

VOLUME 13

NUMBER 1

April 2004

**TRANSNATIONAL
CORPORATIONS**

**Multilateral rules on FDI: Do we need them? Will we get them?
A developing country perspective**

by
Stephen Young and Ana Teresa Tavares



UNITED NATIONS
United Nations Conference on Trade and Development
Division on Investment, Technology and Enterprise Development
Geneva, 2004

Multilateral rules on FDI: do we need them? Will we get them? A developing country perspective

Stephen Young and Ana Teresa Tavares *

This article reviews the state of play regarding the investment regime in the World Trade Organization, with the objective of contributing to the debate on policy priorities for developing countries. It concludes that substantial progress on an investment regime at the multilateral level is unlikely and perhaps undesirable. A multilateral investment accord appears to be relatively unimportant to investors. Furthermore, institutional and regulatory harmonization derived from rules imposed by the World Trade Organization is costly and may be inappropriate for developing countries, as it may divert resources from higher priorities in development and act as a barrier to experimentation. Focus should be on the domestic policy agenda, including further external liberalization, and principally domestic regulatory and institutional reform. Improving these fundamentals should have a significant positive impact on the attraction of foreign direct investment. Host-country support for a multilateral trading system, nevertheless, continues to be of paramount importance, alongside a gradualist approach to a multilateral investment accord over the long term.

Key words: World Trade Organization, Doha Round, multilateral investment rules, foreign direct investment, developing countries

Introduction

This article provides a review and evaluation of the state of play with respect to multilateral rules on foreign direct investment

* The authors are Professor of International Business at the Strathclyde Business School, Glasgow, United Kingdom, and Assistant Professor at the Centro de Estudos Macroeconómicos e Previsão, Faculty of Economics, University of Porto, Portugal, respectively. The authors would like to thank three anonymous referees for their valuable comments and advice. Contact: Stephen.young@strath.ac.uk.

(FDI), focusing specifically on implications for developing countries. It provides comments on a number of linked questions: Where are we now with multilateral investment rules? Is a multilateral investment regime at the World Trade Organization (WTO) desirable? Are multilateral investment rules actually achievable? Where do we go from here, and what are the implications for developing economies?

These issues are the subject of extensive debate, often within the wider context of discussions on globalization and its benefits and costs, and the roles of multilateral institutions (including the International Monetary Fund (IMF), the World Bank and the WTO) within the post-war global architecture of rules for trade and investment. Joseph Stiglitz labels the current system one of “*global governance without global government ... in which a few institutions ... and a few players – the finance, commerce and trade ministries, closely linked to certain financial and commercial interests – dominate the scene, but in which many of those affected by their decisions are left almost voiceless*” (Stiglitz, 2002, pp. 21-22).

The overall objective of the article is to assist developing countries in deciding upon policy priorities. Drawing on available evidence, it concludes that substantial progress on an investment regime at the multilateral level is unlikely, and, without radical changes to the WTO itself and to the underlying principles of an investment regime, probably undesirable. The policy focus for developing countries should, therefore, be on domestic regulatory and institutional reform, while maintaining a strong commitment to the multilateral trading system, and recognizing the potential benefits from progress towards a multilateral investment accord over the long-term.

State of play in investment regulation

Multilateral investment rules

The history of multilateral investment rules is a tale of successive disappointments (Brewer and Young, 2000). The history begins with the proposal for an International Trade Organization (ITO) in the 1940s, and its rejection by the United States Congress. FDI-related topics were among the most important and controversial. In the end,

they were a crucial factor in the rejection by the United States of the Havana Charter that would have created the ITO. As a result of these developments, FDI-related aspects were largely ignored in the context of the General Agreement on Tariffs and Trade (GATT) until the Uruguay Round negotiations. In between times, however, a range of initiatives were promoted in different forums, key among these being:

- the binding codes of the Organisation for Economic Co-operation and Development (OECD) on *Liberalisation of Capital Movements* and *Current Invisible Operations* (1963), requiring the liberalization of inward and outward capital movements over the long-term;
- the draft United Nations *Code of Conduct on Transnational Corporations* (voluntary), submitted in 1990 but not finished;
- the voluntary OECD *Guidelines for Multinational Enterprises*, published in 1976 and regularly updated (with little evidence of implementation by transnational corporations (TNCs)); and
- the draft OECD *Multilateral Agreement on Investment* (MAI), aiming to achieve a comprehensive multilateral framework, whose negotiations were suspended in October 1998 (with no agreement).

