PART THREE

POLICY IMPLICATIONS

Chapter XI

INTERNATIONAL PRODUCTION AND GOVERNANCE

The analysis in the present report documents the rising importance of foreign direct investment (FDI) in the world economy. Investment flows have grown considerably in both absolute terms and relative to a number of key economic indicators, with, for instance, sales of foreign affiliates being larger than world exports (Part One). Foreign direct investment, and the flows of capital, technology, training and trade that are part of it, has become the primary means by which a growing number of countries are integrated in the international economy. As a result, transnational corporations (TNCs) have become the principal private actors in the world economy.

This also means that TNCs play an important role in the growth process of countries. The analysis in Part Two has shown that those firms can make significant quantitative and qualitative contributions to the growth of developing countries. This contribution takes the form of providing additional investment resources, facilitating technological change, improving the quality of human resources and opening up new opportunities for trade. In all these areas, the catalytic qualitative role that TNCs can play in accelerating the growth process is perhaps even more important than its quantitative dimension by way of making investments in outputs with higher growth potential, introducing new products and technologies that contribute to structural change in a country's economy, raising productivity through the provision of training for workers and managerial staff, and changing the composition of exports and imports in a manner that permits a more sustainable integration in the international economy. Thus, TNCs invest a package of tangible and intangible assets in their foreign affiliates. Those, in turn, are linked to

domestic enterprises through various forward and backward linkages, while, at the same time, being part of the global affiliate networks of their parent firms.

The growth of such cross-national networks is beginning to give rise to an international production system for goods and services, organized and managed by TNCs. If anything, the characteristics of the new world economy (outlined in chapter IV) further underline the centrality of TNCs and encourage the development of an international production system. Against this backdrop, the Report also documented that the share of developing countries in global FDI continues to decline, even though those countries have introduced many policy changes to facilitate FDI inflows into their economies, and most of them run the risk of being marginalized in the emerging international production system.

Those developments require that the conventional approach to international economic transactions, which focuses on trade and finance, be revised to take into account explicitly investment flows. More specifically, in a world in which the book value of FDI has reached $1.7 trillion, undertaken by some 35,000 TNCs through some 150,000 foreign affiliates, in which the total volume of goods and services delivered to foreign markets through the foreign affiliates of TNCs is larger than that delivered by exports; in which a good part of trade, technology and finance flows is associated with FDI; in which FDI is a mechanism through which economies are linked together at a deeper level of integration than at the trade level; and in which TNCs have a central impact on economic growth, international economic transactions ought to be viewed from the perspective of foreign direct investment and transnational corporations.

Thus, with the ascendancy of TNCs, the international economic reality has changed fundamentally. Economic theory, policy-making and institutional arrangements must follow suit, lest they lose their relevance.

Some of the implications that follow from seeing the world economy from the perspective of foreign direct investment and transnational corporations are outlined in this chapter. Section A contains an illustrative examination of two sets of policy measures that recently have received attention in international discussions or negotiations: measures that distort international flows, and measures taken at the national level to increase, under certain conditions, the benefits that accrue to the country taking them. But, in distinction to the conventional approach, the discussion here is not conducted from a trade perspective, which would focus on, respectively, trade related investment measures (TRIMs) and strategic trade theory; rather, the discussion is conducted from the perspective of FDI and, therefore, focuses on investment related trade measures (IRTMs) and strategic FDI policy.

Section B, then, turns to the principal actor of international production, the transnational corporation. The question is asked: what consequences does the failure of a TNC have, and how does the international community deal with such an occurrence in a world of multiple jurisdictions? Given the great number of TNCs, such incidents are likely to occur from time to time, and provisions have to be made sooner or later to deal with them in a cooperative manner.

The implications of viewing the world economy from the perspective of FDI would reach, of course, into the institutional sphere. Section C deals, therefore, with FDI-supporting mechanisms. Trade-supporting measures are quite common at the national level and, at the international level, had found their

expression in the establishment of the United Nations Conference on Trade and Development (UNCTAD) in the 1960s. In the FDI area, however, such supportive measures are fairly limited and, at the international level, furthermore, quite dispersed. An appropriate mechanism in that respect would be particularly important to accelerate the flow of FDI to developing countries and enhance its growth-promoting role in those countries. That need alone calls for concerted efforts by host countries, home countries and the international community.

A more comprehensive approach, moreover, would also aim at increasing the transparency of national FDI regimes and introduce a measure of review of FDI policies—mechanisms that have become accepted and valued features of the multilateral trading system. Such mechanisms do not yet exist in the FDI sphere. Section D outlines, therefore, a multilateral approach to increase the transparency of national FDI regimes and to review national FDI policies, focusing particularly on the benefits such an approach would have for countries and firms.

A. A new policy perspective

1. Investment related trade measures

(a) Relevance

Transnational corporations have come to be responsible for a substantial share of world exports and imports. As mentioned in chapter VIII, in the case of the United States, for example, some 80 per cent of the country's trade was undertaken by TNCs in 1989, including parent companies in the United States, foreign affiliates of United States TNCs and United States affiliates of foreign TNCs. If only trade that passes through foreign affiliates of home-country TNCs is considered, the role of those firms is still quite important. To use again the example of the United States, in 1989, approximately half of the merchandise trade passed through either the foreign affiliates of United States TNCs or the United States affiliates of foreign TNCs. At the same time, more than a third of United States trade represented intra-firm transactions, between foreign affiliates and their parent corporations.

Such a symbiotic relationship between FDI and trade establishes the potential for the volume, sectoral composition and geographical distribution of FDI to be affected by trade measures with attendant consequences for the world at large and for the distribution of gains among countries. For example, if tariffs on imports imposed by one country attracts FDI, that may be at the expense of FDI in another country, and so the distribution of benefits associated with FDI is altered. It is also possible that such tariff-jumping FDI can reduce, under some circumstances, the welfare of the tariff-imposing country as well, and thus reduce overall global welfare.

Accordingly, in consideration of the importance of FDI, one has to explore investment related trade measures (IRTMs)—trade measures that are not specifically aimed at affecting FDI flows but, in the

final analysis, do so—in the same spirit that underlies international negotiations on trade related investment measures (TRIMs). In view of the symbiotic relationship between FDI and trade, IRTMs carry significant policy implications, since investment diversion could arise from a variety of trade measures, just as trade diversion can result from investment measures. The spirit underlying the discussion of TRIMs is to review measures related to investment that have the effect of causing a pattern of trade different from what would be obtained from the operation of market forces in the absence of those measures. TRIMs have become a subject of discussion despite the recognition that the operation of market forces in the real world, with all its structural imperfections and multitude of interventions in product and factor markets, by no means guarantees that the elimination of TRIMs would bring about a pattern of trade conceived in a world of perfect competition with the same welfare consequences. The issue is essentially the deviation from the pattern of trade that emerges owing to interventions aimed at affecting investment. In the same vein, it is logical to consider the deviation from the pattern of FDI that emerges owing to interventions aimed at affecting trade. In each case, the concern is that such intervention affects national and global welfare.

(b) How do investment related trade measures work?

It would require considerable research to identify all trade measures that fall in the category of IRTMs, and to quantify their impact on FDI flows. However, considering that virtually all countries in the world adopt tariff and non-tariff measures to affect exports and/or imports and that much FDI involves international trade, it would appear that a very large part of FDI is affected by trade measures. The principal objective here is to identify possible IRTMs, without any claim to being exhaustive, and to indicate briefly how they might affect FDI. Table XI.1 contains a suggestive list of IRTMs and their likely impact on FDI flows.

Table XI.1. A suggestive list of IRTMs

Trade measure	*Possible impact on FDI*
Tariffs and quantitative restrictions on imports	Induces import-substituting FDI
Sectorally managed trade, including voluntary export restraints	Induces import-substituting FDI
Regional free trade agreements	Promotes FDI in the member countries
Rules-of-origin policies	Induces FDI in component production
Export processing zones	Induces export-oriented FDI
Export controls (security and foreign policy)	Induces export-replacing FDI
Export financing	Increases export-oriented FDI
Non-monetary trade arrangements (coproduction; buy-back)	Depends on the nature of specific arrangements
Safety, health, environment, privacy and other national standards	Induces import-substituting FDI

The most obvious trade measure—one that has received considerable attention by researchers—is the imposition of *tariffs* or *quantitative restrictions on imports*. Both of those measures affect the volume of trade. If the market of the country imposing that trade restriction is considered to be of significant interest to foreign firms, they might seek to engage in FDI in order to maintain their participation in that market. Foreign direct investment in this case, known as tariff-jumping investment, is therefore a response to restrictions on trade. As is well-known, many developing countries have pursued import-substituting development strategies, using protective tariff walls and other import restrictions. This was particularly true for such industries as automobile, steel and selected consumer electronics. A considerable amount of FDI took place in those and other industries in which restrictions were imposed on imports; often the foreign affiliates operating under those conditions are not efficient and, hence, not competitive in world markets. Given these inefficiencies, such FDI might not have occurred in the absence of trade restrictions.

Another significant trade measure that has proliferated in recent years involves an increase in structured *managed trade* arrangements, centred on particular sectors. Sectoral arrangements have included automobiles, textiles, semiconductors, steel, aerospace and construction projects. Such arrangements may take various forms. In the case of trade between the United States and Japan in automobiles, trade has been managed principally through voluntary export restraints by Japan. Since the United States auto market is considered important by Japanese producers, they have responded by undertaking FDI in the United States to protect or enhance their market share. Similarly, the Multi-fibre Arrangement (which provides the framework for managing trade in textile products) permits importing countries to assign quotas on exporting countries selectively. In consequence, countries whose quota on exports had been reached have undertaken FDI in other countries whose quota remained under- or unutilized or were not subject to quota. A considerable portion of FDI by Asian newly industrialized economies in other developing countries of Asia has been undertaken for that purpose. Here, again, FDI has been made in response to specific trade restrictions.

The creation of *regional free trade areas* can have considerable effects on FDI flows. Although regional arrangements may envision an eventual reduction of trade barriers *vis-à-vis* non-member nations, their typical immediate effect is to implement significant and advantageous trade liberalization measures exclusively within the free trade area. Such arrangements may draw in FDI from enterprises based in non-member countries. The impact is most pronounced for enterprises whose exports lose their relative competitiveness to local producers benefiting from the trade agreement, essentially forcing outside firms to invest within the region in order to maintain their market share. This effect can be seen in the case of the European Community (EC), when, after the announcement of the EC 1992 Single Market programme, FDI by firms based outside the Community increased considerably. [1] Investments were motivated both by the desire to take advantage of the expected market growth and to protect against exclusion from the EC market. Neither objective could be reached as effectively, if at all, from outside the regional trade zone. A parallel movement appears to be occurring in anticipation of a North American Free Trade Agreement, particularly in terms of FDI in Mexico (see chapter I). A similar effect could also arise sectorally in response to related efforts to create exclusive, regionally-assisted R&D or manufacturing programmes such as Esprit, Eureka and Sematech, which often incorporate an important trade-related element; currently, however, that type of IRTM probably exerts only a low impact on FDI flows.

