Chapter 12

Trade-Related Investment Measures and Investment

Governments use two measures to attract and regulate foreign direct investment: performance requirements (such as local content, local manufacturing, export performance and technology transfer requirements) and investment incentives (such as loans and tax rebates). Performance requirements are intended to ensure that foreign investment contributes to the host country's development and is consistent with its policy goals.

Investment incentives involve a wide range of fiscal and monetary policy tools. When these incentives are related to trade in goods, they are called Trade-Related Investment Measures (TRIMs). Some TRIMs entail performance requirements. Such measures have been extremely important for many developing and some industrial countries, often serving as part of broad strategies aimed at achieving economic growth, industrialization and technology transfer. TRIMs have also been used to guard against and counter anticompetitive and trade-restrictive business practices—particularly those of transnational corporations.

This chapter begins by analysing the TRIMs agreement—its history, its relationship to development and its possible future. The chapter then discusses investment more broadly, because the two issues are closely related. The discussion focuses on foreign direct investment, arguing that it—not portfolio flows—should be the focus of any discussion on investment in the World Trade Organization (WTO). The chapter then traces how the nature of such investment has changed and analyses how it can contribute to human development. The chapter also highlights what a multilateral investment agreement might cover under the WTO, and concludes by identifying some of the prerequisites and flexibilities needed for a multilateral investment agreement.

The TRIMs agreement

The TRIMs agreement aims at eliminating the trade-distorting effects of investment measures taken by WTO members. It does not introduce any new obligations, but merely prohibits TRIMs considered inconsistent with the provisions of the 1994 General Agreement on Tariffs and Trade (GATT) for both agricultural and industrial goods. Measures deemed inconsistent with the agreement were to be identified (by the countries where they were in effect) within 90 days of 1 January 1995, the day the WTO came into existence.

Industrial country members were expected to eliminate these measures within two years, while developing countries were given five years and the least developed countries seven years. The agreement provides flexibility on these deadlines if a country is experiencing implementation difficulties for development, finance or trade reasons. For example, some developing countries were recently granted an extension through 2003.

The agreement does not define TRIMs or provide objective criteria for identifying them, leaving it to members to decide which of their TRIMs are illegal. This approach allows considerable room for interpretation and dispute, though TRIMs that do not violate the national treatment obligations of GATT article III or the prohibition on quantitative restrictions of article IX are clearly permitted. The agreement calls for increased transparency in administering TRIMs, allowing countries to challenge measures they consider non-transparent.

Guidance on TRIMs was provided only through an illustrative list that identifies measures inconsistent with national treatment and local content requirements and with the prohibition on quantitative restrictions that link imports to export performance through trade or foreign exchange restrictions or through export restrictions based on domestic sales. Thus the TRIMs agreement does not prohibit export performance requirements. But subsidies linked to such requirements are covered under the Agreement on Subsidies and Countervailing Measures (ASCM) and subject to its disciplines.

Although investment measures that do not violate GATT articles III and IX are permitted, countries that have recently joined the WTO have been obliged to eliminate additional performance requirements as part of the terms of their accession—notably requirements related to export performance and technology transfer. Similar 'WTO plus' demands are being made on countries in the process of accession to the WTO, including least developed countries (see UNCTAD, 2002).

Where we are now

The 2001 WTO Ministerial Conference in Doha, Qatar, remained deadlocked on investment and the three other 'Singapore issues' (competition policy, trade facilitation, transparency in government procurement). Most industrial countries, especially EU members, wanted to start negotiating an agreement on these four issues after the Doha conference, while many developing countries wanted to continue studying them (box 12.1). The Doha declaration agreed to continue studying the issues until the 2003 conference in Cancun, Mexico. Although it is not inevitable that negotiations on these issues will begin after the Mexico conference, pressure for such an outcome has intensified since Doha.

BOX 12.1 THE HISTORY OF INTERNATIONAL AGREEMENTS ON INVESTMENT

Attempts to reach international agreements on investment have a long history. In the late 18th and the 19th centuries the European powers and the US set standards for the protection of foreign investment that were superior to national treatment. Furthermore, host countries were not permitted to interfere with or expropriate foreign assets.

Latin American countries were the first to challenge the favourable treatment of foreign investors. The 1868 Calvo Doctrine established the same rights for foreigners and nationals and prohibited countries from intervening to enforce the claims of their citizens in other countries. Between World War I and II the League of Nations was stalemated on this issue, and since World War II industrial countries have been unsuccessful in their efforts to establish an international regime for the protection of international investment.

The 1947–48 United Nations Conference on Trade and Employment considered investment in its discussions on the expansion of international trade. Investment measures formed part of a wider discussion of restrictive business practices, and the Havana charter for an International Trade Organization (ITO) contained provisions on such measures. But the negotiations leading to the charter and eventually to the GATT showed that governments were not prepared to subject their investment policies to international rules and disciplines.

Following the failure to establish the ITO, industrial countries implemented policies bilaterally through investment promotion and protection treaties and agreements. Such treaties were intended to ensure that investors' property would not be expropriated without prompt, adequate and effective compensation, non-discriminatory treatment, transfer of funds and dispute settlement procedures. In addition, in the late 1950s an evaluation of restrictive business practices was carried out by a GATT group of experts, focusing on activities of international cartels and trusts that could hamper the expansion of world trade and interfere with GATT objectives.