Investment came back on the GATT agenda with the Uruguay Round Agreements (1995). As part of a package that led to the establishment of the WTO, a number of agreements with explicit investment content were approved, namely, the Agreement on Trade-Related Investment Measures (TRIMs), which limits FDI performance requirements to some extent; and the General Agreement on Trade in Services (GATS), which includes FDI in services. In addition, agreements with continuous and direct relevance to investment include the Agreement on Trade-Related Intellectual Property Rights (TRIPS), which establishes standards and enforcement procedures for intellectual property; the Agreement on Subsidies and Countervailing Measures restricting some subsidies and retaliatory actions; and the Agreement on Dispute Settlement Understanding where government-to-government disputes on investment issues are included (for detail see Brewer and Young, 2000, pp. 121-131). However, the agreements do not appear to

have been designed specifically with investment in mind, are limited in scope and lack integration. Pierre Sauv  and Christopher Wilkie commented that: “there is still not a great deal of appreciation among WTO members of the extent to which existing rules address investment-related matters” (Sauv  and Wilkie, 2000, p. 338).

WTO rules established that biennial ministerial-level meetings would be held to continue the process of liberalization within a rules-based system. After the failure to initiate a millennium round of negotiations at the 3rd Ministerial Conference in Seattle in late 1999, eventually in November 2001 the Doha Round was launched. Heralded as a “development round”, 21 subjects are listed in the Doha Declaration, including a number of investment-related items, namely: negotiations on specific issues in the GATS, in the TRIPS Agreement, and in the Anti-Dumping and Subsidies Agreements; while working groups study the topics of the relationship between trade and investment, the interaction between trade and competition policy, and trade and technology transfer. The 5th Ministerial Conference (2003) in Canc n, Mexico, proved a setback to the Doha Round, and to its claims to be a development round. But whatever happens, only very limited progress on investment issues is possible, and the prospects for a comprehensive multilateral investment regime are as far away as ever.

As this article will show, from the days of the Havana Charter there have been three key and interrelated barriers to progress on a multilateral investment regime. The first concerns the problem of the relationship between multilateral rules and domestic priorities. The second relates to the balance between the rights of TNCs and obligations of countries (compared with the rights of countries and obligations of TNCs); and the third concerns asymmetries between home countries for FDI (mainly industrialized countries) and recipient host nations (mainly in the developing world).

The architecture of investment rules encompasses multiple overlapping levels, namely, multilateral, macro-regional (trade/investment blocs), national/bilateral and sub-national/micro-regional levels. These levels interact with and may eventually contradict each other, creating problems of systemic coordination (Tavares, 2001).

Furthermore, the importance given to investment rules, and the state of development of regulation in this regard, are highly variable between levels and even within each level. For instance, some regional blocs have explicit investment provisions and others do not have them (Brewer and Young, 2000). The provisions of the North American Free Trade Agreement (NAFTA) on investment are among the most advanced at a macro-regional level. They are wide-ranging, including fourteen chapters, the most relevant being Chapter 11, which uses terms similar to those of many bilateral investment treaties (BITs) on important issues such as expropriation. Under that Chapter appeared some of the first cases where TNCs have sued rich OECD host governments (Hallward-Driemeier, 2003).¹ Space does not permit a full review of investment regulation at these different levels, and because of the relevance to the article, further comment is restricted to bilateral rules.

