35 per cent between 1990 and 1995. However, these flows were highly concentrated, with 10 countries receiving nearly 80 per cent of the total ($78 billion out of $102 billion).

• Nearly one-third of the 20 leading host economies for FDI during 1985-95 are developing economies. China is in fourth place, with Mexico, Singapore, Malaysia, Argentina, Brazil and Hong Kong also on the list.

• Non-OECD countries accounted for 15 per cent of worldwide outflows of FDI in 1995, compared with only 5 per cent in the period 1983-87.

A wide range of interlinkages

• Trade polices can affect FDI in many ways. A low level of import protection -especially if it is bound - can be a strong magnet for export-oriented FDI. High tariffs, in contrast, may induce tariff-jumping FDI to serve the local market, and so-called quid pro quo FDI may be undertaken for the purpose of defusing a protectionist threat.

• The single market program of the European Union stimulated substantial investment activity, both within the Union and into the Union from third countries, and similar effects on FDI flows have been observed for other regional trade agreements.

• **There is no serious empirical support for the view that FDI has an important negative effect on the overall level of exports from the home country.** Rather, the empirical evidence points to a modestly positive relationship between FDI and home country exports and imports. Similarly, the evidence indicates that FDI and host country exports are complementary, but that FDI and host country imports may be either substitutes or

complements, depending on the details of the situation, including the policies pursued by the host country (FDI attracted by low costs of production and liberal trade regimes is likely to be complementary with imports, and vice versa for tariff-jumping FDI).

• FDI can be a source not just of capital, but also of new technology and other intangibles such as organizational and managerial skills, and marketing networks. It can also boost trade, economic growth and employment in host countries by providing a stimulus to the production of locally produced inputs, as well as to competition, innovation, savings and capital formation. Furthermore, FDI gives the investor a stake in the future economic development of the host country. In short, it is a key element for promoting growth and progress in developing countries.

The reality of FDI incentives

• Incentives to attract FDI are very high in some of the most industrialized countries. Such incentives not only bias FDI towards countries with “deep pockets”, but the reality of their operation - they are no different from any other kind of subsidy program - is a source of considerable concern. Very often there is little or no knowledge of a project's true value to the host country (necessary for using incentives efficiently). Moreover, incentives are vulnerable to political capture by special interest groups; there is considerable scope for introducing new distortions; and competition among potential host countries in the granting of incentives can drive up the cost of attracting FDI, thereby reducing or even eliminating any net gain for the successful bidder.

A multitude of rules

• Since the early 1980s, there has been a widespread trend towards liberalization of national laws and regulations relating to foreign investment, especially in developing and transition countries. However, unilateral action has not been found sufficient as regards either the locking-in of reforms and their credibility in the eyes of investors, or the compatibility with other FDI regimes. In the absence of a multilateral regime, the liberalization of national FDI regimes has been accompanied by a rapid proliferation of intergovernmental arrangements dealing with foreign investment issues at the bilateral, regional (for example, NAFTA and MERCOSUR) and plurilateral levels. Some two-thirds of the nearly 1,160 bilateral investment treaties concluded up to June 1996 were signed during the 1990s.

• In addition, OECD members - which currently account for about 85 per cent of world outflows of FDI - have been negotiating since May 1995, with the aim of concluding a Multilateral Agreement on Investment (MAI) in 1997. The objective is an independent international treaty, open to OECD members and the European Community and to accession by non-OECD countries.

The WTO also has FDI-related rules

• While the original GATT rules put obligations on governments only in respect of the treatment of foreign goods, the WTO - through the GATS and the TRIPS Agreement, as well as the plurilateral Government Procurement Agreement - places important obligations on governments with respect to the treatment of foreign nationals or companies within their territories. Through the inclusion of rules on “commercial presence” (defined as any type of business or professional establishment), the GATS recognizes that FDI is a prerequisite for exporting many services.

• The TRIMs Agreement provides for a review within five years, in the context of which consideration will be given to whether the Agreement should be complemented with

provisions on investment policy and competition policy.

• The Agreement on Subsidies and Countervailing Measures defines as subsidies some types of measures in each of the three main categories of FDI incentives (fiscal incentives, financial incentives and indirect incentives).

• WTO members are considering, in the context of preparations for the WTO Ministerial Meeting to be held in Singapore in December 1996, a proposal for the establishment of a work program on trade and investment aimed at clarifying the issues in this area.