One instrument of regional integration arrangements that can be a particularly important IRTM are *rules of origin,* especially their *local content* components; local content requirements can also be imposed independently of integration agreements. The investment impact of such trade measures is obviously to encourage investment and production in the consuming market, presumably at the expense of economies from which exports are displaced. For example, if country A decides that it would allow imports from country B only under rules of origin that require a minimum local content (that is, country A plus B's combined content), then all the countries that have been exporting inputs and components to the region may be forced to produce directly those inputs and components in A, B or both. In the evolving North American Free Trade Agreement, a key negotiating issue concerns rules of origin and local content, which set the minimum amount of North American value-added to qualify for duty-free status. As mentioned in chapter I, the three United States car manufacturers, all of whom already operate in Mexico (General Motors, Ford and Chrysler), are promoting local content requirements of 60 to 70 per cent for goods in that industry to qualify for duty-free access to other NAFTA countries. This would place most European and Asian car manufacturers in a disadvantaged position because they would not be able to rely on sourcing from their home countries in order to qualify for duty-free status in NAFTA. Clearly, local content requirements on imports and rules of origin significantly affect investment decisions.

The flow of FDI is also affected by *export processing zones* introduced by many countries, particularly developing countries. Using very liberal trade rules (and other incentives), the specific purpose of those zones is to attract FDI flows to them in order to boost exports and employment. During the past two decades, the number of such zones (also known by various other names, such as special economic zones and free economic zones), has increased significantly. By early 1989, there were about 200 export processing zones in operation in the developing world, and more than 150 under construction or at the planning stage. The operational zones employed over 1.5 million workers, and their exports were of the order of $15 billion. [2] A large part of investment in export processing zones is by TNCs.

Export controls and *export credits* can also influence FDI flows. The imposition of national export controls (applied for security or foreign policy reasons) over time can lead corporations to invest in areas outside the jurisdiction of control-prone Governments or prevent FDI flows into particular industries. For example, a prohibition of the export of technologies with potential military uses may discourage FDI in activities that make use of those technologies in their civilian applications. Export credits by developed countries are subject to an OECD agreement that seeks to limit the effective subsidization of trade through publicly assisted export-financing mechanisms. Although not comprehensive nor entirely effective, that agreement has reduced the level of competition among export-financing programmes. Differentials in the export financing support available in various nations can still affect corporate decisions to invest. Export-oriented investors would have an incentive to choose locations that offer more favourable export financing, which has the effect of subsidizing exports.

Rebates of indirect taxes on exported goods and services as an export incentive can also affect investment flows. Even if indirect tax rebates may be a step towards correcting a distortion of trade flows, that decision could nevertheless affect investment patterns. Export-oriented investors can often choose between alternative production sites. A country whose taxation system is based heavily on indirect taxes

would be in an advantageous position over a nation using primarily a direct taxation structure for export-oriented investment projects that could benefit from the sanctioned rebates.

Since the debt crisis of the early 1980s, a growing proportion of world trade (estimated to range between 8 per cent and 30 per cent) has been conducted through such *non-monetary trade transactions* as barter arrangements or more sophisticated forms of countertrade, clearing provisions, co-production, buy-back agreements and other such mechanisms. In the case of buy-back agreements, for example, an enterprise setting up a plant in another country agrees to buy back all or part of the output of that plant. Thus, a host country permits FDI in exchange for guaranteed exports.

An impact on FDI might arise from *trade standards* that define appropriate and acceptable policy measures dealing with safety, health, the environment, privacy protection or cultural concerns. Countries sometimes adopt measures that may appear to be based on legitimate domestic policy concerns, but which, in practice, may erect discriminatory non-tariff trade barriers. For example, requiring health and safety inspections to be carried out by national inspectors can have the effect of a non-tariff barrier against imports and may favour import-substituting FDI.

Finally, trade measures undertaken by subnational Governments in the United States, Canada and several other nations with federal government structures also can act as IRTMs. For instance, many United States state agencies and many cities offer a variety of fiscal and non-fiscal incentives to promote exports with potential interactive effects on FDI flows. A trend towards economic decentralization in other countries, coupled with the growing appeal of federal structures in Europe, may further increase the importance of subnational government policies over the remainder of this decade.

(c) Conclusions

These examples provide a broad picture of how a variety of trade measures adopted by Governments can influence FDI flows. In fact, a significant part of global FDI flows is likely to have been influenced by trade measures in one way or another. Obviously, not all measures are equally potent in this respect. Trade interventions in the form of import tariffs, sectorally managed trade, regional trading arrangements and export processing zones are likely to be of greater significance than others. The purpose of this discussion is not to pass judgement on IRTMs; as in the case of TRIMs, positive and negative (intended and unintended) effects of each measure need to be weighed. The purpose is, rather, to point out that, in view of the increasing importance of FDI in the world economy, the international allocation of FDI and policy interventions that have the effect of changing the pattern of its allocation should be matters of great concern. Thus, the impact of IRTMs and their effects on efficiency and welfare need to be examined and, if need be, made subject to policy action.

Some of the IRTMs identified above are sanctioned by GATT, while others lie outside current multilateral agreements. GATT-actionable trade measures presumably either eliminate distortions or reduce them to their lowest practicable political level (which may be reduced further through periodic negotiations). However, a reduction of trade distortions does not necessarily mean a similar and

accompanying reduction of investment distortions. Some measures that promote freer trade may have an adverse impact on investment flows from the viewpoint of global welfare. Where trade policies have a differential effect on investment flows, a new negotiating approach may be required.

Since FDI has emerged as a critical structural determinant of the international economy, its increased importance in shaping trade flows requires a policy analysis that reverses the historical concentration on trade policy and the more recent focus on investment issues only as they distort trade flows. Both policy analysis and political negotiations might be better served by examining also the impact of trade and other policy measures on investment flows, rather than simply concentrating on the reverse relationship. An investment analysis would help to inform public officials better about the impact of trade-policy choices. Such discussions could also contribute towards the acceptance of broad FDI principles to promote and guide global economic relations into the next century.

2. Strategic foreign-direct-investment policy

Few countries, developed or developing, pursue a policy of complete non-intervention in the area of FDI. The extent of intervention, of course, differs between countries and take various forms: closure of certain sectors to FDI; limitations on the share of foreign ownership; performance requirements, such as requiring foreign investors to meet some pre-determined levels of exports, or to use a minimum proportion of locally produced inputs; and a host of fiscal and non-fiscal incentives applied either to FDI generally or in particular sectors. Those and other measures, adopted by Governments with varying degrees and coverage, have as their objective to increase the benefits of FDI to host economies or to minimize negative economic or non-economic impacts. As has been documented in chapter III, however, the recent trend in policy changes has been unmistakably in the direction of progressively greater liberalization and significantly reduced intervention. This in turn raises the question as to whether there is any scope for "strategic FDI policy". The purpose of such a policy would be to increase the long-run benefits of FDI to an economy, both economic and non-economic, for example, through learning-by-doing, the development of an indigenous technological capability or attaining self-sufficiency in certain selected industries, even if such a policy were to impose some short-run cost (for example, by reducing FDI inflows or causing a fiscal drain).

Another reason why some attention should be paid to strategic FDI policy is that, during the past ten years or so, there has been considerable discussion of what is termed "strategic trade policy". This discussion usually deals with two aspects: one dealing with policies of Governments towards specific industries or sectors that might be termed "strategic" in that they confer certain special benefits on the economy; and the other with rent-transfer behaviour by Governments. [3] In both cases, the treatment of imperfect competition is at the heart of the new thinking, that is, the presence of firms that behave as monopolists or oligopolists in their relevant markets. Imperfect competition might result from economies of scale (including those resulting from fixed costs, such as R&D expenditures), economies of learning, product differentiation combined with economies of scope, or other factors that create barriers to entry to an industry. At the same time, the growth of FDI and the role of TNCs in host economies are, in turn,

largely attributable to the presence of monopolistic or oligopolistic competition. Therefore, strategic FDI policy deserves the attention of policy makers owing to the same considerations which underline strategic trade policy.

The preceding discussion suggests that the rationale behind strategic FDI policy falls into one of two broad categories: the realization of long-term benefits (even with some short-term costs) and transferring rents from foreigners. Investment policies usually adopted by Governments of home and host countries to achieve either long-term benefits (including minimizing negative impact) or rent transfer include (i) the offering of subsidies or other investment incentives to TNCs to induce them to locate operations to territories within the offering Government's jurisdiction; (ii) the imposing of performance requirements (or, as termed in the GATT negotiations, "trade related investment measures" or TRIMs) on local operations of TNCs to induce them to take measures that are consistent with host nations' goals and objectives; and (iii) closure of the domestic market to, or restrictions on, FDI. Often, host countries link the first two sets of policies, that is, they mandate performance requirements as a condition for the receipt of investment incentives.

(a) Policy instruments to increase long-term benefits

(i) Investment incentives and performance requirements

Investment incentives and performance requirements can be fairly general, implemented with the objectives of enhancing the flow and increasing the long-term benefits from FDI. Alternatively, they can be geared to specific industries considered to be strategic for economic or non-economic reasons. The discussion below examines both aspects, though, in practice, the distinction between them may be rather blurred. The use of general investment incentives can be effective in some situations by inducing TNCs to place their operations in one geographic location rather than another. However, if the firms' choice of location in the absence of any such incentive is different from the choice they would make given the incentive, there must be some reason why firms prefer the former location over the latter; for example, the former location might offer lower operating costs, or have higher expected profitability than the latter (and, hence, from a global perspective, the former would be more efficient). To be induced to locate in the latter location, TNCs must, therefore, be offered incentives large enough to compensate for the reduced efficiency (lower profits) at the latter site.

As noted before, Governments often offer investment incentives in conjunction with performance requirements. These are designed to ensure that TNCs do in fact bring benefits to the local economy, often by specifying that TNCs meet certain goals and objectives, such as creating employment, generating exports, expanding domestic value-added and the like. If TNCs accept those performance requirements, it can be assumed that the value (to the firms) of the incentives or other concessions granted to them exceeds the costs (again, to the firms) of meeting the performance requirements. Otherwise, TNCs would locate elsewhere because they are capable of recognizing any performance requirement that acts as a hidden tax.

From the point of view of host countries, the relevant question is whether they can secure long-term net gains from an investment incentive/performance requirement package. There might be situations in which both the Government of the host country and TNCs might gain from the package. An example is when a performance requirement is linked to an incentive in the form of preferential access to the local market. This preferential access, in effect a monopoly or semi-monopoly right, acts as an inducement to the firm to accept performance requirements. Such linkages of local monopoly rights to performance requirements were quite common in larger developing countries such as Mexico during the 1970s; the local automotive industry, a major Mexican exporter controlled in effect by four TNCs, was built on this sort of arrangement. However, the nature of this arrangement has changed significantly due, in part, to policy changes.