Bilateral investment treaties

Recent years have witnessed an extraordinary proliferation of BITs (UNCTAD, 1998 and 2003), which are nowadays the most important instrument for the international protection of FDI. They are usually heralded as a means of attracting further FDI to the signatory countries; and are especially important when domestic institutions are fragile and protection of property rights is weak. BITs protect the affiliates of TNCs in host countries from discrimination, by requiring the granting of national treatment and most-favoured-nation treatment. In addition, they usually deal with cases of expropriation, capital transfer restrictions, and losses resulting from war and civil disturbance etc.

The first BIT was ratified in 1959. The number of such treaties quintupled during the 1990s and totalled 2,256 by the end of 2002 (UNCTAD, 2003). 173 countries were involved in BITs at the end of the 1990s (contrasted with only 2 at the end of the 1950s). The importance of BITs in international investment regulation worldwide

¹ A major advantage of regional integration agreements for small countries is, of course, to create larger markets; and market size is a major FDI determinant.

is thus very clear. Until the late 1980s, most BITs were signed between a developed and a developing country, usually by initiative of the former, aiming to secure protection of its investors. Since that time, BITs between developing countries are increasingly frequent. BITs where the two counterparts are developed countries are infrequent, mainly because investment relations between such countries are by and large dealt with in various instruments adopted under the aegis of the OECD.

Articles in this journal have evaluated a number of dimensions of BITs. John Kline and Rodney Ludema (1997) note that TNCs are granted a number of rights while having few responsibilities. Similarly, home-country governments have few responsibilities other than using best endeavours to stimulate capital flows. BITs grant investors legal standing, so they have a direct role in international trade disputes. Kline and Ludema (1997) argue that this investor-State approach is conceptually preferable to the State-State system of WTO dispute settlement. Thus the decisions in BITs dispute proceedings are more narrowly defined and create fewer market distortions; whereas WTO judgments go beyond the particular case to penalize exporters who have no involvement in the dispute. A.V. Ganesan (1998) suggests that BITs have found favour with developing countries because they commonly provide for national treatment to foreign investors in the post-establishment phase only, and do not restrict host countries from following their own FDI policies. A comprehensive multilateral regime would, by contrast, allow TNCs market access under conditions of non-discrimination between domestic and foreign investors in respect of entry, establishment and operation.

The huge increase in BITs was associated with the adoption of policies to attract rather than restrict or regulate FDI and can, therefore, be seen as part of the liberalization agenda of the 1980s and 1990s in developing and emerging nations. A recent series of country studies of policy reform in Latin America (Lengyel and Ventura-Dias, 2004) concluded that the proliferation of bilateral and plurilateral agreements can be explained by the lack of measurable benefits from multilateralism when compared to the high costs of

adjustment and reduced government autonomy. Countries wanted control over the pace, sequencing and direction of liberalization and reform. So the failure to make progress at the multilateral level has led to alternative arrangement emerging: given their bargaining power, home country governments find it easier to achieve the goal of protecting and facilitating outward FDI at the bilateral level;² TNCs obtain similar benefits, although, as Joachim Karl (1998) points out, regionally or globally integrated TNCs are unprotected in cases in which violations of agreements by host countries cause cross-border harm.

Despite the arguments presented above, however, studies have found that BITs are not important FDI determinants (UNCTAD, 1998; Hallward-Driemeier, 2003), thereby questioning their effectiveness.

Are multilateral investment rules desirable? Theoretical perspectives

This section reviews the major theoretical arguments relating to the establishment of a rules-based multilateral investment regime. From an economic perspective, the benefits from such a regime have been clearly stated by various authors (UNCTAD, 1996; Graham, 1996; Brewer and Young, 2000; Sauvé and Wilkie, 2000; Young and Brewer, 2003).

The most general argument pro-investment liberalization within a multilateral framework parallels that for multilateral trade liberalization, basically relying on the equivalent of the gains-from-trade argument. The general conclusion is that, as with trade, the liberalization of international FDI flows should be encouraged since it generates both national and global welfare gains, both by stimulating an increase in such flows, and preventing deadweight losses emanating from protectionist behaviour and the absence of a harmonized framework.