Later the issue of international investment surfaced at the United Nations, where developing countries sought international approval for their sovereign aspirations and tried to alter the international investment standards that had prevailed in the colonial period. One outcome was the UN General Assembly's Charter of Economic Rights and Duties of States, passed in 1974. Article 2 of the charter provided for the rights of every state to regulate and exercise authority over foreign investment in conformity with its national objectives and stated that no state would be compelled to grant preferential treatment to foreign investment. The draft Code of Conduct for Transnational Corporations, issued by the United Nations Center on Transnational Corporations, addressed a range of additional issues—almost all of which remain unresolved because most industrial countries opposed a legally binding status for the code. In addition, the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Practices, negotiated under the United Nations Conference on Trade and Development, covered investment and competition policy issues—and suffered the same fate.

After the conclusion of the GATT's Tokyo Round in 1979, renewed attempts were made to bring under its purview a limited number of performance requirements imposed on foreign investors by host countries, particularly local content and export performance requirements (TRIMs). Though many developing countries continued to maintain that foreign direct investment was beyond the GATT's purview, the US and some other industrial countries argued that such performance requirements affect trade and should be addressed by the trade regime.

A 1982 dispute over administration of the Foreign Investment Review Act, brought by the US against Canada, significantly boosted its efforts to bring investment under the purview

(Box continues on next page.)

of multilateral trade disciplines. While many delegations were sceptical about bringing such a dispute to the GATT, its council finally decided to allow a panel to investigate the US claim. Among other things, the panel ruled that Canada's practice of requiring foreign direct investors to purchase Canadian goods was inconsistent with GATT article III:4, though not with article XI:1. The US-Canada dispute set the stage for a more effective challenge of TRIMs at the multilateral level. The ruling also appears to have led to an amendment in US trade legislation to address investment issues more directly.

Investment was a major issue in the Uruguay Round, featuring in and affecting discussions and agreements on trade in services (GATS), TRIMs, Trade-Related Aspects of Intellectual Property Rights (TRIPS), government procurement and subsidies. The 1988 Omnibus Trade and Competitiveness Act, which provided the US with negotiating authority for the Uruguay Round, had explicit language on investment. TRIMs were viewed by the US as preventing its transnational corporations from designing coherent global strategies, and their removal became a main negotiating issue for the US and some other industrial countries during the Uruguay Round.

During the negotiations attempts were made to go beyond TRIMs to develop a regime for investment in general, including the right of establishment and national treatment. Industrial countries also argued for the elimination of all TRIMs, rather than just minimizing and avoiding their adverse affects on trade. Most developing countries differed from the US, Japan and other industrial countries on two main counts: whether multilateral disciplines should be limited by existing GATT articles or expanded to develop an investment regime; and whether some or all actionable TRIMs should be prohibited or dealt with case by case, based on a clear demonstration of their direct and significant restrictive and adverse effects on trade. The US and Japan favoured an all-encompassing investment regime, with TRIMs as one part of it. Developing countries called for strict adherence to the GATT mandate and for limiting negotiations to investment measures with direct and significant adverse effects on trade. While developing countries managed to limit the scope of the TRIMs agreement during the Uruguay Round, article 9 called for a review of the agreement's operation within five years of its entry into force—with a view to determining whether it should be complemented with provisions on investment and competition policy.

In addition, the General Agreement on Trade in Services (GATS), which takes a 'positive list' approach, covers investment liberalization since it includes commercial presence as one of the modes of service supply (mode 3). In fact, it is believed that the term 'trade in services' was coined as a way of bringing investment within the scope of Uruguay Round agreements in a more forceful way than the TRIMs agreement would allow due to opposition from developing countries. Most developing countries opposed bringing trade in services under the purview of multilateral disciplines and agreed only on the condition that it be kept separate from negotiations on trade in goods. Thus while TRIMs were discussed during negotiations on goods, the GATS was discussed in separate negotiations on services. Nevertheless, the US and transnational private sector actors devoted substantial efforts to ensuring that 'trade in services' was defined to include investment and that it would become acceptable terminology. Thus it is no surprise that the maximum market access commitments under the GATS have been achieved under mode 3, especially in financial services and telecommunications.

Regional agreements such as the North American Free Trade Agreement (NAFTA) go further than the TRIMs agreement and the GATS, providing national and non-discriminatory treatment to foreign investment. NAFTA also prohibits a number of performance requirements. For this reason services are clearly differentiated from investment in NAFTA. In addition, by January 1997 there were 1,330 bilateral investment treaties in 162 countries—up from fewer than 400 treaties in the early 1990s.

Major differences remain on the issue of bringing investment under multilateral trade disciplines. Not satisfied with the TRIMs agreement, industrial countries maintained intense pressure for the inclusion of four new issues (investment, competition policy, trade facilitation, government procurement) at the first WTO ministerial conference, held in Singapore in 1996. Investment was probably the most important to them. Despite most developing countries' resistance to the inclusion of these issues, members agreed that all four (subsequently dubbed the 'Singapore issues') should be studied further in working groups, with a view to recommending whether negotiations should take place on them at a future ministerial conference. The scope of the government procurement discussion was limited to transparency, not market access.