The benefits that might be captured by the local economy from this type of arrangement vary. Some gains might come in the form of the realization of returns from a potential but unexploited comparative advantage in the production of certain goods or services. Such returns are of value to the host country; if a strong case can be made that, without the investment incentive/performance requirement package, the economy would never have achieved these or would have taken a considerably longer time to do so, the Government of the host country might feel justified in adopting those measures. Further gains might come from externalities, especially in the case of developing countries. For example, these might result from technology transferred to suppliers of local affiliates of TNCs, which, in turn, are able to use the technologies to benefit other customers. They might also take the form of infrastructure created by TNCs that is useful to agents other than those firms alone.

However, while investment/performance-requirement packages might be advantageous from the perspective of both TNCs and Governments in the case of a particular host country, they might well be disadvantageous from the perspective of other countries, especially smaller and poorer developing countries. The packages are most likely to be successfully implemented by those countries that are relatively large and prosperous; but smaller and poorer countries that can offer little in the form of incentives to TNCs as an inducement to accept a performance requirement are not likely to be able to implement packages that are of net benefit to their economies.

There are other considerations that need to be taken into account in relation to generalized investment incentives and performance requirements. For the country implementing such measures, there may be a loss of potential tax revenues that would be earned from FDI that could have taken place even in the absence of incentives. Furthermore, performance requirements may deter FDI that might otherwise be beneficial to a host economy. In addition, the offering of incentives may lead to a bidding war between host countries, to the detriment of all host countries.

The situation may, however, be different in the case of industries that are considered to be of strategic importance. If a Government has identified specific activities in which TNCs can offer certain special long-term benefits (for example, by opening export markets or producing products for export with proprietary technology), there may be a case for differentiated incentives. Incentives geared to such activities function as production or export subsidies *for those specific activities* and form part of the panoply of policy tools of a Government implementing a strategic FDI policy. However, those induce-

ments should be moderate, their economic rationale should be clear and they should be offered only to a small number of activities.

That kind of industry-specific incentive may also be appropriate in order to encourage certain kinds of activities (beneficial to the host economy) by specific companies, for reasons of externalities. In those cases, the company and activity in question are usually identifiable. The investors are normally international oligopolies that have proprietary technologies and products whose introduction into the domestic economy can have effects that go far beyond the benefits accruing to the factors of production directly engaged by the company. That is the case of most manufacturing goods produced with complex technologies, and particularly those using information technologies.

Industry and activity-specific inducements to FDI can be usefully accompanied by performance requirements. For example, incentives can be made conditional on the export of a certain proportion of output or on training programmes for domestic employees or managers. An interesting example of this kind of approach is the agreement between the Government of Mexico and IBM whereby, in exchange for being allowed to set up an affiliate with 100 per cent ownership, IBM agreed, among other things, to establish facilities to train Mexican computer programmers. In many cases, performance requirements can be implicit, since foreign firms have to apply for special incentives not offered to all foreign investors and, in the process, will have to modify the nature of their operations in the host country. The more desirable a country is as a location and the fewer the locational alternatives, the greater will be the possibility that the Government of a host country can induce TNCs to contribute towards specific long-term development objectives through a combination of activity-specific incentives and performance requirements.

(ii) Restrictions on foreign direct investment in strategic industries

There are many cases in which Governments prohibit or regulate FDI in particular industries—not in an effort to capture rent, but to obtain some long-term benefits, usually non-economic in nature. These often have to do with national security; Governments are uncomfortable if the provision of certain goods and services deemed essential to national security is under the control of foreign nationals. But other goods and services are often affected as well. For example, almost all nations place some limits on foreign ownership or control of domestic broadcasting operations, the provision of telecommunications services and other public utilities and railroads and other common carriers. Similarly, many developing countries that are major suppliers of petroleum or minerals have taken steps to put the extraction of natural resources under national control and, in many cases, national control extends to at least some downstream operations as well. In many countries, both developing and developed, certain industries are deemed to be essential to economic security, and restrictions have been placed upon foreign ownership and control of firms undertaking those activities.

In all of these cases, the arguments for and against foreign ownership and control are intellectually complex as well as often emotionally charged. Also, the policy climate is subject to periodic change; in many countries, policies towards industries in which local ownership and control once was seen as a vital

national goal are being re-evaluated at the present time in light of the economic cost of maintaining such policies. And in some countries in which such costs are seen as too high, the policies have been changed to allow a greater role for FDI. [4]

One of the arguments for restricting foreign ownership or control of activities that are deemed strategic concerns avoidance of dependence on foreign TNCs in a situation of defence emergency. That consideration is a special case of trade-off faced by all nations between self-sufficiency and efficiency. In the extreme case, countries might argue that national security considerations demand that they be self-sufficient in the production of all goods and services. But the cost of self-sufficiency in terms of inefficiencies is very high for most countries. Even large and advanced nations such as the United States have found themselves increasingly dependent upon foreign firms for a wide range of goods and services, including some that are militarily sensitive.

Another argument relates to the fear of Governments of host countries that foreign affiliates in their territories might not receive the latest and best technologies from parent firms, which might limit the diffusion of those technologies in order to gain advantages for the home country. There are, in fact, many goods and services for which firms (rather than nations *per se*) control the latest and best technologies or the latest and best product and process designs, and hence such fears might be justified. Indeed, it is widely recognized that firm-specific ownership advantages are among the key determinants of the ability of a firm to operate transnationally. If a TNC under foreign control is the sole or dominant supplier of products or services that are deemed necessary to a country's security, that country must often decide between accepting some degree of dependence on the TNC, or making its own efforts, with the risk of incurring gross inefficiency or technological inferiority. [5] Faced with that choice, many countries have concluded that admitting FDI is a more desirable option because a local foreign affiliate involves less dependence on the outside world than, for example, relying on a domestic supplier who must import products embodying critical technologies through arm's-length transactions from a foreign TNC.

Some arguments are also advanced in favour of restrictions on FDI in strategic industries for economic reasons. It is also argued, for example, that some activities are so critical to the economy of a nation that, although perhaps not sensitive for military reasons, they must none the less be under domestic ownership or control for considerations of "economic security" or "economic sovereignty". Typically, however, it is difficult to determine what exactly is meant by those considerations. In addition, countries risk costly errors when singling out specific activities and reserving them for domestically controlled enterprises on grounds of economic security (for example, building domestic steel mills that may never be cost-efficient). For those reasons, countries might be well advised to make sure that there are strong economic reasons for such policies before implementing them.

Another economic reason which is sometimes cited to exclude foreign ownership and control in specific activities is R&D. Since most TNCs concentrate their R&D activities in their home countries (see chapter VI), it is sometimes felt that, to encourage local R&D, it is necessary to limit foreign ownership or control of R&D-intensive activities. Research and development generates benefits that are captured by three sets of actors: the firms that undertake R&D, if that R&D leads to the creation of new products or processes that earn rents for the innovating firm; customers of the firm who are users of those

products or processes and hence either benefit from lower prices or new or improved products; and the society at large, if new knowledge created by R&D can be useful in applications apart from those controlled by the innovating firm or its immediate customers. The benefits captured by society at large are one example of "externalities"—benefits that are captured by not only producer or the consumer of a product or service, but also by others. The preceding section discussed policies designed to *attract* FDI in order to capture externalities; thus, the discussion here is the opposite, namely to *exclude* FDI in order to capture externalities, a special case of which is R&D.

Two things would have to take place simultaneously for this strategy to be successful. First, if the Government of the host country were to exclude FDI in a certain industry, locally-controlled entities would have to undertake R&D that would otherwise have been performed by a foreign TNC. And second, if the R&D were to be performed by local firms, externalities would have to be generated that could not have been captured if the same R&D had been undertaken by a TNC and located elsewhere.

The key issue is whether both of these are, in fact, likely to happen simultaneously. Research and development doubtlessly does create externalities; but there appears to exist no strong basis to argue that externalities associated with R&D cannot be captured if R&D is performed by TNCs. In fact, in recent times there has been an emphasis on the benefits to one organization locating its R&D activity in close proximity to R&D activities of rival organizations, precisely in order to capture externalities. That partly explains why R&D activity is often clustered in one locality, for example, in California's "Silicon Valley", a cluster of related activities located in a region around the southern shores of San Francisco Bay. This would suggest that Governments might indeed wish to take positive measures to encourage locally-controlled firms to perform R&D, without necessarily excluding foreign-controlled firms. The presence of foreign affiliates might, in fact, serve to stimulate local R&D, precisely by creating the kernel of a potential cluster of related activities.

If FDI is excluded, it is possible that local entities would then perform the R&D that would otherwise have been undertaken by TNCs. But that possibility is much higher in developed than in developing countries. In this context, the cases of Japan during the 1950s and 1960s and of the Republic of Korea during the 1970s and 1980s are instructive. The past policies of those two countries were to restrict inward FDI and to encourage the local development of technology. But Japan, especially during the period 1959-1975, largely used this policy as a means of inducing non-Japanese holders of technology to license their technology to Japanese firms, rather than to induce Japanese firms to create equivalent technologies independently. The Government of Japan simultaneously encouraged Japanese firms to develop R&D activities needed to absorb and improve upon the technology acquired from abroad. Over time, those activities moved away from absorption and improvement and towards *de novo* development of technology; but that did not happen quickly. In effect, then, Japan used access to its internal market as an incentive for non-Japanese firms to *license* technology, by denying those firms access via other channels. Whether or not many other countries could successfully pursue a similar strategy is open to serious doubt; in high-technology industries, even the Republic of Korea—the country that has come the closest to emulating the Japanese model in that regard—has adopted relatively liberal policies towards FDI, as noted in chapter VI.

None of this is to suggest that Governments of developing countries should not promote technological innovation. Virtually all countries that are home to technologically dynamic firms have experienced governmental involvement in high-technology industries, and there are many ways in which Governments support technological innovation. But selective exclusion of foreign ownership from high-technology activities with the hope that such exclusion will foster local entities to do R&D that otherwise would be done by TNCs is not likely to be particularly fruitful.

Overall, therefore, it appears that, in general, the arguments for an exclusion of foreign ownership from selected activities on strictly economic grounds tend to be weak, even for high-technology industries. Rationales based on national security might be somewhat stronger, but they are open to abuse. The relevant criteria in either case are how important strategic considerations are and at what cost self-sufficiency is achieved. In the case of exclusions based on national security, the cost can be very high: efforts to be self sufficient in specific military-related technologies might not only raise costs (and hence reduce national income, the effect of which by itself is to weaken national security), but also threaten the local military with technological inferiority.