Policy considerations

• The WTO's investment-related rules are binding, as are the rules in nearly all the bilateral, regional and plurilateral agreements. In contrast, the various multilateral FDI instruments, none of which is comprehensive, are by and large non-binding. More generally, one of the striking characteristics of the present pattern of multi-layered investment rules is the diversity of approaches and legal architectures.

• A key consideration at the present juncture, therefore, is that of **current and future policy coherence.** Governments face a choice between continuing to deal with FDI issues bilaterally or in small groups, supplemented by a patchwork of rules in the WTO, and exploring options for a comprehensive framework designed to ensure that investment and trade rules are compatible and mutually supportive. There is little doubt that investors have a strong preference for the second option.

FDI and trade

The most obvious economic interlinkage between FDI and trade is the one examined in Part II, namely the impact of FDI on the trade of the host and home countries, and thus on the level and pattern of world trade. For many services, the producer must have production facilities (bank branches, hotels, accounting offices) in foreign countries in order to export the service. Although not necessarily to the same extent, the same is increasingly true for firms producing goods. In a progressively more competitive global economy, an export-oriented firm might well have to acquire facilities in other countries in order to remain competitive - that is, in order to survive. This can include distribution networks that handle marketing, inventories and after-sales service. The result is likely to be not simply the maintenance of current trade levels, but expanded trade.

FDI and trade are also integral parts of firms' efforts to organize their production processes efficiently. By subdividing a production process into different stages, locating each stage in a country where that particular part of the process can be done efficiently, and then linking all the various stages through trade, firms can supply efficiently produced goods and services to buyers worldwide. Recalling that intra-firm trade among MNCs accounts for roughly one-third of world trade, and that MNC exports to non-affiliates accounts for roughly another one-third, it is clear that FDI can improve host country access to foreign markets. FDI also affects trade flows through the transfer of technology, as well as through its role as a stimulus to competition, innovation, productivity, savings and capital formation in host countries.

Interlinkages at the policy level

The reality of FDI thus is much more complex than is suggested by the traditional view that FDI and trade are alternative means of servicing a foreign market, and hence substitutes. **FDI and the trade of home and host countries are, as has been noted, generally complementary. In this connection, liberal trade and investment policies boost FDI and**

strengthen the positive relationship between FDI and trade. In contrast, high tariffs, threats of contingent protection and financial or tax-based subsidies can create strong incentives to substitute investment for trade, including - in the case of countries with large domestic markets relative to their neighbours - for the diversion of investment by neighbouring firms into the protecting country. As is true of all tariff-jumping FDI, such beggar-thy-neighbour investment diversion not only harms other countries, but also adds to the stock of internationally uncompetitive firms in the new host country.

True, a country's trade policy is only one of a number of factors that determine FDI inflows. However, a critically important dimension of any investment decision is the degree of uncertainty and risk over the (frequently long) time horizon of the proposed investment. It follows that the structure and stability of current and possible future trade policies, both of potential host countries and of potential foreign markets, will be important influences on the willingness of firms to seek customers in foreign markets, locate production processes in host countries, or separate the production processes into stages located in different host countries. This "trade policy dimension" of programs to attract FDI is important not only for the vast majority of countries that lack a large domestic market, but increasingly for all markets as more and more firms "think globally" and often see even large markets as potential export bases.

Investment policy, in turn, is an important factor in the extent to which a country can benefit from the international distribution systems of MNCs, intra-corporate international trade and transfers of technology. It is also a factor in the extent to which trading partners will enjoy effective access to that country's market, not only for services but also increasingly for many types of goods. Thus it is important not only that FDI is now keenly sought by a large number of countries at all levels of development, but that many countries have liberalized their investment regimes in parallel with their trade regimes. During 1991-94, virtually all of the changes (368 out of 373) in national investment regimes were in a liberalizing direction. This process of liberalization has been particularly marked in those developing and transition economies which have also undertaken very considerable and, to a large extent, autonomous liberalization of their trade regimes. The reversal of earlier scepticism or hostility to FDI by developing and transition countries, together with the liberalization and introduction of greater predictability in their trade and investment policies, has been a major element in the increasing share of global FDI going to these economies.