At the same time, the Organisation for Economic Co-operation and Development (OECD) began trying to reach a Multilateral Agreement on Investment among its members—only to fail, indicating how difficult it is to agree on investment issues even among countries at similar levels of human development.

Source: UNCTAD, 1994; Gibbs and Mashayekhi, 1998; UNDP, 2002; Ganesan, 1998.

Many developing countries contend that, based on the implementation experience so far, the TRIMs agreement has not taken into account their development requirements. They are particularly concerned about the agreement's negative effects on employment and value added, because it prohibits late-industrializing countries from pursuing domestic content polices. Such policies were crucial to the successful development strategies of today's industrial countries and East Asia's newly industrialized countries.

Developing countries have put forward a number of reasons for maintaining TRIMs. Among these are ensuring the fullest, most efficient contribution of investment to their economic development. For example, TRIMs may allow small firms to expand to full competitive scale and can be used to channel foreign direct investment to bring infant industries to maturity. In doing so, such enterprises are likely to increase domestic employment and valued added. TRIMs can also mitigate the problems of disadvantaged regions and enhance investment's contribution to building and upgrading domestic technological capacity, increasing the value-added share of exports. In this context the TRIMs agreement is viewed by many developing countries as a major impediment to upgrading technology and increasing value added.

Developing country governments have also argued that TRIMs counter the trade-restrictive and -distorting strategies of transnational corporations. For example, local content requirements can be used to increase employment, protect the viability of local firms and avoid overpricing by transnational corporations. Local content requirements can also be a necessary response to vertically integrated transnational corporations that dominate the market.

For example, the electronics industry derives little local content from developing countries despite having significant operations in them. This is because many of the corporations that dominate the industry prefer to source components and parts from parent companies or foreign affiliates—even if parts of comparable quality are available domestically in developing countries. As a result most of the value added from the industry goes to transnational corporations.[1]

Implementation of the TRIMs agreement has posed a number of challenges for developing countries. These include the difficulty of identifying TRIMs covered by the agreement and ensuring their timely notification to the WTO, the inadequacy of the transition period for phasing out prohibited TRIMs and disputes arising from the lack of clarity between the GATT, the TRIMs agreement and the Agreement on Subsidies and Countervailing Measures. Of greatest concern, however, are dispute settlement rulings involving prohibitions on local content requirements—rulings that many developing countries view as running counter to their interests.

Although a number of countries have de-emphasized the use of local content in recent years, such requirements continue to be used in both developing and industrial countries—particularly in the automotive sector, where they are most widespread in developing countries.[2] Accordingly, since the TRIMs agreement came into force, this sector has seen the largest number of disputes lodged by industrial against developing countries. Between 1995 and February 2002, 11 complaints in the automotive sector (involving not just local content requirements but also subsidies, incentives and foreign exchange balancing) were brought by Japan, the European Communities and the US against four developing countries with large potential automotive markets: Brazil, India, Indonesia, and the Philippines. Rulings have been made on six of these complaints—four against Indonesia and two against India. Japan's complaint against Indonesia (and similar subsequent complaints against Indonesia by the EU and US) illustrates a number of development concerns (box 12.2).

The way forward

A positive response to some of the implementation concerns of developing countries was the July 2001 decision of the WTO Council for Trade in Goods to extend until the end of 2001 the transition period for the TRIMs notified under article 5:1. Another two-year extension was made available upon request and upon the fulfilment of certain conditions, such as the presentation of a phase-out plan for TRIMs.

Though useful in the short run, these extensions do not deal with the fundamental problem of the TRIMs agreement: it does not give developing countries the policy space they need to use certain development policy instruments—such as local content and other performance requirements—that could enhance their value added, employment and trade competitiveness.

The TRIMs agreement may not be in the best interests of developing countries and human development. Thus it should be reassessed, with a view to rolling back its prohibition on the use of instruments that enhanced the development prospects of today's industrial and newly industrialized countries. In addition, TRIMs and GATS (General Agreement on Trade in Services) provisions on

Box 12.2 Complaints about Indonesia's car programme

In 1997 Japan asked a WTO panel to investigate its complaint that Indonesia was in violation of a number of articles of the TRIMs agreement. (The EU and US reserved third-party rights in the case.) Indonesia had not given notification of the disputed measures because it believed that its national car programme, which included local content requirements, did not violate the TRIMs agreement. It felt that the measures it was taking were more appropriately discussed under the Agreement on Subsidies and Countervailing Measures (ASCM).

The panel, however, judged the local content requirements as violating article 2 of the TRIMs agreement. Further, the panel concluded that the tariff and luxury sales tax exemptions Indonesia provided as incentives through its car programme were specific subsidies that had caused serious prejudice to the interests of the complainants. This interpretation of article 5 of the ASCM indicated that TRIMs could be adjudicated under the ASCM as well.

This case brings together most of the TRIMs-related implementation concerns identified by developing countries. Most important, like many other developing countries, Indonesia felt that it was being denied legitimate development measures for the promotion of its automotive industry. Regardless of the particular merits of Indonesia's national car programme, the automotive industry has long been viewed as central to the development of many large, populous developing countries with large internal markets. The rapid development of the automotive industry in such countries has significant multiplier effects and backward linkages, with positive implications for domestic value added, technological capacity and employment.