(b) Policies to transfer rents

One aspect of strategic trade policy concerns policies pursued by Governments that enable local agents to earn rents, where the rents in the absence of these policies might be captured by foreign rather than domestic agents. In most cases, the relevant agent is a local producer and exporter of a good or service.The major premises behind rent-seeking strategic trade policies are that, first, imperfect (oligopolistic or monopolistic) competition in an industry creates opportunities for firms supplying the industry to appropriate a rent from world markets for the relevant product; and, second, intervention by a Government can enable domestic firms to capture those rents from foreign producers such that the value of the rents captured by domestic residents exceeds the cost to the domestic economy of the intervention. The interventions might be, among other things, in the form of a subsidy to domestic producers [6] or trade protection for these producers. [7]

As regards the applicability of rent-seeking logic in the area of FDI, the overall conclusion that emerges from the literature on the analysis of the closure of markets to FDI as a means to appropriate rent from foreign markets is that some rent might, in fact, be gained by an enterprise based in a country closing its internal market to inward FDI, but that any such gain can easily be outweighed by efficiency losses within the same market. Inward FDI can increase efficiency by stimulating competition and enabling inward technology transfer. Lack of the latter can be especially serious in industries in which domestic and foreign firms possess technological complementarities. The only situation in which a strong case might be made for market closure on rent-transferring grounds is where the industry is marked by strong economies of learning.

Taxation is one means by which host countries can obtain a share of any rents garnered by TNCs. But it should be noted that taxation is not a rent-snatching policy tool *per se*; taxes can only be used to gain rents from TNCs if they are, in fact, established and are showing profits. Further, if a Government

abuses the use of taxes as a means of rent-snatching, it could induce TNCs to relocate their operations elsewhere.

It is clear also that a Government cannot offer subsidies (incentives), on the one hand, and simultaneously try to capture a net rent via taxation, on the other. The latter would tend to offset the effects of the former, and the firm would judge an incentive/tax programme in light of its net subsidy or tax. Thus, it is difficult to imagine how an investment incentive can be effective as a rent-snatching device for a host country beyond what the country would normally have obtained. The reverse is more likely to occur, namely, that, after all costs of investment incentives are added up, TNCs extract rent from host countries.

This last possibility is especially likely in cases in which Governments engage in bidding contests against each other in efforts to offer the most attractive incentive packages to TNCs in order to lure FDI into their territories. The likely outcome of a bidding contest is that rents that might normally accrue to host countries from FDI would be bid away and, hence, would be captured instead by the foreign investors or their home countries. None the less, Governments might elect to offer investment incentives to attract FDI, if they believe that benefits other than rents (discussed earlier) will accrue from FDI.

The conclusion that emerges from the above discussion is that there is little scope for FDI policies by way of closure of markets or tax-subsidies to be successful in transferring rent.

(c) Some policy implications

In assessing the overall policy implications of the discussion of the two previous sections, a few points stand out. First, if countries pursue policies that exclude FDI from certain industries, and they make wrong choices, they largely hurt themselves. (If countries reduce their own national incomes as a result of such policies, other nations will suffer some indirect losses, but those are likely to be second-order losses at most.) But, second, if countries pursue policies designed to attract FDI in order to capture benefits that they might not otherwise have obtained (for example, externalities), they may actually obtain those benefits, but they do risk hurting other countries both through redistribution effects (one nation's gain might be another nation's loss) and in the aggregate (world welfare can be reduced as the result of TNCs responding to incentives to locate activities in localities that are not globally optimal). Similar considerations would also apply to performance requirements. Aggregate losses to host countries can be magnified if they are induced to retaliate against other countries' strategic FDI policies. There may be some gain captured by home countries as a result of such policies, if TNCs are able to capture rents from host countries and transfer these to home-country shareholders or treasuries. Third, it is clear that strategic FDI policies must be implemented unilaterally; otherwise, the gains of one country can be nullified by countervailing measures adopted by other countries. Furthermore, special care needs to be taken that strategic FDI policies are not merely short-term protectionist policies.

With regard to the desirability of specific investment inducements (such as tax rebates, outright cash grants, or production or export subsidies), the effects will depend on a variety of factors, not least

on what other competing countries are offering. In order not to engage in bidding contests that benefit only the foreign investors or their home countries, it is important that countries exchange information on their FDI policies as a first step towards harmonizing them. Furthermore, investment incentives should be moderate and industry-specific, because of both budgetary considerations and in order not to shift the rents accruing from FDI to foreign investors. In addition, all such incentives should be open to domestic investors. Only in specific cases where TNCs make a contribution to the economy that domestic investors are unable to make, it may be justified economically to offer foreign firms encouragements that are better than those available to domestic investors. In any event, the economic rationale for such incentives should be carefully reviewed, to avoid unnecessary and costly incentives. Moreover, foreign investors with an orientation towards world or regional markets are more likely to be interested in the overall macroeconomic environment, the general policy framework for FDI and trade policies than in investment incentives *per se*.

B. International cooperation on issues arising from the failure of a transnational corporation

As more and more firms transnationalize, the likelihood increases that some of them will fail. The actual failure rate among TNCs is not known. Some national figures may, however, be indicative. In Germany, Japan, Sweden and the United States, the failure rate (primarily bankruptcies) of national firms is approximately 1 per cent. [8] Even if one were to presume that the world-wide failure rate of TNCs is lower than 1 per cent, one might still expect some 200 to 300 failures per year, given the total number of TNCs of about 35,000. In other words, failures by TNCs are not exceptional occurrences. While the overwhelming number of TNCs is small in size, some large TNCs fail as well—witness the 1991 failures of the Bank of Credit and Commerce International (BCCI) and the Maxwell Communication Corporation. Those two occurrences highlighted some of the consequences of major TNCs suspending their operations world-wide for reasons of insolvency and, possibly (but not necessarily so), going into liquidation. For example, BCCI operated in 73 countries, with over 400 offices and some 14,000 employees of 83 nationalities; the collapse of that bank reportedly affected 1.3 million persons world-wide. [9] In those cases, national action alone is not sufficient to address adequately the problems and issues resulting from TNC failures. In the emerging international production system, TNC failures are yet another aspect of governance for which more international cooperation is needed. [10]

1. Who may be affected by a transnational failure?

The failure of a TNC may affect a large number of persons in many countries. Most national bankruptcy laws establish a ranking of protection for creditors who are affected by the liquidation of an enterprise. With some variations among national regimes on the degree of protection or the ranking of

credits, the following persons are considered to be among the most directly affected by the failure of an enterprise, though not necessarily in the same order:

- *The State.* Under most national bankruptcy laws, the State has a preferred claim, as tax collector, over any other creditor (secured or unsecured) in the liquidation of the assets of an enterprise.
- *The enterprise's employees.* Employees are obviously directly affected by failures because of the resulting loss of jobs and, therefore, for many, their only means of livelihood. Moreover, if a failing enterprise is in default of pension payments, retired employees could also see their pension funds affected by a failure.
- *Suppliers and contractors.* As a result of a failure, payments for supplies of goods and services sold and delivered may not be made and contractors may not receive full payment of their fees.
- *Lenders.* In the normal course of business, a corporation may borrow from a number of sources for a variety of purposes, including mortgages, secured and non-secured loans, bonds, commercial credits and overdrafts. Many creditors (particularly the non-secured ones) may never be able to recuperate their advances, principal or interest in full.
- *Shareholders of the company.* In the case of a company with limited liability, shareholders are liable up to the unpaid amount of capital subscribed for any financial responsibilities of the corporation. In the case of a failure, they would be called upon to pay up to the outstanding amounts in order for the failing corporation to meet its financial responsibilities, which might include criminal or civil penalties and damages. Where there is fraud or other wrongdoing, shareholders may not be protected by limited liability provisions in the applicable company law; officers and directors may be personally liable.

But the impact of a failure by a major TNC may extend also to a number of other individuals and corporations in a number of countries which, in many ways, depend on the failing enterprise for industrial and trade financing, imports and exports, raw materials and transfer of technology, skills, capital, goods and services. A failure could have destabilizing effects in a specific economic sector, and it could undermine consumer confidence (for example, of depositors, insurance policy holders, utility users). Those problems can acquire serious proportions in small developing countries for which the failing enterprise may be one of the main sources of essential capital, technology, skills, goods, services and employment. The failure of BCCI provided an instructive illustration of the consequences of a transnational failure for a large number of industrial and commercial enterprises and projects, mainly in developing countries, that relied on that bank for international financing.

The economic and social costs of a transnational failure inevitably reach the consumer and taxpayer. It is not uncommon to see the prices of insurance policies increase as a result of major failures of enterprises. Similarly, major rescue operations by Governments are likely to be financed from public resources. The multi-billion dollar rescue effort to protect uninsured depositors in the savings and loans failures in the United States is an example of the kind of massive public disbursements that may be needed to mitigate the consequences of major failures.

2. Shortcomings of unilateral actions

In general, bankruptcy laws are national in scope and aim at protecting the interests of the State, employees, creditors, contractors and shareholders within the jurisdiction to which they apply. Transnational bankruptcies present a number of problems that are not addressed by such legislation.

Box XI.1. The United States Bankruptcy Code

Bankruptcy cases in the United States are administered under the Bankruptcy Reform Act of 1978, as amended (11 U.S.C. Chapters 101 et seq., effective since 1 October 1979) (the "Bankruptcy Code"). Prior to its enactment, bankruptcies were administered under the so-called Bankruptcy Act of 1898, as amended. The current Bankruptcy Code seeks to provide greater flexibility for debtors in the reorganization and rehabilitation of their businesses.[1] For example, in the so-called Chapter 11 (reorganization) case under the Bankruptcy Code, debtors are normally left in possession of their property and business, and no receiver or trustee is appointed to take over the debtors' affairs. During a reorganization, the "debtors-in-possession", as the debtors are called, may continue to operate the business, needing specific court authority only for certain statutorily enumerated functions and for activities not in the ordinary course of business. A debtor-in-possession can reject unduly burdensome executory contracts (including labour agreements in certain circumstances) and leases. Moreover, debtors-in-possession have virtually all of the powers of a trustee (allowing them to avoid and recover preferential and fraudulent transfers, compel turnovers of their properties and challenge the claims and security interests of their creditors). At the same time, the creditors are held at bay by operation of the automatic stay, preventing enforcement of their claims during the reorganization case. Moreover, under the so-called "cram-down" provisions of the Bankruptcy Code, debtors-in-possession can obtain bankruptcy court approval of their plans of reorganization, notwithstanding the objection of one or more secured and unsecured creditors. Indeed, that shift in favour of debtors under the Bankruptcy Code has promoted the use of bankruptcy as a "business tool", prompting such well-known bankruptcy cases as those filed by some major United States airlines, including Continental Airlines, Eastern Airlines, Braniff Airlines and PanAmerican Airlines; major retailers such as R. H. Macy & Co., Federated Department Stores and Allied Department Stores; and other large United States corporations and businesses, such as Texaco, LTV Corporation and A. H. Robins.