A potential FDI boost for least-developed countries

The complementary relationship between FDI and trade is also a key aspect of one of the most pressing problems currently confronting the international community, namely how to reverse the growing gap between many of the world's poorest economies and the rest of the global economy. In 1994, there were 35 developing countries (many of them least-developed countries) whose merchandise exports were below the 1985 level. Since the value of world merchandise trade more than doubled over that ten year period, even an unchanged level of exports would have signalled a significant falling behind in the ongoing integration of the global economy. And, despite a more than doubling of the share of developing countries in world FDI inflows between 1990 and 1994, the least-developed countries still receive virtually no FDI. For the period 1988-94, flows of official development assistance represented 98 per cent of the net financial flows to the least-developed countries.

Low levels of trade and of inflows of FDI are more symptoms than causes of the plight of many of the poorest countries. At the same time, unless the corrective actions by the countries themselves, and by other countries concerned with their situation, lead to - among

other improvements - increased inflows of FDI and increased trade, it is difficult to imagine how a major improvement in their economic prospects can be achieved. As has been stressed above, FDI brings with it resources that are in critically short supply in poor countries, including capital, technology and such intangible resources as organizational, managerial and marketing skills. These resources, in turn, can play a vital role in efforts to restructure and diversify the economy and make it more competitive.

As in the trade area, countries have perceived that purely unilateral action in the investment area is not sufficient - in this case, not sufficient to give the desired stimulus to FDI flows. The result has been a widely felt need for international agreements that provide a framework for the protection and promotion of investment. One manifestation of this has been the previously noted big increase in bilateral investment treaties since 1990, including a growing number among developing countries. There has also been a proliferation of regional and other initiatives to address a perceived need for international rules relating to foreign investment. Most of these deal with investment questions as part of broader economic integration arrangements centering on trade. Some are long-standing, such as the European Community, whose rules in this area have now been extended to the whole of Western Europe. Another example is the North American Free Trade Area (NAFTA) which integrates issues of investment into a single trade agreement. Among developing countries, efforts are also being made in the context of a number of regional trading arrangements, for example in ASEAN and MERCOSUR. More broadly, there is work under way in the APEC and the Free Trade Area of the Americas (FTTA) contexts. At the plurilateral level, there is the European Energy Charter Treaty, adopted by 41 countries and the European Community in December 1994, which contains detailed commitments on investment in the energy sector, as well as the previously mentioned ongoing MAI negotiations in the OECD. Finally, at the multilateral level, there are two conventions and one set of guidelines that were negotiated in the World Bank between 1965 and 1992, plus one ILO and seven United Nations non-binding instruments.

As is described in Part V above, the trend toward greater integration of investment and trade in the world economy has also increasingly manifested itself in the work of the GATT and now the WTO. In particular, the WTO Agreements on Services and Intellectual Property, as well as the plurilateral Agreement on Government Procurement, establish international rules on the treatment of foreign companies operating within a country's territory, the issue at the heart of investment policy. The integration of trade and investment is most evident in the General Agreement on Trade in Services (GATS), which treats the supply of the market by foreign companies through a local "commercial presence" as a form of trade in services. Certain incentives which governments might consider offering as part of their efforts to attract FDI are covered by the Agreement on Subsidies and Countervailing Measures. Looking to the future, the GATS and the TRIMs Agreement provide for important in-built work programs on investment-related matters in the areas of services and goods. More immediately, as part of the preparations for December's Ministerial Meeting in Singapore, WTO members are considering proposals for WTO's future work on investment-related matters.

There is a broad institutional interlinkage - not just between FDI and trade, but between investment in general and trade - that derives from the fact that the primary function of the WTO rules and procedures is to reduce the uncertainty surrounding economic transactions across national frontiers. In this way, the rules and procedures, together with reductions in trade barriers, promote trade-related investment at home and abroad and bring the gains that come from increased international specialization. Part of the gains from trade liberalization, it

is true, come via lower prices to consumers. But the more efficient use of a country's resources requires that some portion of existing labour, capital and land move from less productive to more productive employment, and that future increments to these resources go into those more productive uses. **This requires new investment.**

It is not enough that trade barriers are reduced. Domestic and foreign investors for whom international competitiveness is a concern - certainly an expanding majority as globalization progresses - value security of future market access, such as that provided by WTO rules and disciplines. **Because the benefits which the WTO brings to the world economy come primarily via the impact of the WTO on investment decisions, it is no exaggeration to say that investment is at the heart of the WTO.**

One of the striking characteristics of the present evolution of investment rules is the diversity of approaches and legal architectures. In many cases, countries are simultaneously parties to bilateral, regional, plurilateral and multilateral agreements. These agreements can be binding and non-binding, with and without commitments on admission, with and without provisions on corporate behaviour, use “top-down” and “bottom-up” architectures, and be part of or outside the context of broader trade agreements. While this diversity of approaches does raise important issues of policy coherence as indicated below, it also reflects the variety of ways in which participating countries have managed to find a balance of advantage and mutual benefits in rule-making in this area.