Despite other significant problems with Indonesia's car programme, including its demise due to domestic political pressures and the conditions imposed by international financial institutions during the East Asian crisis of the late 1990s, the programme appears to have had implications for both the TRIMs agreement and future negotiations on investment in the WTO. Although Indonesia did not appeal the panel's report because the financial crisis made it impossible for the programme to continue, the issues raised in the complaint have led many developing countries to regard the TRIMs agreement as hostile to their development interests and designed to maintain the industrialization and technology gap between industrial and developing countries.

Source: Tang, 2002.

performance requirements should be made consistent: the GATS allows them while the TRIMs agreement prohibits many.

If a rollback is not possible, it will be necessary to rethink the parameters of the TRIMs agreement through the application of special and differential treatment exemptions for local content requirements, especially in the automotive and electronics industries of developing countries. These industries should be prioritised because they are dynamic, with significant potential for contributing to human development outcomes. As some have argued, there may also be value in rethinking the TRIMs agreement to focus it on trade-related investment measures with direct and negative implications for trade, as opposed to the current outright prohibition of certain measures. In addition, any discussions on bringing other investment measures under multilateral disciplines should be approached with caution, keeping in mind the experience with TRIMs so far.

Investment

OECD discussions on the Multilateral Agreement on Investment (see box 12.1) were all-encompassing, reaching beyond traditional notions of foreign direct investment to cover nearly every type of tangible and intangible asset (OECD, 1997). Thus in addition to foreign direct investment the proposed agreement included both intellectual property and portfolio investment.

The motivations for the failed OECD discussions and the investment discussions in the WTO appear to have a lot in common, even if the types of investment covered by the WTO Working Group on the Relationship Between Trade and Investment are likely to be more limited. The common motives seem to be the strategic interests of transnational corporations to ensure uniform global rules that will reduce both their transactions costs and the uncertainty surrounding their investment decisions while simultaneously giving them secure property rights. Since the vast majority of transnational corporations are based in OECD countries, it is not surprising that reaching a multilateral agreement on investment with such an emphasis is a high priority for OECD governments.

But from a developing country perspective these motivations imply an inherent asymmetry in the discussions, because so far the discussions have focused on the rights of foreign investors in host countries—not their obligations. From a human development perspective, key issues include whether foreign direct investment is supportive of human development and whether a multilateral agreement on investment in the WTO will give developing countries the policy flexibility and autonomy they need to pursue their human development goals. Given that the TRIMs agreement has been in effect for more than seven years, it will be important to take its experience into account while making such an assessment.

While the 2001 Doha declaration does not explicitly define what is meant by investment for WTO discussion purposes, the relevant paragraph reads: ‘recognizing the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade’. This suggests that any proposed agreement in the WTO can be expected to focus on long-term foreign direct investment, not short-term portfolio capital flows.

This interpretation is consistent with the frequent reminders of developing countries since the 1996 Singapore ministerial conference that the working group in this area was established with the understanding that its work would be limited to foreign direct investment (cited in Correa 1999). Given the Doha emphasis and Singapore understanding, it can be reasonably expected that the Working Group on the Relationship Between Trade and Investment will, at least initially, focus exclusively on foreign direct investment.

The changing nature of foreign direct investment

There is growing recognition that in the context of financial globalization, some of the long-standing characteristics of foreign direct investment (such as its stability and long-term nature) that have differentiated it from portfolio investment may be eroding, making their distinction increasingly blurred. This has complicated the debate about the nature of foreign direct investment and its potential and real benefits for human development. Almost a decade ago a World Bank study illustrated the changing nature of foreign direct investment in the context of financial liberalization (Claessens, Dooley and Warner, 1993). It argued that 'bricks and mortar' investments can easily be converted into liquid assets and remitted out of a country. The study stated that:

> *'Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets, there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows'. (cited in Singh, 2001)*

In such situations there is no documentation that distinguishes foreign direct investment from other financial capital. Retained profits, repatriated out of the host country, now account for a significant portion of foreign assets—as much as 50 per cent in the case of US-based foreign investors.

Clearly, foreign direct investment in this form cannot be compared with domestic capital accumulation. As a result, Singh (2001) argues that in the context of financial globalization, a first-order issue is understanding what foreign direct investment comprises. He indicates that the past decade probably saw the largest volume of cross-border mergers and acquisitions in world history. While most took place between industrial countries, mergers and acquisitions also greatly expanded in developing countries in the second half of the 1990s. Excluding China, the share of mergers and acquisitions in the combined foreign direct investment of developing countries rose from an average of 22 per cent during 1988–91 to 72 per cent during1992–97 (UNCTAD, 1999b). Moreover, most of this was in form of acquisitions, not mergers.

This trend accelerated during and after the 1997 East Asian financial crisis. Singh argues that the implications of this trend are troubling for developing countries because, unlike 'greenfield' investment (which represents a net addition to the capital stock of developing countries), foreign direct investment in the form of an acquisition may not represent any addition in terms of capital stock, employment or even output. But as others note, such investment could lead to positive effects in terms of subsequent investment, technology transfer and short-term balance of payments effects. While there is no conclusive evidence on the human development impacts of this form of foreign direct investment, on balance it appears less likely to create value added in developing countries, at least in the short run, compared with traditional greenfield investment in productive assets that add to the host country's capital stock.