Section 304 of the Bankruptcy Code

Section 304 of the Bankruptcy Code is best summarized, perhaps, by quoting pertinent parts of its legislative history:

"This section governs cases filed in the bankruptcy courts that are ancillary to foreign proceedings. That is, where a foreign bankruptcy case is pending concerning a particular debtor and that debtor has assets in this country, the foreign representative may file a petition under this section, which does not commence a full bankruptcy case, in order to administer assets located in this country, to prevent dismemberment by local creditors of assets located here, or for other appropriate relief. The debtor is given the opportunity to controvert the petition.

/.....

National laws usually provide for the appointment of liquidators to determine the liabilities, realize the assets and distribute assets equitably among those creditors of bankrupt firms who have proved their claims. As a result of a company's transnationality, however, the assets in one national jurisdiction may not match the liabilities in that jurisdiction, so that one State may find more than enough assets to satisfy the claimants and another can have a shortfall. Hence creditors in one country could be fully paid, while those in another country might receive much less than the full amount of their claims, or might not even be paid at all. Furthermore, most bankruptcy laws give priority in distributions to the Government for

(Box XI.1, cont'd.)

"Subsection (c) [of Section 304] requires the court to consider several factors in determining what relief, if any, to grant. The court is to be guided by what will best assure an economical and expeditious administration of the estate, consistent with just treatment of all creditors and equity security holders; protection of local creditors and equity security holders against prejudice and inconvenience in processing claims and interests in the foreign proceeding; prevention of preferential or fraudulent disposition of property of the estate; distribution of the proceeds of the estate substantially in conformity with the distribution provisions of the bankruptcy code; and, if the debtor is an individual, the provision of an opportunity for a fresh start. Those guidelines are designed to give the court the maximum flexibility in handling ancillary cases. Principles of international comity and respect for the judgements and laws of other nations suggests that the court be permitted to make the appropriate orders under all of the circumstances of each case, rather than being provided with inflexible rules." [2]

There was no comparable provision to Section 304 in the former Bankruptcy Act of 1898. One section of the former Act authorized the bankruptcy court to exercise, withhold or suspend exercise of jurisdiction when a bankrupt had be adjudged bankrupt by a court outside of the United States. [3] Before Section 304 was enacted, a foreign representative seeking relief involving assets located in the United States had to resort to litigation in state or federal non-bankruptcy courts or had to subject the debtor's estate to a full bankruptcy case.

The administration of ancillary cases under Section 304 has shown that Section 304 is far from perfect. The flexibility given to the bankruptcy courts under Section 304 has led to some inconsistent and confusing results. [4] In brief, Section 304 embodies a strong departure of historical United States policy towards foreign bankruptcies. Section 304 has been utilized in the BCCI case in the Bankruptcy Court in the Southern District of New York; its use in this case and others has undoubtedly increased awareness of its availability among bankruptcy practitioners. This, coupled with the increasing globalization of business, should invoke its more frequent use in the future.

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1 See, for example, Thomas Hollanger (1981), *Bankruptcy Reporter*, vol. 15, No. 19 (Minnesota, West's Publishing Co., 1982), p. 35. ("There is an express Congressional policy in favour of rehabilitating debtors and maintaining the equity in their property"), p. 48.

2 H. R. No. 95-595, 95th Congress (1977), 1st Session, pp. 324-325; S. Rep. No. 95-989, 95th Congress (1978), 2nd Session, p. 35.

3 See, Comment to Section 304 of the Bankruptcy Code, *1991/1992 Collier Pamphlet Edition* (New York, Matthew Bender & Company, 1991), p. 97.

4 For further discussion, see, Jay L. Westbrook, "Theory and pragmatism in global insolvencies: choice of law and choice of forum", *American Bankruptcy Law Journal*, vol. 65 (1991), pp. 471-483; and Richard A. Gitlin and Evan D. Flaschen, "The international void in the law of multinational bankruptcies", *Business Lawyer*, vol. 42 (1987), pp. 317-325.

taxes owed and to employees for their wages. But a priority in one country may not be recognized in ancillary liquidation proceedings in another.

In other words, there is no mechanism to provide for the fair distribution of the assets of a bankrupt firm on a transnational basis. An example of legislation allowing liquidators to file a petition in another jurisdiction's bankruptcy proceedings in order to prevent dismemberment by local creditors of local assets is Section 304 of the United States Bankruptcy Code (box XI.1). But those examples are rare. As a consequence, in a transnational bankruptcy the liquidators may try to find and keep as many assets as possible in their jurisdiction—a kind of "ring fencing". That can lead to inequities and, furthermore, make it impossible to realize the true value of the assets of a TNC , which could be greater as a going transnational concern than the sum of its national parts.

The matter becomes even more complex in situations in which a TNC operates in some countries through branches and in others through locally incorporated subsidiaries. Within a group of companies, some subsidiaries may be only partially owned, making the determination of assets and liabilities more intricate.

Intra-group transactions further complicate the distribution of assets and liabilities as transactions result in debit and credit balances that can be quickly altered between jurisdictions when financial difficulties or collapse is expected. Transfer pricing at more or less than fair market values can serve the same purpose. Moreover, there may be some time-lags between the failure of individual units of a TNC located in different countries. The "timing" of individual failures may be manipulated by the enterprise concerned to favour certain creditors, or protect certain assets.

It may be difficult for liquidators in a transnational bankruptcy to locate and identify certain assets because of the confidentiality and secrecy laws of some jurisdictions that have been used to hide or protect assets from creditors. Such information is necessary to determine what assets could be salvaged and how to value them. There are very few international or bilateral agreements that require cooperation or the exchange of information in such circumstances. Furthermore, in certain jurisdictions, some assets may not be convertible or realizable at real market value owing, for example, to the non-convertibility of certain currencies, exchange control regulations or to restrictions on the transfer of land.

Those problems illustrate a fact found in many transnational failures that the interests of creditors of TNCs as a group may be similar, but the differences in the laws of national jurisdictions can lead to different treatment and, consequently, to inequities and conflicts. The law favours those countries that are in possession of assets rather than assuring the fairness of multinational claims.

Moreover, while there are procedures and mechanisms that are set in motion at the national level to avoid the liquidation of a failing enterprise and thus prevent some of the negative consequences of a closure of a major enterprise, they do not have any counterparts at the international level. The aim of such mechanisms is to protect the interests of creditors, beneficiaries, shareholders, employees, subcontractors, clients and other innocent parties who stand to be adversely affected if the liquidation were allowed to proceed. Public interest calls for maintaining confidence in the economic and social system and thus can justify the rescue of financial institutions as well as basic utilities and vital industries. The

multi-billion dollar rescue effort to protect uninsured depositors, including the establishment of the Resolution Trust Corporation to guarantee the savings and loan associations in the United States, is a recent example of such mechanisms. Indeed, the vigorous implementation of such rescue mechanisms at the national level may even impede the resolution (especially the fair resolution) of the problem at the international level.

In summary, the potential costs of the current state of affairs for transnational business can be considerable. An analyst summarized the status quo as follows:

> "There are two categories of costs imposed by the current punitive regime. The most important is the inability to predict the results of defaults, which adds to the costs of every international transaction, especially international financing.....The second type of cost arises in the insolvency process itself. The present incoherent system destroys values that would otherwise be available to claimants in the enterprise, including commercial creditors, employers, tort victims, customers and shareholders. The destruction of values affects both reorganization and liquidation. The use of reorganization to maintain going concern values is almost impossible..." [11]

3. Possible international approaches

In the case of the failure of a TNC, liquidation under one or more national jurisdictions is not likely to produce satisfactory results - either to preserve the firm, or to realize the maximum value of the assets or to protect the interests of innocent parties in an equitable manner. Conventional approaches to preserving the viable portions of a TNC require that there be going concern values, at least in part. They also require information about what can be preserved and what is beyond recovery. All of this becomes more difficult in a transnational situation.

In those situations, increasing cooperation among national authorities would be an initial step forward towards avoiding some of the problems outlined above, while other, more comprehensive approaches, are being explored. Such cooperation could take several forms. Firstly, cooperation along sectoral lines may allow the utilization of existing networks and agreements between countries and institutions (as in the cases of banking and insurance). Secondly, cooperation on a non-strictly binding basis (as in the case of banks) may be useful. Thirdly, disclosure to appropriate national authorities of a TNC's activities and problems in other countries may help prevent ultimate failures.

Especially where the going concern values are substantial, international cooperation, based on a global approach, offers the best opportunity to preserve those values and, hence, minimize losses to all concerned.

Effective international cooperation on those matters may require the conclusion of an international agreement to fill the international void in this area. Indeed, to date, there have been few treaties dealing with bankruptcies or insolvency questions. Among these are the Bustamante Code of Private International

Law (1928),[12] ratified by 15 Latin American countries, and the Scandinavian Convention, adopted in 1933 and ratified by Denmark, Finland, Iceland, Norway and Sweden.[13] The European Community has yet to ratify a bankruptcy instrument. Some States, however, may accede to the draft Strasbourg Convention, a proposal for international cooperation in insolvency matters (including a provision allowing a liquidator appointed in one member country to act as such in another). Similarly, the draft Benelux Bankruptcy Convention has not yet been ratified. The United States is not yet a party to any treaties concerning bankruptcy, though there have been some sporadic attempts to conclude one with Canada.[14]

An international instrument could build upon the existing efforts while bringing them up to date to match the complexities of the emerging international production system. It could provide for, among other things, the exchange of information (thus overriding secrecy provisions under national legislation) on the firm's assets and liabilities, operations, branches, affiliates, shareholders, creditors etc., and the coordination of activities regarding the protection of assets and going concern values. In addition, the instrument could include provisions concerning the allocation of primary and secondary jurisdictions among the countries concerned; the notification of legal actions; judicial assistance with respect to claims, proceedings, the execution of settlements and their implementation between the countries involved. Such provisions would help to avoid a multiplicity of legal proceedings (and their high costs), as well as "ring fencing" and similar defensive actions by local authorities in transnational failures. Such an instrument could also prescribe the creation of such mechanisms as joint teams of experts to assess the overall situation; a joint executive body to design, where feasible, a scheme for the restructuring of an enterprise and, where that is not the case, to determine equitable distribution; a supervisory board to supervise a rescue operation; and mutually agreed dispute-settlement mechanisms to deal with conflicts arising from a restructuring. An international agreement to deal with such matters could be concluded at the bilateral level (based on mutual obligations and reciprocity) or at the multilateral level, or both. Given the fact that major TNCs tend to operate globally, however, a multilateral treaty may provide the most appropriate format for dealing effectively with all the parties concerned in a TNC failure.