In essence, the analysis in this Chapter has shown that both at the level of business decisions of individual firms and at the government policy level, whether national, regional or multilateral, it is increasingly difficult to separate issues of investment from traditional trade issues. Against this background, the proliferation of treaties and initiatives aimed at international rules on investment raises a number of issues.

The situation in the investment area is reminiscent of that which existed in the trade area. In the second half of the nineteenth century, trade was liberalized in Europe on the basis of a large number of bilateral treaties (close to 80 by 1865 and well over 100 by 1908) containing most-favoured-nation clauses modelled on the one in the Cobden-Chevalier Treaty of 1860 between England and France. This system broke-down, and in the latter half of the 1930s there was a largely unsuccessful attempt to resurrect it. In the mid-1940s, when plans were being laid for the postwar international economic order, the drafters of the Havana Charter (and subsequently the GATT) saw clearly that a stable, non-discriminatory and liberal international trading system could be achieved much better through a single set of legally binding multilateral rules and disciplines, than through the negotiation of thousands of bilateral trade agreements.

It is seldom easy for a government to relinquish some of the discretion it has in a particular policy area. But governments have been persuaded of the benefits of doing just that in the area of trade policies. What they have given up in policy discretion by accepting WTO rules and disciplines is more than compensated by the increased predictability and stability of trade policies. Every country gains from the stimulus which this, along with trade liberalization, gives to trade and trade-related investment.

Much the same considerations are behind efforts at international rule-making on the treatment of FDI. Just as trade liberalization that is not bound has much less value than bound reductions in import barriers, an opportunity to bind liberalized FDI rules would greatly enhance their credibility and value in the eyes of foreign investors. It would also make the FDI policies of other countries much more predictable, for example, as regards the use of incentives in competing to attract FDI. Enhanced credibility of one's own FDI regime would

be especially beneficial to non-OECD countries competing against the wealthy countries for FDI.

Given the increasing inseparability of economic developments, as well as of policy formulation, in these two areas, it is not surprising that many of the current issues arising out of the interlinkages between trade and FDI have to do with policy coherence. There is, first of all, the problem of "rule coherence" among agreements and instruments dealing with investment at various levels ranging from the national to the multilateral. The existence of a large number of overlapping legal instruments and initiatives in the investment area creates risks of confusion, uncertainties and legal conflicts, especially where the agreements in question follow different architectures. A particular aspect of this is the problem of coherence between the investment rules and the trade rules - especially the interaction of the multitude of agreements and initiatives described above in Part IV with the existing WTO multilateral rules and dispute settlement system.

There is also the issue of coherence in efforts to further develop international cooperation in the areas of trade and investment. Clearly, the interrelation between these policy areas should be handled in a way that does not compartmentalize policy areas that are, in reality, becoming increasingly intertwined. **A lack of rule and policy coherence poses a danger to security and predictability, which are basic goals of trade and investment agreements.** Foreign direct investment, like trade, is particularly sensitive to uncertainty and instability. Indeed, the long-term commitment that an investing company makes, through the transfer of resources and establishment of commercial operations in another country, make it particularly sensitive to risk, not only to the investment itself but also to the trade flows on which the viability of the investment depends.

Linked to the issue of coherence are those of discrimination and marginalization. Except to the extent provided by the GATS MFN clause, the present network of international agreements in the investment area provides little protection against discrimination vis-à-vis non-participating countries. Genuinely multilateral rules would enable bilateral and regional initiatives to be drafted and function within a framework which protects the interests of third parties. A related concern is that current work on investment-related issues tends to focus more on those countries which are already receiving significant inflows of foreign investment, to the neglect of those whose needs may be greater. Nor does it always provide for the effective participation, in the formulation of new rules, of all those who may be affected by them.

In the face of these growing economic, institutional and legal interlinkages between trade and FDI, 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 in 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. Their decision will have an important impact on the efficiency with which scarce supplies of capital and technology will be employed in the next decade and beyond. It will also have an impact on the strength, coherence and relevance of efforts to integrate all developing countries into the multilateral trading system.

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