² The Government of the United States has made it clear in the wake of Cancún that it will make greater efforts to develop bilateral and regional trade initiatives (De Jonquières, 2003).

The situation regarding FDI contrasts starkly with that for international trade where there is a long-established, comprehensive multilateral system of rules and principles (for a comprehensive review see Brewer and Young, 2000). An agreement on a multilateral trade regime may be easier because the symmetries of imports and exports mean that countries' interests are relatively similar. Furthermore, negotiations on tariff (although not non-tariff) barriers are simpler than with investment and related barriers because the former are readily identified and isolated. Identification and quantification of countries' gains and losses is more straightforward in the case of trade impediments as well (Caves, 1996).

According to Richard Caves (1996), while two-way movements of investment are becoming more important, there are still major asymmetries – and, therefore, difficulties in ensuring that the benefits of international policy co-ordination are spread fairly among participants. Alan Rugman and Alain Verbeke (1998) argue that the symmetry of FDI positions at the national level and the dispersion of ownership-specific advantages at the firm level suggest support by both countries and firms for multilateral trade and investment liberalization. This, however, primarily applies to the two-way FDI flows between developed countries (admittedly the bulk of global investment flows) rather than to relations between developed and developing countries.

Hence, the asymmetry in investment positions, compounded by, we argue, the “invisibility” of FDI and relative complexity of measuring FDI flows make fair and balanced negotiations on investment very difficult.

Another important economic argument in favour of a multilaterally agreed framework is that it would limit the considerable waste of resources produced by the often scandalous incentive escalation (Oxelheim and Ghauri, 2003) and other distorting idiosyncratic measures that are only possible due to the lack of an internationally agreed and coordinated framework. Aside from the waste and misallocation of resources, competition may be distorted,

especially for large-scale capital-intensive projects in oligopolistic markets (Brewer and Young, 1997; Young, 2004).

Furthermore, as there is a trade-off between the granting of incentives and other policy measures, the efficiency of incentives can be strongly questioned, and the potentially significant opportunity costs highlighted (Driffield, 2000; Blomström and Kokko, 2003). The payment of incentives is dominated by the industrialized countries; and even within an area such as the European Union (EU), the wealthier nations spend significantly more than the poorer developing countries (Brewer and Young, 1997).

The *World Investment Report 1996* (UNCTAD, 1996), supported by numerous studies, has highlighted the significance of incentives in FDI decisions in host developed countries. Conversely, many developing countries still regard performance (principally local content) requirements as important tools in encouraging indigenous industrial development and strengthening trade balances. Under conditions of oligopoly, performance requirements may be employed to shift rents and producer surplus from firms to host countries; but the conclusion depends on the type of measure, and performance requirements are a second best development tool. On balance, theory and empirical evidence largely favours the elimination of investment incentives and performance requirements, from both global and national perspectives (Moran, 1998; Guisinger *et al.*, 2003).

Another conceptual argument presented in favour of binding multilateral rules is that they would lock-in liberalization and protection measures, and make reversal of policies much more difficult than the case with national/bilateral rules. This lock-in of policy measures could be particularly important when changes of government occurred or recession conditions encouraged protectionism, and would solve dynamic consistency problems.

Similar arguments have been developed by James Markusen (2001) from a game-theory perspective. He suggests that a multilateral investment agreement can bind future political leaders or make it difficult for them to withdraw from such rules. Again, if there

is no multilateral agreement, negotiations will be on a case-by-case basis with no fixed or transparent policies; this can lead to rent seeking and corruption by local government officials.³

The issue of transparency and openness is crucial. Indeed, there is a significant amount of research showing that openness lowers corruption, the latter seen as a major inhibitor to growth and development. Theory suggests that trade policy, competition by foreign producers and international investors, and openness-related differences in institution-building costs are three major transmission mechanisms through which openness affects a country's corruption levels. Recent empirical work (Bonaglia *et al.*, 2001) indicates that the effect of openness on corruption is nearly one third of that exercised by the level of development. Thus multilateral and national policies can work together to reduce corruption, hence contributing to economic growth and development.