The harmonization of standards at the multilateral level to ensure that the same meaning is ascribed to the key terms and concepts used could be another important aspect of intergovernmental cooperation. Harmonization of accounting and reporting standards could result in easier and clearer analysis and interpretation of financial information. International cooperation among external auditors could be required, along with timely communication with primary and other regulatory authorities. Information and disclosure requirements, as well as auditing standards, need to be improved.

Those are some options available in order to deal with failures of TNCs in a world of multiple jurisdictions. It would be worthwhile to examine those and others in order to arrive at mechanisms that would allow Governments to deal more effectively and equitably with failures of TNCs.

In conclusion, the same need and desire for commercial certainty that prompts international cooperation in the areas of trade, finance and FDI applies with equal force to the area of business insolvency.[15] However, relative to progress made in recent years in other areas, efforts to coordinate rules in the area of insolvency lag far behind. As one author put it: "At present the legal treatment of

troubled multinationals is primitive and chaotic...[T]he development of sensible and efficient management of commercial default is a crucial element of the integration of the world economy".[16] The emergence of an international production system, with TNCs as its central actors, underlines the importance of action in this area.

C. Mechanisms to support foreign direct investment

In the past few years, developing countries have made great efforts to attract FDI by liberalizing and simplifying their FDI regimes, including, among other things, opening virtually all their industries to foreign investors, instituting privatization programmes that permit the participation of foreign investors, increasing fiscal incentives, relaxing performance requirements, guaranteeing the repatriation of profits, expediting screening and approval and providing one-stop services (see, for example, annex table 11).[17] Yet, for many of these countries, those efforts have not led to increased FDI flows and, for developing countries overall, their share in global FDI flows is still declining.

There are a few specific home country programmes aimed at encouraging TNCs to invest in developing countries.[18] Many of those relate to the protection of FDI, especially in the form of guarantees to foreign investors (that is, home country TNCs) concerning nationalization and expropriation and the conflicts associated with such actions. Those were important issues at a time when relations between TNCs and host countries were antagonistic, and nationalizations occurred frequently. However, circumstances have changed entirely, and much of the tension between TNCs and host countries has disappeared, as evidenced by the sharp drop in the number of expropriation acts from a peak of 83 in 1975 to 1 in 1985; since then, barely any nationalizations have taken place.[19] Apart from guarantees, a number of home countries offer some information and promotion services to their TNCs, some fiscal incentives (mostly in the framework of double taxation treaties) and some financial assistance (through public development finance corporations) for feasibility studies, co-financing or loan-guarantees. However, resources devoted to such purposes are generally quite small. At the moment (and with some exceptions), such support is given only to small and medium-size enterprises investing abroad.[20]

A number of international organizations such as the International Finance Corporation, the Multilateral Investment Guarantee Agency of the World Bank, ICSID, UNIDO and the Transnational Corporations and Management Division of the United Nations Department of Economic and Social Development, also participate in activities involving the co-financing of joint ventures, feasibility studies, investment guarantees or the provision of information-, promotional- or technical-assistance services. Yet, as noted before, the share of the developing countries in FDI flows continues to decline.

Thus, it may be useful to review the current national, bilateral and multilateral efforts to examine whether they could be re-directed in a more pro-active manner towards augmenting the flow of FDI and creating a more appropriate investment environment in developing countries. For instance, the national agencies in developed countries dealing with outward investment could pay more attention to the financing of feasibility studies, tax breaks for FDI infrastructure, the establishment of service parks for

basic business services etc. Similarly, bilateral investment treaties for the protection and promotion of investment, which typically focus on the protection aspect, could pay more attention to the promotion of FDI flows to developing countries (box XI.2). Perhaps national FDI facilities need to be established which, similar to various programmes aimed at the promotion of exports, could dedicate themselves to the promotion of outward FDI to developing countries.

While all encouragement should be given to strengthen the current mechanisms at the national, bilateral and multilateral levels, a new impetus to multilateral efforts may be needed in the light of the crucial role of FDI as an engine of growth.

More specifically, one could consider establishing a multilateral FDI facility with a view to providing loans to developing countries to promote development through FDI (see box XI.3 for some of the types of activities that could be supported in this way). Such a facility, distinct from a multilateral ODA facility, would have to be geared specifically to FDI issues. While the objectives of ODA are of a general nature and aim at improving the overall infrastructure and policy environment of developing countries (particularly in the least developed

Box XI.2. How bilateral investment treaties could be made more promotional

In principle, bilateral investment treaties deal not only with the protection, but also with the promotion of FDI. But many questions arise in connection with the promotional aspects of these treaties. An initial question is that regard is whether it is the host country, the home country or both that have an obligation to encourage investment. In current treaty practice, the obligation seems to fall more heavily on the host country. But, even then, bilateral investment treaties are not clear about the types of promotional measures that should be adopted to promote investment from the other country (whether it refers simply to laws and policies, or may include also the improvement of physical conditions, such as infrastructure, power supplies etc.). One may also ask whether bilateral investment treaties impose a reciprocal obligation on the home country to encourage its nationals and companies to invest in the territory of the treaty partner. Generally, the capital-exporting countries have taken the position that encouraging their nationals to invest in the other country is not their responsibility under the treaty.

Nevertheless, in the spirit of reciprocity, which forms the basis of bilateral relationships, capital-importing countries could seek to obtain some commitment that the capital-exporting country will take positive steps to encourage investment in the other country. In that respect, the Fourth Lomé Convention between African, Caribbean and Pacific (ACP) countries and the European Community provides a useful example of the type of promotional efforts that may be incorporated in bilateral investment treaties. Those include encouraging the flow of information on investment opportunities and the nature and availability of investment guarantees; providing assistance to small and medium-size enterprises in designing and obtaining equity and loan financing; exploring ways of overcoming or reducing the host-country risk for individual investment projects; providing assistance in strengthening the host country's capacity to improve the quality of feasibility studies and project preparation so that the appropriate economic and financial conclusions might be drawn; producing integrated management mechanisms covering the entire project management cycle within the framework of the development programme of the host State; and institutionalizing periodic discussions between any interested private investors and the host country. Alternatively, a cross-reference in particular bilateral investment treaties to relevant provisions of the Fourth Lomé Convention or other similar inter-regional or multilateral schemes would be a helpful reminder of the type of promotional measures that capital-exporting countries could take to promote investment in their partner countries.

Box. XI.3. Supporting foreign direct investment

Elements of an FDI facility—albeit in a regional context—already exist in some multilateral institutions. One noteworthy example is that of the Inter-American Development Bank (IDB) which is in the process of implementing two related programmes in response to the Enterprise for the Americas Initiative: the Investment Sector Loan Program and the Multilateral Investment Fund. Another is the European Community's Investment Partners facility.

Coinciding with reforms already under way in countries of Latin America and the Caribbean to increase economic growth and international competitiveness, the Enterprise for the Americas Initiative proposes to harness and strengthen those trends through encouraging trade, investment and the reduction of debt. The investment component of the Initiative, which continues to be defined in greater detail, seeks to create a competitive environment for attracting new capital and the return of flight capital to the hemisphere. To stimulate economic reforms and the liberalization of investment regimes, the Initiative gives a specific mandate to the IDB to implement the two programmes mentioned above, namely, the Investment Sector Loan Program and the Multilateral Investment Fund.

The Investment Sector Loan Program provides adjustment loans to countries committed to removing impediments to investment and fostering open investment regimes. Specific investment reforms encouraged by the loans include:

- adoption of clear and transparent investment regimes hospitable to all investors;
- measures to encourage the return of flight capital;
- opening of the financial sectors to competition, and modernization of financial services and markets to facilitate private investment;
- privatization of state-owned enterprises;
- adoption of international dispute settlement procedures to arbitrate investment disputes.

The IDB has already negotiated investor sector loans totaling $485 million with the Governments of Bolivia, Chile, Colombia and Jamaica.

In a parallel effort, the *Multilateral Investment Fund* (projected to reach $1.5 billion over five years) is meant to facilitate the adoption of comprehensive investment reforms by providing grant and loan financing for the following three purposes:

- technical assistance to identify and implement policy changes needed to transform the climate for investment;
- human resource development to meet the needs of an expanded private sector;
- credit and equity financing and technical assistance to small enterprises.

Twenty-one countries signed the Multilateral Investment Fund agreement in February 1992, pledging a total of $1.2 billion to the Fund. The United States has expressed its intent to contribute $500 million to the Fund over a five-year period. The other major contributors to the Fund are Japan ($500 million), Spain ($50 million), Canada and Germany ($30 million each) .

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countries), an FDI facility would focus solely on FDI issues. If that is done, caution should be exercised that such a facility does not merely subsidize TNCs wishing to invest in developing countries. In addition, there should be a clear demarcation line between the use of an FDI facility for FDI-supporting activities and the traditional uses of development funds, such as improving infrastructure, which will have an indirect impact on FDI promotion.

(Box XI.3, cont'd.)

To promote mutually advantageous economic cooperation between the members of the European Community (EC) and the countries of the Mediterranean, the *European Community's Investment Partners* (ECIP) facility was created. Launched in September 1988 on an experimental basis, ECIP is designed to enable participating developing countries to realize the potential of FDI in their development process. To that end, ECIP offers financial support covering:

- grants to financial institutions, chambers of commerce, professional associations and public agencies for the identification of potential projects and partners;
- interest-free advances for feasibility studies and other actions to firms intending to set up joint ventures or to invest;
- capital requirements of a joint venture or a local company with licensing agreements, in order to meet investment risks peculiar to developing countries, through participation in the provision of equity, or by equity loans;
- interest-free advances for training, technical assistance or management expertise of an existing joint venture, or joint ventures about to be set up, or a local company with licensing agreements.

One innovative aspect of ECIP is its largely decentralized functioning through a network of financial institutions (official development banks, private sector investment banks or multilateral institutions) which promote the instrument with their clientele, receive and evaluate project proposals and requests for financing, intervene as financial intermediaries between the EC and the final beneficiaries, act as partners in projects and ensure the follow-up and monitoring of the projects. At the end of February 1992, the network included 54 financial institutions located in EC member States and the participating developing countries.

The total financial support provided by ECIP to a single investment project is ECU 1,000,000. As of 31 December 1991, 285 projects had been approved for financial assistance. Over half of the financing requests concerned feasibility studies and pilot projects.

In light of the potential of ECIP to realize economic cooperation objectives, the EC Parliament, in a resolution adopted on 3 February 1992, proposed to continue, extend and improve the functioning of ECIP for a further three-year period starting 1 January 1992.

Sources: United States, Department of Commerce, *Enterprise for the Americas Initiative*, February 1992; *The IDB*, November 1991; *LA/C Business Bulletin*, March 1992; *Business America*, March 1992; and Commission of the European Communities, *E.C. International Investment Partners*, Directorate of External Relations, Brussels, 1991.