Finally, it is important to bear in mind that, contrary to a widespread view, not all foreign direct investment is in the form of equity. Much is in the form of high-interest-bearing loans and of an intrafirm nature. Sometimes these loans are even government guaranteed.

Foreign direct investment and development

Despite features that can make foreign direct investment expensive, and important changes in its evolving nature, most developing countries welcome it because they believe that it can contribute to their development objectives. This is because the potential development role of certain types of foreign direct investment is almost universally acknowledged. Still, important disagreements remain about whether all foreign direct investment is development friendly and about the nature of the pre-requisites and conditions—including the role of government policy—in ensuring that it plays a positive development role.

Proponents of foreign direct investment and its inclusion in the multilateral trade regime argue that, on balance, it has a positive impact on human development, especially through its technology transfer and domestic productivity spillover effects (WTO, 1996). Over the past two decades such optimism about the economic growth, technology transfer and productivity consequences of foreign direct investment have led most developing countries to unilaterally lower barriers to foreign investment, including portfolio capital. Country after country has adopted regimes friendly to foreign direct investment and transnational corporations, with at least 103 countries offering special tax concessions to foreign corporations that have established production or administrative facilities within their borders since 1998 (Avi-Yonah, 1999, cited in Hanson, 2001). This, despite widespread evidence and agreement that such incentives, offered largely for reasons of competition between developing countries, play a relatively small role in the location decisions of all but footloose foreign investors (such as those attracted to export processing zones). Indeed, since most foreign investors are interested in domestic market opportunities in developing countries, there is evidence that such incentives merely lower the collective potential gains of developing countries from foreign direct investment.

Is all foreign direct investment good for human development?

While there is little disagreement that foreign direct investment can play an important role in enhancing human development, a more important question is whether all foreign direct investment is good for human development. Many proponents argue for a multilateral investment agreement in the WTO because they believe it will provide security and predictability to foreign investors, enhancing foreign direct investment—which is assumed to be good for developing countries.

There have been numerous studies on the impact of greenfield foreign direct investment in different countries, sectors and settings. The results have been mixed, with no conclusive evidence in any one direction. Such investment has been used for different purposes. For example, Latin American countries have often relied on foreign direct investment to finance balance of payments deficits, while Asian countries have used it more for technology transfer. Foreign direct investment can be expensive and unsustainable if used for balance of payments purposes. It is also much harder to differentiate from financial capital if it is used in this manner.

In a number of cases foreign direct investment has not realized its human development potential. Firm-level evidence from a large sample of manufacturing plants in developing countries fails to indicate the existence of productivity spillovers related to foreign direct investment. Indeed, the presence of transnational corporations appears to depress the productivity of domestic plants in some countries—with negative consequences for employment and other human development variables (Hanson, 2001).

Lost opportunities for technology transfer through foreign direct investment are also well documented. In fact, successful, sustainable technology transfer through foreign direct investment has been more the exception than the rule. Moreover, foreign direct investment may be an expensive way of achieving technology transfer. This is because, given the many risks associated with foreign direct investment, investors need to ensure high rates of return—exceeding the interest rates that typically apply on foreign loans for imports of capital goods.

Moreover, foreign direct investment can have negative development effects through its balance of payments impact, especially in the context of financial liberalization. As Kregel (1996) argues, 'FDI [foreign direct investment] may have both a short and a longer-term structural influence on the composition of a country's external payment flows. While financial innovation allows FDI to have an impact in the short run which is increasingly similar in terms of volatility to portfolio flows, the more important aspect is the way it may mask the true position of a country's balance of payments and the sustainability of any combination of policies….Accumulated foreign claims in the form of accumulated FDI stocks may create a potentially disruptive force that can offset any domestic or external policy goals.'

So, whatever the potential merits of foreign direct investment for human development—and there are many—it is by no means always a positive influence on the variables that are most important for advancing human development in developing countries: employment, productivity and technology transfer. A comprehensive review of experiences with foreign direct investment perhaps summed up the evidence best when it concluded that 'in terms of the impact of FDI on different parameters of development…FDI promises more than it delivers' (Kumar, 1996, p. 40).

Some kinds of foreign investment are preferable to others. Because not all types of foreign direct investment are equally desirable, less may be better than more unless all of it is of the desirable kind. Moreover, foreign direct investment in certain sectors may be preferable to others. In other words, developing countries need to both attract foreign direct investment selectively and govern it effectively if it is to play a positive role in human development.

What really matters?

While development-friendly foreign direct investment should be welcomed, the empirical evidence suggests no clear correlation between the volume of foreign direct investment and development success. Some of the most successful countries have not relied heavily on foreign direct investment. For example, Japan and the Republic of Korea relied only marginally on foreign direct investment for their success (South Center, 1997; see also UNCTAD, 1997). While such flows were higher for Korea than for Japan (as a share of gross fixed capital formation), they were among the lowest for all developing countries—including those in sub-Saharan Africa. Moreover, foreign direct investment flows to Japan were minimal not just for the decade of comparison (1984–93) but for the entire period after World War II. Data for Korea for 1970–94 show a similar pattern (South Center, 1997).