The final economic argument presented here is that the existence of a multilateral regime, by leading to reductions in uncertainty, would be conducive to a substantial decrease in information/communication and transaction costs (Casson, 1997); these can be extremely high in the case of continuous haggling over FDI conditions.

Thus there are powerful economic arguments in favour of a multilateral investment agreement at the global level. However, the key issue is the asymmetric nature of investment flows, and the problems this creates for ensuring a fair distribution of benefits between capital exporters (mainly developed countries) and capital

³ Conversely Markusen (2001) also notes a number of arguments that might favour domestic as opposed to international rule making. First, commitment to international rules means a sacrifice of flexibility and potential bargaining power. Second, there will be an inability to discriminate among investment projects, meaning that the host country could lose out on possible larger rent shares on the more profitable projects. Third, projects may vary widely in terms of their potential net spillover and other benefits and governments would like flexibility to exploit these. In the main, these arguments do not carry much weight.

importers (mainly developing countries). This is a strong *proviso* to the pro-multilateralism arguments.

To conclude this discussion, it is worth adding what is essentially a political economy argument pro-multilateral FDI regulation, namely that it would have a positive impact on TNC-government relations, and on government-government interaction. According to Edward M. Graham (1996), the consequences of an imperfectly integrated world economy and a political system based on nation States are that conflicts inevitably arise between and among TNCs and governments. These can lead to global and national welfare losses through inefficiencies and/or resource misallocations. In a similar vein, Caves (1996) highlights a divergence of national welfare from global welfare in a number of major policy areas, including taxation and competition. One of the reasons for the imperfectly integrated global economy derives from the absence of a credible and coherent framework for international investment. What exists comprises a patchwork of bilateral treaties, regional arrangements, and limited plurilateral or multilateral instruments. This patchwork creates a considerable problem of lack of coordination and consequent systemic failure, and in the end weakens the bargaining power of countries *vis-à-vis* TNCs, which have learned how to exploit the absence of a transparent and harmonized FDI regulatory framework.

Are multilateral investment rules actually achievable (or desirable)? Political-economy and institutional perspectives

Despite the economic case for multilateral rules, other arguments exist, in a political economy (or strictly political science) sphere that may tip the balance against multilateralism. A number of themes have been developed in the literature highlighting the problems of achieving a multilateral system of rules (of all types, including investment). Challenges emphasized relate to the dilemmas posed by relationships between globalization, the nation State and democratic politics; issues of supranational governance; decision-making processes and bargaining power; and the debate over the relative merits and demerits of institutional and regulatory harmonization versus diversity at country level.

Globalization, the nation State and democratic politics

There are arguments that the requirements for stronger integration are unattainable and probably undesirable in a world of nation States and democratic politics. Literature on the topic of investment frameworks distinguishes between “strong” and “weak” rules and “deep” or “shallow” integration (e.g. UNCTAD, 1996). The requirements for achieving the benefits of deep integration are, however, very demanding, requiring market contestability and modal neutrality;⁴ policy coherence; binding rules with wide country coverage; and comprehensive rules, incorporating national treatment, most favoured nation treatment and effective dispute settlement mechanisms (Brewer and Young, 2000, p. 37-38).

Dani Rodrik (2002) argues that a requirement for deep integration is *either* removing the sovereignty of the nation State *or* abandoning domestic politics. Since these latter two options are unlikely to be feasible together, then the only remaining possibility is the abandonment of the goal of deep economic integration. This is what he calls the “political trilemma” of the world economy.