Perhaps, such a facility could consist of a capital-investment fund and of a fund through which other activities are financed. The capital-investment fund could provide credit to developing countries for the establishment of export-processing zones, science parks, service parks and similar facilities that would help attract FDI to a country. Finance for other activities could cover, for instance, technical assistance, information activities, the preparation of country assessment studies and the establishment of contacts between potential foreign investors and host country firms (including potential joint venture partners). What is critically important is to provide adequate resources for such a facility and to entrust it to an agency that can operate it effectively and provide a range of integrated services in harmony with the perspectives of developing countries, home countries, as well as TNCs.

A special window of the facility could be devoted to the promotion of outward FDI by TNCs from developing countries, enabling those firms to become more competitive in the world economy. Although cumulative outward FDI from developing countries for the period 1970-1990 reached $35 billion, this represented only 3 per cent of global FDI outflows and originated mainly from a small number of Asian and, to a lesser extent, Latin American developing countries. Increases in outward FDI by developing countries have several potential benefits, such as securing supplies of raw materials, providing access to new technologies and markets and, generally, making developing country firms more competitive in the world market. [21] A proposed FDI facility could therefore also be used to promote outward investment from developing countries.

In sum, a multilateral FDI facility, especially if established as a tripartite venture between host and home countries and TNCs, could give a new impetus to FDI flows to developing countries and, in that manner, contribute to their overall development.

D. Transparency and policy review

Policies on FDI affect the overall level, sectoral composition and direction of capital flows and the trade, technology, training and financial flows associated with them, as well as the degree and type of production integration effected between countries. [22] As a result, national FDI policies in one country affect economic performance in other countries, especially given the importance of FDI in the world economy and the role of TNCs as integrating agents of various international economic flows. Various measures, including trade measures and measures aimed directly at FDI, can divert FDI flows from one country to another; this is likely to become more important in the future, as many countries are viewing TNCs in a more positive light and are increasing their efforts to attract FDI. Where countries form part of an integrating region, their separate FDI policies are important determinants in the allocation of FDI within the region, while their common policies can cause FDI to be diverted from other locations. [23] In addition to FDI, other variables are also affected by policies relating to TNCs. For instance, export-performance requirements affect the trade balances of a country's trading partners (by increasing imports and/or reducing exports), as well as possibly leading to disinvestment from those countries. Requirements related to the local sourcing of technology can cause a reduction of R&D activities in other locations.

Home-country policies to encourage outward FDI in particular regions or sectors also influence the distribution and composition of FDI. Policy-making in the area of FDI thus carries international, as well as national, implications.

In order to construct effective policy frameworks, policy makers require information about a wide variety of interactions at both the national and the international levels. In the context of increasing international production, both Governments and TNCs rarely have access to all the information needed to understand the complex processes by which such integration is taking place. Hence they are often unable to evaluate properly the potential consequences of a given policy decision and its interrelation with policies in other countries. Furthermore, deep integration effected through FDI involves a degree of convergence of national policies that impact national sovereignty to a far greater degree than integration effected through trade liberalization. Thus, improved access to information about international investment policies and the analysis of those policies is critical to effective policy-making that promotes an efficient international production system for Governments and TNCs alike.

1. International transparency of investment policies

(a) *The rationale*

An important step in creating a more cooperative, open environment for FDI is to increase international transparency in the area of FDI policies. [24] Currently, no notification and verification mechanism exists through which Governments make their FDI policies, laws and regulations readily, and in an authoritative manner, available to each other and to foreign investors. In part, this reflects the fact that FDI is not governed by an international framework of rules that would necessitate international notification and reporting as a means of ensuring that the signatories are adhering to their commitments. Despite the absence of such a framework, however, there is still a need to increase international transparency in the area of FDI, by providing information regarding FDI policies of both home and host countries to a wide range of parties.

Currently, international transparency is required in the area of trade, where the contracting parties to GATT are obliged to inform the Secretariat about their trade policies on a regular basis. Other international organizations, such as IMF, the World Bank and OECD, routinely collect information regarding policies in their relevant areas of responsibility; however, none of them provides a mechanism for international transparency for all countries in the area of FDI.

A mechanism is therefore needed through which information on policies relating to both inward and outward FDI can be collected and disseminated in an authoritative manner. It certainly would be desirable if a large number of countries would participate in such a process in order to provide a comprehensive overview of prevailing policy regimes. Policy instruments that could be subject to greater international transparency would include, at a minimum, those that directly bear upon the activities of TNCs, in particular, FDI policy statements, laws, regulations and administrative guidelines (including

those relating to incentives and performance requirements), bilateral investment treaties, double taxation treaties and instruments dealing with technology transfer and the repatriation of earnings. In addition, policies that significantly impact the locational decisions and activities of TNCs could also be made more transparent; those might include, for instance, certain laws and regulations regarding employment, the environment and intellectual property rights. While transparency could not extend to cover contracts and agreements between Governments and TNCs (since most of them are not in the public domain), those contracts that are published in official gazettes could be included. In sum, it would be helpful if a country's overall FDI regime could be made more transparent, and could include those policies that might apply most directly to TNCs.

(b) The benefits of increased transparency of investment policies

Increasing international transparency in the area of investment policies carries a number of benefits for multilateral agencies, for home and host countries and for TNCs, especially small- and medium-size ones and those from developing countries. Increasingly, FDI matters are at the heart of international and bilateral policy discussions on issues such as trade and technology. The growth of Japanese FDI in the United States and Europe, for example, is likely to influence any future discussions in the area of trade with Japan; similarly, European Community technology policy, which promotes joint research programmes, will increasingly have to consider the implications of the growing numbers of non-European TNCs active in high-technology industries in the Community.

Given those interlinkages, it is important to monitor the FDI policies of countries. Otherwise, the international community is likely to encounter increasing difficulties in constructing policies to promote a stable and efficient functioning of the international economic system. As outlined above, such transparency would encourage efforts to create a more favourable environment for FDI flows, and would also support multilateral efforts in related areas, such as trade and technology. In brief, greater transparency would contribute to a better functioning of the international market mechanism.

Host countries would also benefit from increased access to information on FDI policies. By disseminating information about their regulatory frameworks that govern FDI, countries facilitate the decision-making processes of TNCs, especially those of small or medium-size and those from developing countries, which may have limited capacities to obtain relevant regulatory information. In the current environment of increased liberalization, many host countries are instituting policy regimes that are more favourable towards FDI than they were in the past; in order for such policy shifts to have their desired effect, it is necessary for them to be made public in a systematic and unbiased manner. Furthermore, by having ready access to information concerning home-country policies, host countries may be able to tailor their inward FDI policies more effectively. Increased international transparency also relieves host countries of the need to convey legal information to foreign investors on a one-to-one basis.

Greater international transparency of FDI policies would also be beneficial to host countries by improving their bargaining position *vis-à-vis* foreign investors. If information about the regulatory regime for FDI is easily available, it may be less likely that foreign investors could encourage competition among

potential host countries for a given investment through the granting of ever-more generous concessions. While increasing transparency would not eliminate competitive bidding for FDI—Governments and TNCs are free to negotiate and enter any agreement of their choice—it would at least take place in a more open environment. In addition, greater transparency allows host countries to judge more accurately the costs and benefits of agreements with TNCs, and hence to make better decisions regarding their contributions.

From the perspective of TNCs, increased transparency of investment laws would enable them to make better FDI decisions in an overall improved policy environment for their international activities. Many large TNCs have the resources to access the information they need concerning investment policies. Thus, among TNCs, the primary beneficiaries would be those that lack the means to engage in large-scale information-gathering, that is, small and medium-size TNCs and those from developing countries.

Even for larger TNCs, one of the ways in which increased transparency would improve the climate for FDI is by providing TNCs with readily accessible information about a large number of host countries, presented in a standardized format by a neutral party. Currently, there is no such authoritative mechanism available, and it is possible that incomplete information is, in some cases, resulting in an allocation of FDI that favours a limited number of developing countries which engage in extensive investment-promotion activities.

Other important reasons why transparency improves the investment climate for TNCs is that it helps promote the stability of investment policies (countries are less likely to resort to frequent rule changes if such changes are consistently recorded), and it lessens the power of special interest groups to influence domestic policy. Both factors are important elements in facilitating an objective assessment by TNCs of host-country regulatory frameworks.

(c) Options for implementation

To increase the international transparency of regulatory frameworks for FDI, Governments could undertake to inform an international agency of their policies, laws, regulations and administrative guidelines that bear directly upon the activities of TNCs. Information could also be provided on instruments that have significant impact on the locational decisions and activities of TNCs. Every effort should be made to encourage all countries to participate in the process.

The designated agency would compile the submissions in a standardized format, organized by a reporting country, and supplemented by information obtained from other sources. The presentation of each country's regulatory framework would be sent by the agency to the competent official authorities of the country for verification or, to facilitate the process, to one national contact point designated by the Government. The agency could also send the presentation to other interested parties for comments; such parties could include other international organizations, Governments of other countries and private entities (for example, chambers of commerce).

After verification, the information would be published and disseminated widely in the form of an authoritative catalogue. The publication would contain, on a country basis, the names and sources of the policy statements, laws, regulations and administrative guidelines comprising the FDI framework. As a further service, the catalogue could also highlight important regulatory instruments through brief descriptions and include selected statistics about the country's FDI position (both inward and outward) to present a more complete picture of the investment climate of a given country. The reports could be updated regularly and disseminated widely to Governments, business organizations and TNCs.

2. Foreign-direct-investment policy review

(a) The need for a review mechanism

The above discussion outlined measures to improve transparency in the area of FDI. If implemented, those measures would result in an authoritative catalogue of the policy statements, laws, regulations and administrative guidelines that comprise a country's FDI framework. While a reporting system of this type is, in and of itself, a desirable objective for both Governments and the private sector, it also provides the basis for improving investment policies through policy reviews. Such reviews would take into account the long-term, indirect consequences of a given policy, which are often greater than the direct, short-term impacts. This process, in turn, requires information about the policy in question, as well as about others which may have influenced its outcome. Unlike tariffs, which are highly visible, or subsidies, which appear in national budgets, investment measures often involve revenues foregone which are not easily traceable in national accounts; their evaluation thus depends on access to information concerning the application of relevant laws and regulations that may influence FDI flows. Furthermore, the actual implementation of a given policy may differ from its original objective, as countries pursue initiatives that differ from their regulatory framework. In addition, Governments may implement policies which, for various reasons, do not yield their desired results. Hence, in order to meet national policy objectives, it is necessary to go beyond the "raw" information contained in a catalogue of FDI measures, and to provide careful analyses and evaluations of those measures. In the long run, a strengthened policy-review system could lead to an increase in the amount and quality of FDI inflows, as a result of more effective, informed policy-making.