Appropriate government intervention matters—and can make the crucial difference. Though its foreign direct investment was low, Korea made strategic and effective use of the investment it did receive. This was in no small measure due to the government, which imposed important restrictions on foreign direct investment, stipulating both local ownership and performance requirements.

The more recent experiences of China, the developing world's largest recipient of foreign direct investment for much of the past decade, reinforce this earlier pattern (UNCTAD, 2002a). China also confirms that regulatory constraints do not significantly or negatively affect the amount of foreign direct investment that a country is able to attract. Malaysia, another successful recipient of foreign direct investment despite significant controls and regulations, appears to be further proof of this (UNCTAD, 1999a). By contrast, many of the countries with the least regulation and most foreign investment–friendly regimes (many in Africa) appear to have been the least successful in attracting foreign direct investment and other capital flows.

Southeast Asian countries also appear to indicate that foreign direct investment has been most successful when governments have integrated it with their national development plans, rather than allowing it unfettered market access. Certain government policies and instruments (such as local content and other performance requirements, and certain controls on investment) have often made the crucial difference to a foreign investment's prospects of being development-friendly.

Moreover, the most useful foreign direct investment has been that driven less by market access needs and more by the 'flying geese' pattern—where foreign direct investment moved from Japan to East and Southeast Asia, ensuring a dynamic division of labour and enhancing productivity and technology in all participating developing countries.[3] So, from a human development perspective it appears that the volume of foreign direct investment is far less important than how it is directed by both source and host countries and how it is integrated with a developing country's national development plans and requirements.

A multilateral regime is not essential to attract foreign direct investment

The legal security provided by a multilateral investment agreement under the WTO may improve perceptions of the investment climate in a developing country (see below). But the most important factors in attracting sustainable, development-friendly foreign direct investment do not include the nature of the legal regime—whether bilateral or multilateral. This is not surprising: ample literature indicates that the more important factors are primarily domestic in nature. These factors include political and economic stability, market size, labour productivity, the quality of health, education and physical infrastructure and the quality of institutions, including their transparency.

If the presence of a multilateral investment agreement is not a major factor in attracting development-friendly foreign direct investment, the case for such an agreement will rest primarily on whether it is able to increase government autonomy in policy-making—particularly in directing foreign direct investment towards human development goals. Such an agreement will also need to be more attractive for developing countries than relying on existing bilateral investment treaties and making commitments through mode 3 of the GATS, which addresses the commercial presence of foreign investors but allows a 'positive list' approach. Many developing countries are reluctant to give up the flexibility provided by bilateral investment treaties, which allow them to tailor different agreements to different objectives without fear of disputes and retaliatory sanctions (Ganesan, 1998).

A multilateral investment agreement under the WTO

The key issue is whether a multilateral agreement on investment under the WTO would limit the policy space of developing countries in a way that precludes the successful policies and investment strategies pursued by countries such as Malaysia, where foreign direct investment played a significant role in the economy and contributed to human development.

What would a multilateral investment agreement most likely cover that is not already covered by the TRIMs agreement and mode 3 of the GATS? The 2001 Doha declaration instructed the Working Group on the Relationship between Trade and Investment to focus on 'scope and definition; transparency; non-discrimination; modalities for pre-establishment based on a GATS-type, positive list approach; development provisions; exceptions and balance of payments safeguards; consultation and the settlement of disputes between Members.'

Although there are no firm proposals at this stage, industrial countries pushing for such an agreement are likely to ask for commitments from developing countries that cover at least the following: the right of establishment for foreign investors, most-favoured-nation treatment, national treatment, investment incentives and protection, abolition of performance requirements still allowed under the TRIMs agreement and binding dispute settlement (Singh, 2001).

Even more important, the WTO investment agenda appears mainly concerned with market access through wide-ranging pre-establishment commitments (such as ensuring that most sectors are open to foreign investment on a non-discriminatory basis; Winters, 2002). As such, a multilateral investment agreement under the WTO is likely to differ considerably from bilateral investment treaties, which have been popular with developing countries because they provide national treatment to foreign investors in the post-establishment phase only, and do not place any restrictions on host countries in identifying and following home grown foreign direct investment policies (Ganesan, 1998).

A multilateral investment agreement would limit policy space

Some critics have questioned whether the notion of a multilateral framework on investment is compatible with the need to preserve flexibility in development policies and strategies. By its nature a multilateral framework aspires to a one-size-fits-all approach—which, while recognizing some differences between countries, allows few lasting exceptions. Such a framework appears unlikely to provide the policy autonomy and flexibility that developing countries need for another important reason: investment discussions in the WTO focus on the pre-establishment phase—which sectors are open to investment and to whom (Winters, 2002).

A focus on the pre-establishment phase will not increase foreign direct investment because the factors most essential to attracting and sustaining foreign direct investment are domestic in nature and come into play only in the post-establishment phase. Moreover, a preoccupation with the pre-establishment phase will reduce—and possibly eliminate—a government's ability to allow only foreign direct investment that promotes its development interests and has a positive impact on human development.