Several authors (Hoekman, 2002; Rodrik, 2002; Ostry, 2001) have contrasted the present WTO system with its predecessor, the Bretton Woods/GATT regime. During the latter period, far-reaching trade liberalization occurred in manufactured goods, but services, agriculture and textiles were effectively omitted; anti-dumping and safeguard clauses were permitted; and investment issues and developing countries’ policies were largely excluded. The deeper integration associated with the WTO regime, by contrast, “involves an inherently intrusive focus on domestic policy ... [and] also greatly

⁴ Modal neutrality means that rules are designed to ensure that government policies do not lead to the choice of an inefficient mode of supply. One argument for investment regulations in the WTO is that if rules exist on trade policy but not on investment policy, government measures may distort the mode of supply. In a theoretical analysis, Hoekman and Saggi (2002) find that a TNC chooses the efficient mode of supply even under a discriminatory output tax levied on FDI. Still, there is ample evidence of distortions occurring in, for example, the FDI decisions of Japanese TNCs entering Europe in the 1980s and early 1990s (e.g. Barrell and Pain, 1999).

reinforces the legalization trend in the trading system” (Ostry, 2001, p. 235). Since further progress is incompatible with national sovereignty or domestic politics, the likely consequence is regarded as being a shallow version of globalization (Rodrik, 2002), with investment rules excluded. This author, as well as others like Stiglitz (2002), has argued that in the absence of any kind of global government, deep integration tends to have a profoundly anti-democratic nature. This, together with a perceived loss of sovereignty (or at least authority), are reasons why developing countries tend to oppose such commitments, and a practical argument that counteracts the theoretical economic advantages of a multilateral investment regime.⁵

Supranational governance and the roles of the WTO, IMF and World Bank

A substantial body of literature has focused upon systemic weaknesses in global governance. One theme emphasizes the defects of the WTO system itself. For example, Rorden Wilkinson (2001) suggests that the WTO was a product of post-war institutional path dependency. As such its provisions are viewed as favouring industrial countries, with its culture being one of anti-developmentalism. Despite the positive theoretical arguments supporting trade rules, Stiglitz (2002) has argued that trade agreements have been asymmetric, with the rich countries doing too little to open their markets to the south. This would encompass investment-related issues too, where there are suggestions that, for example, the TRIPS agreement in the Uruguay Round was anti-developmental. The requirement to establish intellectual property laws and institutions to enforce them has been argued to lead to substantial transfers from poor to rich countries through royalty payments (Maskus, 2000; Srinivasan, 2002; additional criticisms are contained in Strange and Katrak, 2003). Similarly, middle-income developing countries (such as those in Latin America) accepted obligations to eliminate a number of policy

⁵ Aside from sovereignty, there can be issues of prestige associated with FDI. Statistics on FDI attraction are now used in many countries as an important economic indicator, and FDI-related agencies tend to be high profile institutions. Because of this “jewel-in-the-crown syndrome”, politicians may seek to maintain control over FDI issues.

instruments (such as local-content requirements) without getting much in return (Lengyel and Ventura-Dias, 2004). Furthermore, the Dispute Settlement Mechanism is biased against developing countries since the possibilities for retaliation in the event of winning a case are related to the economic size of the country. Among the positives, on the other hand, Miguel Lengyel and Vivianne Ventura-Dias (2004) suggest that membership of the WTO has led to improved information dissemination, especially in respect of complex technical knowledge, and so has assisted the involvement of poor and small States.

The need for reform of global institutions (the WTO but also the IMF and World Bank) is also evident in the work of a number of authors (e.g. Hart, 1997; Tita, 1998; Marceau and Pedersen, 1999; and Sharma, 2000). James Boughton (2002) highlights problem areas such as the absence of clear mechanisms to handle the relationships between the trade liberalization rules of the WTO, and trade reforms undertaken as part of World Bank or IMF programmes; and the differential voting systems of these institutions (one-country one-vote in the WTO; weighted voting in the World Bank and IMF), which could allow, for example, WTO members to be “punished” in a World Bank or IMF forum for breaching WTO agreements. Finally, Dukgeun Ahn (2000) and others emphasize the requirement for improved cooperation and coherence among the multilateral institutions.

Hence reform of supranational governance is regarded as being essential if a multilateral regime is to be achieved. Aside from the specific problems associated with multilateral investment negotiations (to be discussed below), the perception of anti-developmentalism in systems of global governance generally makes many developing countries strong opponents of a multilateral investment framework under the aegis of the WTO.