Another important aspect of a policy-review mechanism for home and host countries could be to promote not only an evaluation of the policy framework, but also the design of policies that are the most efficient from the viewpoint of national welfare. Often, there is an imbalance in the influence held by different economic actors on the policy-making process; for instance, producers frequently exert a disproportionate influence on policy as compared to consumers, as do urban areas compared to rural ones. In the area of FDI policy-making, domestic producers often press for limitations on the activities of TNCs, even if such limitations could be detrimental to national welfare. The result may be implicit protectionism. Conversely, Governments—whether knowingly or unknowingly—may provide special

benefits to TNCs that may be unnecessary or damaging to domestic producers. Such imbalances have in some instances led to an unfavourable economic climate for investment, both domestic as well as foreign.

In such situations, the best way of ensuring that the wider national interest is being served is to open up the decision-making processes to public scrutiny and debate. International transparency of investment policies as outlined above is a necessary (though not sufficient) step in this direction. With proper information to weigh the costs and benefits of particular policies, Governments are in a better position to evaluate the choices they confront, including the weight to be attached to non-economic factors. Public choices made in this way are also likely to attract wider confidence and support in the community at large, which increases the stability of the policy framework. In order for the objectives of greater international transparency to be realized fully—increased investment flows to developing countries, a stable policy environment for FDI and the promotion of effective, equitable public policies—it is probably necessary to extend the process to include a multilateral policy review mechanism, similar to that performed by GATT in the area of trade.

The recently established GATT policy review mechanism involves systematic, periodic reviews of the trade policies of States that are parties to GATT. Such reviews are not meant to enforce specific GATT obligations or dispute settlements, nor are they intended to impose new policy commitments on member States. Rather, the review process is intended to foster greater transparency in trade policies and practices, to analyse their effectiveness against the broader context of domestic economic and development objectives and to examine the impact of such policies on the multilateral trading system.

A similar practice in the area of FDI could greatly support the efforts of countries to maximize the benefits of FDI, both inward and outward, to their economies. A review mechanism would provide to those countries requesting it an evaluation of their FDI policies, laws, regulations and administrative guidelines. The goal of the review process would be to assist countries in achieving national objectives in the specific area of FDI, as well as in related areas, such as trade performance and employment, which may be influenced by FDI policies. The review process could also promote a harmonization of national FDI policies in areas in which this is desired.

The reviews could consist of an analysis of the role of FDI (both inward and outward) in the participating country; an examination of the country's FDI regime (highlighting recent trends in the policy environment); an evaluation of the country's potential for FDI at the country, industry and perhaps major projects levels; options for realizing this potential (including through an improvement of the regulatory framework for FDI); and an outline of a comprehensive technical assistance programme aimed at assisting the country in improving its capacity to attract and benefit from FDI. The focus should be to provide an analysis of, and outline options for, the use of relevant policies and policy instruments in light of national policy objectives. Overall, the reviews should contain an objective, authoritative assessment of the participating country's FDI climate, with specific options of how to improve its FDI policy framework and realize its potential for greater investment.

Few multilateral commitments exist in the area of FDI. Reflecting this, the reviews should be carried out primarily from an economic standpoint with a view to improving policy-making through informed

analysis in order to further domestic objectives, for both developed and developing countries. While an implicit objective of the review process could be to maximize the benefits of FDI while minimizing potentially negative impacts, no particular point of view regarding FDI should be promoted; rather, policies ought to be judged in light of the country's own objectives. The review process itself could be undertaken on a voluntary basis. This has the advantage of encouraging countries under review to participate actively in the process, and to benefit from outside discussions of their policy frameworks.

(b) Ways and means of implementation

A feasible investment review mechanism could be patterned on the trade-policy review mechanism of GATT. Accordingly, it could consist of the preparation of two reports, one by the Government of the country that has volunteered for a review, and the second by a competent international organization. If so desired by the Government of the country reviewed, the reports could perhaps be discussed by the United Nations Commission on Transnational Corporations, to benefit from the experiences of other countries. The reports, together with a report of the proceedings of the review meeting, could then be published and disseminated widely.

The national report could be prepared by the Government of the country concerned, and could focus principally on a description and explanation of its policies and its objectives. Governments of some countries, for example, the least developed countries, may require some technical assistance in the preparation of their own reports. To the extent possible, however, Governments should prepare their reports by themselves; it has been found in the trade-policy review mechanism of GATT that Governments learn more from the preparation of their own reports than if they use outside experts.

The second report could be prepared by a competent international agency. The contents would be based on the agency's own research, with the use of one or more questionnaires to be completed by the Government of the relevant country, and supplemented by field missions. The mission team could consist of staff of the international agency, international experts, as well as representatives from TNCs with substantial experience in the country. Alternatively, only one report could be prepared, by a team consisting of staff of the international agency, international experts, representatives of the Government and representatives of TNCs active in the country. In any event, every effort would have to be made to ensure that the report is based on careful research, is accurate and objective and presents an impartial view of the investment environment in the country.

A credible report, in turn, could become the basis of follow-up action by the Government of the country, in terms of improving its regulatory framework for FDI and realizing its investment potential. Additionally, it could become the basis of a comprehensive programme of technical cooperation aimed at assisting the country in the area of FDI. Finally, the report could also become the basis for locational decisions of foreign investors, especially small and medium-size TNCs that have only limited capacities to conduct thorough FDI assessment studies of countries in which they may wish to invest.

Notes

[1]See UNCTC, *Regional Integration and Transnational Corporations in the 1990s: Europe 1992, North America, and Developing Countries,* UNCTC Current Studies, Series A, No. 15 (United Nations publication, Sales No. E.90.II.A.14); and Transnational Corporations and Management Division, *The implications of EC economic integration on FDI to, from and within the EC,* Vol. 1 (New York, United Nations, forthcoming).

[2]UNCTC, *The Challenge of Free Economic Zones in Central and Eastern Europe: International Perspectives* (United Nations publication, Sales No. E.90.11.A.27), p. 2.

[3]This distinction is emphasized and expanded upon in Richard Pomfret, "The new trade theories, rent-snatching, and jet aircraft", *The World Economy,* vol. 14, No. 3 (September 1991), pp. 269-278.

[4]In the United States, however, the Exon-Florio provision of the Defense Production Act, enacted originally as part of the Omnibus Trade and Competitiveness Act late in 1988, grants to the President new power to block foreign takeovers of domestically-owned firms. While this new power has to date been used sparingly, there is a debate within the Congress as to whether it should be used more widely. See Edward M. Graham and Michael E. Ebert, "Foreign direct investment and United States national security: fixing Exon-Florio", *The World Economy* vol. 14, No. 3 (September 1991), pp. 245-268.

[5]This risk is not to be minimized. During the 1970s, for example, the United Kingdom attempted to develop the NIMROD, an alternative to the United States-developed air early warning system, or AWACs. The system developed by the United Kingdom was initiated in part to implement national industrial policy goals, and the effort was made to use all indigenous components. (The United States system was developed using substantial foreign content, by contrast.) One result was that the system developed by the United Kingdom was more costly than that of the United States; but, perhaps more important, the implementation of the system was delayed repeatedly. A case history is contained in Theodore H. Moran, "The globalization of the defense industry", *International Security,* vol. 15, No. 1 (Summer 1990), pp. 57-99.

[6]See, for example, J. A. Brander and B. J. Spencer, "Export subsidies and international market share rivalry", *Journal of International Economics,* vol. 18 (1985), pp. 83-100.

[7]See, for example, Paul R. Krugman, "Import competition as export promotion: international competition in the presence of oligopoly and economies of scale", in H. Kierzkowski, ed., *Monopolistic Competition and International Trade* (Oxford, Clarendon Press, 1984), pp. 180-193.

[8]See, Statistisches Bundesamt, *Statistisches Jahrbuch 1990 fuer die Bundesrepublik Deutschland* (Stuttgart, Metsler-Poeschel Verlag, 1990); Statistiska Centralbyran, *Statistik arsbok for Sverige 1989: Sveriges Officiella Statistik* (Stockholm, Norstedts Tryckeri, 1988); United States, Department of Commerce, *Survey of Current Business,* vol. 71, No. 1 (January 1991); Statistical Bureau, Management and Coordination Agency, *Japan Statistical Yearbook,* No. 41 (Tokyo, Management and Coordination Agency, 1991) , pp. 136-137; and *Japan Statistical Yearbook,* No. 40 (1990), pp. 386-387.

[9]See John M. Kline, "Testimony before the Joint Economic Committee of the United States Congress, 13 May 1992" (Washington, D.C., Georgetown University, 1992), mimeo, pp. 10-11.

[10]This section draws partly on UNCTC, "New issues for international cooperation in transnational banking" (New York, UNCTC, 1992), mimeo.

[11]See Jay L. Westbrook, "Theory and pragmatism in global insolvencies: choice of laws and choice of forum", *American Bankruptcy Law Journal,* vol. 65 (July 1991), pp. 460-461.

[12]*League of Nations Treaty Series,* vol. 86 (Geneva, League of Nations, 1929), p. 362.

[13]Ibid, vol. 155 (1935), p. 136.

[14]See Richard A. Giltin and Evan D. Flascher, "The international void in the law of multinational bankruptcies", *Business Lawyer,* vol. 42, No. 2 (February 1987), p. 487, pp. 307-325.

[15]See, for example, Report of the Insolvency Law Review Committee, *Insolvency Law and Practice,* 1982, Command Paper No. 8558, chaps. 49 and 50.

[16]Westbrook, op. cit., p. 458.

[17]On the factors influencing FDI flows, see UNCTC, *The Determinants of Foreign Direct Investment: A Survey of the Evidence* (United Nations publication, Sales No. E.92.II.A.2).

[18]See UNCTC, *Foreign Direct Investment, Debt and Home Country Policies* (United Nations publication, Sales No. E.90.II.A.16), pp. 25-41.

[19]UNCTC, *Transnational Corporations in World Development* (United Nations publication, Sales No. E.88.II.A.7), p. 314. See also Michael Minor, "Whatever happened to expropriation?" (Edinburg, Texas, The University of Texas, 1992), mimeo. For a more cautionary view for the future, see Charles R. Kennedy, Jr., "Relations between transnational corporations and Governments of host countries: a look to the future", *Transnational Corporations,* vol. 1, No. 1 (February 1992), pp. 67-92.

[20]Transnational Corporations and Management Division, *Small and Medium-sized Firms as Suppliers of Productive Resources to Developing Countries* (New York, United Nations, forthcoming).

[21]Transnational Corporations and Management Division, *Transnational Corporations from Developing Countries: Impact on Home Countries* (New York, United Nations, forthcoming).

[22]Factors besides government policies, such as market size and firm-specific advantages, are also very important (and may be even more important than policies in specific circumstances) in determining FDI flows. See UNCTC, *The Determinants of Foreign Direct Investment,* op. cit.

[23]See UNCTC, *Regional Integration and Transnational Corporations in the 1990s,* op. cit.

[24]There is a concurrent need to improve disclosure of information by TNCs, an issue that is being dealt with in the framework of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) of the United Nations Commission on Transnational Corporations.