More specifically, a multilateral investment agreement focused on the pre-establishment phase will mean that countries will no longer be able to restrict the types of assets that may be acquired by foreigners, specify the structure of ownership and lay down requirements for the future operations of foreign investors (such as employment of local workers, use of local raw materials and export requirements). All these policies were crucial elements in the pre-WTO policy arsenals of the East and Southeast Asian countries that have been most successful in enhancing human development since World War II.

Moreover, in negotiations on any multilateral investment agreement, industrial countries will seek to reduce the choice of development instruments available to developing countries—such as performance requirements currently allowed under the TRIMs agreement (see the US Trade Act of 2002, title XXI, section 2102). A multilateral investment agreement, even one based on a GATS-style positive list approach as intended by the Doha declaration, will nevertheless be binding. Acceptance of the national treatment principle, for example, would limit the ability of host governments to restrict or exclude investment in certain sectors and require that local ownership clauses and other currently permitted performance requirements be specified in country schedules. This would also limit the ability of governments to control and direct domestic investment for development purposes, including by reducing the flexibility provided by bilateral investment treaties. Moreover, transgressions of the agreement will invite disputes and retaliatory sanctions.

Relationship with the General Agreement on Trade in Services

There is also concern that a multilateral investment agreement could 'swallow' the GATS by incorporating mode 3 commitments into an agreement that would provide much less flexibility for developing countries. The North American Free Trade Agreement (NAFTA), for example, contains general obligations on investment that do not distinguish between investments in goods and services.

In some cases developing countries have not been able to maintain their GATS limitations. For example, in Thailand investment liberalization measures imposed by the International Monetary Fund (IMF) after the 1997–98 financial crisis opened up the distribution services sector despite GATS commitments. This has resulted in an influx of large foreign retailers, hurting the many small domestic retail businesses that employ many Thais (*South-North Development Monitor*, 'Thailand: Local Retailers up in Arms over Foreign Retail Chains', 16 August 2002).

Mechanism for investor-state disputes

Another aspect of multilateral negotiations on investment of great concern from a human development perspective is the possible inclusion of an investor-state dispute mechanism—particularly if the NAFTA investor-state clause or the failed OECD Multilateral Agreement on Investment is used as a model. NAFTA, the trade agreement with the most extensive investor rights, shows why there is and should be cause for concern (box 12.3).

The draft agreement that failed in the OECD reflected the aspirations of many industrial countries, and contained both state-to-state and investor-to-state dispute settlement mechanisms. State-to-state arbitration was to follow a process similar to that of the WTO Dispute Settlement Understanding in its early stages. The International Centre for the Settlement of Investment Disputes was to be called in to establish rules if an amicable solution could not be reached. But the draft agreement also allowed for an investor-to-state arbitration system. While it remains unclear what dispute resolution mechanism would be chosen if there were to be a multilateral investment agreement under the WTO, the NAFTA illustrations make

Box 12.3 Two examples of NAFTA's chapter 11 on investor-state relationships

Metalclad Corporation

Investors have used the investor-state provision of NAFTA to aggressively challenge a wide range of laws and regulations. For example, an arbitration tribunal found violations of NAFTA investment rules stemming from a Mexican municipality's decision to deny a permit to Metalclad Corporation for a hazardous waste facility in 1997. The state governor of San Luis Potosi ordered that the facility be closed after a geological audit showed that the facility would contaminate the state's water supply. The governor then declared the site part of a 600,000-acre ecological zone. Metalclad claimed that this amounted to expropriation and sought $90 million in compensation.

The decision was based on a selective reading of NAFTA objectives, with a focus on the promotion of investment. This ignores the counterbalancing sections in the preamble to the NAFTA identifying environmental protection and sustainable development as equal underlying principles. The tribunal ruled that environmental factors were legally a federal issue and could not be used as a basis for denying a municipal permit. Thus a critical underpinning of this decision is challenging Mexican law on municipalities' authority when it comes to environmental issues—despite the fact that local authorities are closest to the problem caused by big facilities such as waste transfer stations.

In terms of levels of government and domestic law, the decision also creates uncertainty about the application and scope of minimum provisions for international standards—as well as about the tribunal's interference with domestic law. Moreover, the legitimacy of a test for closure based only on the significance of its impact on the investor, with no consideration of the purpose of the measure taken by the government, raises a broader question: should considerations of damage to investor interests be enough to decide on cases affecting human health and the environment?

Methanex

Methanex is a Canadian company that manufactures a key ingredient of methyl tertiary butyl ether (MTBE), an additive that makes gasoline burn cleaner. The US Environmental Protection Agency has classified MTBE as a potential carcinogen. California state officials cite studies showing that MTBE causes cancer on laboratory animals and symptoms such as headaches and nausea in humans. Most gasoline components stick to the soil. MTBE, however, is highly solvent, leaking even from reinforced tanks and moving at a great pace into water wells. Because of this additive the water in Santa Monica, California, is undrinkable—and the cleanup costs to the city are estimated to be about $300 million. Moreover, the cleanup could take 30 years.