Decision-making processes and bargaining power

The dissatisfaction with supranational governance systems extends to forceful (sometimes polemical) criticisms of decision-making processes in the WTO and imbalances in bargaining power.

Within the international business field, studies of TNC-host government relations and bargaining power have a long history (Root and Ahmed, 1978; Fagre and Wells, 1982; Lecraw, 1984; Kobrin, 1987). More recently, the approach has been extended to include a second tier of bargaining at the bilateral level between host developing and developed countries or multilateral institutions (Ramamurti, 2001). The conclusion was that the bargaining power of TNCs has been strengthened, while that of host countries has been weakened, meaning a much greater emphasis on the rights of firms and obligations of countries.

It is not difficult to utilize such an approach to analyze the Doha Round of WTO negotiations and show the practical problems of making any substantive progress on investment-related matters. New actors have emerged such as non-governmental organizations, which have challenged many of the assumptions of deeper integration based on a corporate commercial agenda, although they have had little direct success in influencing multilateral negotiations. The demise of the MAI also showed that there was little support for investment rules among major players like the TNCs and the Government of the United States. TNCs have largely achieved what they want from investment rules (as discussed above, BITs have tipped the balance towards the rights of firms and specifically investor protection, a major concern). Therefore, TNCs are not actively pursuing an investment-related agenda, although their trading interests suggest support for a trade-related round of negotiations. The large developing-country block in the WTO is by no means unified; but there has been determined opposition to an investment agreement by key members like India, and genuine concerns about the benefits associated with the widespread trade and investment liberalization and deregulation policies pursued in the last decades.

Key issues for a successful agreement include investment incentives and performance requirements which are basically non-negotiable (but see Theodore Moran's "grand bargain" (1998)). It is questionable whether there is a political market for multilateral rules on investment incentives, especially in federal countries: no or little progress was made in the MAI, NAFTA or in the OECD's Industry Committee (Sauvé and Wilkie, 2000). Conversely,

developing countries are unwilling to expand agreements on TRIMs. There also more important issues than investment for developing nations, particularly, for example, market access for exports of agricultural and textile products. From a bargaining power perspective, the conclusion is one of stalemate.

Authors in political science focus strongly on decision-making processes, and some are highly critical of the domination of the WTO by the United States and EU. Despite the fact that developing countries represent a large majority in the WTO, they are dependent on industrialized nations for imports, exports, aid, security etc. and may end up compromising their interests. Richard Steinberg (2002) labels bargaining in the WTO as power-based and asymmetrical even though in theory it should be law-based. Aileen Kwa (2003) comments similarly that decision-making is non-transparent and non-accountable, with the major industrial nations making the real decisions and ignoring opposing views. It is not necessary to accept the extreme versions of such arguments to recognize the widespread dissatisfaction with current decision-making processes. The issue for this article concerns the effects on negotiations on investment-related matters. While power rests with the industrialized nations, the developing country majority has enabled them to use power in a negative way, which is to halt progress on issues that are critical to them, such as performance requirements (TRIMs).

Institutional and regulatory harmonization versus diversity at country level

A likely trade-off exists between harmonization and diversity in rule-making. There is currently substantial institutional diversity around the world, leading to high transaction costs. The latter derive from problems of contract enforcement; implicit (versus explicit) contracts and the need for repeated interaction between parties; and national differences in regulations and in the rules of doing business. Deep economic integration would require removing these transaction costs through the harmonization of institutions and associated regulations, a process that would parallel the removal of barriers to investment and trade.

Authors such as Sylvia Ostry (2001), Rodrik (2002) and Sharun Mukand and Rodrik (2002) have, however, focused upon the challenges posed by multilateral agreements for institutional reform in developing countries. Following Douglass North (1994; see also World Bank, 2002), it is well recognized that markets require effective non-market institutions in order to operate efficiently. However, as Stiglitz (2002) has noted, the establishment of these institutions can be prohibitively costly to some developing countries, and may not suit these countries' interests. There is no *a priori* recipe for harmonization. Difficulties of adjustment have also been noted by various authors (see, for example, Lengyel and Ventura-Dias, 2004, in a Latin American context).