In 1999 California ordered a phase-out of MTBE that would end in a complete ban by the end of 2002. Several other US states have followed suit. Methanex, on the other hand, claims that the problem is leaking gasoline tanks, not MTBE. Another Methanex claim is that the California governor ordered the ban because he received campaign contributions from a US manufacturer of ethanol. This argument led to another grounded in NAFTA chapter 11, article 1106, which prohibits host governments from 'showing a preference for domestic goods and services'. Methanex also claims that 'any violation of an international principle for the protection of trade or investment is also a violation of the NAFTA article 1105 requirement that state measures be fair, equitable and in accordance with international law'. The company's complaint seeks to expand the scope of NAFTA chapter 11 to allow the investor-state process to litigate any trade law issue.

This time involving a basic human need, drinkable water, the investor-biased provisions of NAFTA make it difficult for governments to regulate businesses that threaten human health and the environment. Methanex wants US taxpayers to compensate it for $970 million in profits lost due to the ban. The broad definition of expropriation allows such bans to be viewed as indirect expropriation and so may entitle the investor to compensation. The Methanex case will be decided under terms of international treaties by a panel of arbitrators chosen by the US State Department and Methanex. As in other cases, these investor-state disputes will be settled behind closed doors.

These two cases show that NAFTA chapter 11 forces governments to spend significant resources defending their regulatory and judicial processes from investor challenges. As a result the three NAFTA countries are likely to have to pay investors considerable sums just to defend their public interest regulations.

Source: IISD and WWF, 2001; Hemispheric Social Alliance, 2001.

it clear that this is a matter of considerable importance—with significant human development and opportunity cost implications for developing countries.

Reconciling the most-favoured-nation principle

Another concern that will need to be addressed is reconciliation of the most-favoured-nation principle, which is basic to all multilateral trade agreements, with the special treatment conferred under bilateral investment treaties and regional agreements to ethnic overseas investors in countries such as China and India. This issue is important because evidence suggests, for example, that in a number of cases ethnic overseas investment is more development-friendly. There is also the question of whether application of the most-favoured-nation principle will imply that the terms in regional agreements (such as the NAFTA chapter 11 investor-state arbitration procedure) will be incorporated in a multilateral investment agreement.

Will the smallest and most vulnerable countries benefit from a multilateral investment agreement?

Advocates of a multilateral investment agreement put forth some important arguments. One is that the smallest, most vulnerable countries are always better off in multilateral than in bilateral agreements because of the unequal power relationships between countries. This is a valid argument, but only if it can be guaranteed that the multilateral agreement will be more flexible and increase development policy autonomy. The previous analysis has shown that this is unlikely: an investment agreement under the WTO will likely considerably limit developing countries' policy autonomy.

Moreover, it cannot be assumed that a multilateral investment agreement will negate the need for bilateral investment treaties. Both types of agreements coexist in trade and other areas; one is not a substitute for the other. A new multilateral investment agreement, in addition to adding another layer that may reduce their policy autonomy, will likely also drain the limited human resources of developing countries especially the least developed, smallest and most vulnerable among them.

Once in, especially as part of the single undertaking, it would also be harder for such countries to withdraw from a multilateral agreement. Such action would be met by threats of dispute claims and retaliatory sanctions or by demands for further unilateral concessions.

Lower transactions costs are not inevitable…

Another argument for a multilateral agreement is that it should lower transactions costs, especially for the poorest and most vulnerable developing countries, as a result of one agreement replacing the multitude of bilateral ones. While this may be true for multilateralism over bilateralism more generally, it is doubtful that a multilateral investment agreement in the WTO will replace bilateral investment treaties, at least in the short-term—especially if bilateral agreements offer more favourable terms and more flexibility. Rather than reducing transactions costs, a multilateral agreement may actually increase them for developing countries, especially the poorest and most vulnerable.

Equally important, a multilateral agreement is unlikely to reduce transactions costs for foreign investors. As Hoekman and Saggi (1999, p. 16) argue, 'it seems that the major proportion of the transactions costs associated with foreign direct investment is likely to arise from differences in language, culture, politics and the general business climate of a host country. Familiarizing oneself with the investment laws of a country seems trivial in contrast to these more daunting challenges that exist regardless of whether the country is a signatory to a multilateral or bilateral investment agreement'.

…and higher opportunity costs may not be justified

Finally, it is questionable whether policy-makers in developing countries could justify the opportunity costs of diverting scarce human and other resources to negotiating and administering new issues such as investment. This is because of the questionable development value of such an agreement and their arguably more pressing domestic and poverty reduction priorities.

Indeed, experts have argued that taking high-quality human and other resources away from such domestic priorities is unlikely to be their best possible economic use (Rodrik, 2001; Winters, 2002). Even if confined to the trade area, developing country priorities and those of poverty reduction lie much more in the traditional 'border' areas (agriculture and textiles)—where they should logically invest their limited resources if they wish to maximize their gains.

Notes

1. UNCTAD (2002a) discusses the role of Japanese foreign direct investment in the international networks of the electronics industry and their policies towards local parts and suppliers. The analysis also highlights how little of the value added from these networks remains in developing countries.

2. Local content requirements also occur in the tobacco, audiovisual, pharmaceutical, computer equipment and food processing industries.

3. A number of commentators, including various Trade and Development Reports from the United Nations Conference on Trade and Development, have elaborated on the important differences between US and Japanese foreign direct investment and transnational corporations in this respect. The US has generally been motivated more by market access reasons, while Japan was motivated—especially in Southeast Asia—by the need for a dynamic division of labour.

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