In fact, there is a growing body of literature which argues for encouraging institutional diversity and experimentation in order to ensure a fit between institutions and local conditions and development needs (Dewatripont and Roland, 1995; Roland, 2000; Rodrik, 2000; Besley, 2000; see also Berglöf and von Thadden, 2001 on corporate governance). This may provide a further rationale for diversity and experimentation among regulatory regimes.

Other writers (e.g. Mukand and Rodrik, 2002; Rodrik, 2003) develop a related argument. Accepting that there has been a general convergence towards an outward-looking, liberalization-based policy model, this hides considerable diversity, particularly in respect of institutional implementation. It is suggested that China and India, which have been markedly successful in terms of growth rates, have implemented solutions very different to those of some Latin American countries. These, it is suggested, have less to do with basic economic principles as with their institutional embodiment, although clearly there are differences in the former, particularly as regards pace of liberalization.

While some authors have focused upon institutions per se, others, such as Bernard Hoekman (2002), have pointed out that the adoption of regulations and standards applied in developed countries may also be costly and inappropriate for developing countries. Thus the required intellectual property regime may differ, for example, according to a country's stage of development; and the customs

system might differ according to the problems faced (Hoekman, 2002; Finger and Nogués, 2001). Again some areas of regulation may not be priorities for developing countries. This suggests greater consideration by the WTO of the investment required by developing countries in implementation and the opportunity costs of diverting resources from higher priorities in development.

Thus multilateral rules are not necessarily desirable, let alone achievable, if they were to lead to excessive harmonization at country level (which could be potentially counterproductive from a development perspective).

Overall, the above-mentioned arguments, mainly from a political economy perspective, highlight the difficulties and potential problems implied by a multilateral regime that have until now counterbalanced the economic reasons pro-multilateralism. In fact, a multilateral regime has considerable difficulties that transcend mere negotiating complexity: these include the global efficiency-equity trade-off; the dangers of a recipe approach given development asymmetries of countries; and considerable coordination/transaction/bargaining costs *ex ante* (though implying a significant reduction of such costs *ex post* if a rules-based framework would be achieved).

Do multilateral investment rules matter for developing countries? The case for domestic reform

There is extensive research on the determinants of FDI in host countries (UNCTAD, 1996). Important variables include market size and growth prospects, labour availability and skills and the quality of infrastructure (for a more refined evaluation, see Nunnenkamp and Spatz, 2002). Accepting the importance of these factors, Ewe-Ghee Lim's (2001) review of the literature on foreign investment and growth suggests that an emphasis on non-tax deficiencies within a country (infrastructure problems, regulatory and legal barriers, macroeconomic instability and economic impediments such as trade barriers) is the most efficient way to attract FDI.

None of the above studies provide evidence that multilateral investment rules are a significant influence on investment decisions.

Certainly there was a ubiquitous process of privatization, deregulation and liberalization (including FDI liberalization) during the 1980s and 1990s. But in the case of Latin America, for instance, this trend preceded the completion of the Uruguay Round negotiations and was brought about by the financial crises of the 1980s and the influence of the World Bank and IMF on policy-making (Lengyel and Ventura-Dias, 2004). The rapid growth in FDI to China again reflects a lengthy liberalization process prior to WTO entry in 2001, which opened up great opportunities for market-seeking and efficiency-seeking TNC activity. Conversely, among the least developed countries, there is disappointment and frustration that market reform and trade and investment liberalization has not been reflected in substantially increased FDI inflows; the explanation relates to a lack of market and investment opportunities.

What may be hypothesized is that a supportive FDI regime is a necessary but not sufficient condition for investment attraction; and that the necessary conditions mostly focus on investment protection that are met by BITs. This explanation would suggest that a multilateral investment regime is relatively unimportant to investors.

Research evidence, however, mostly shows a positive relationship between *trade* policy liberalization and FDI inflows (Nunnekkamp and Spatz, 2002 is something of an exception). TNCs, particularly those with regionally or globally integrated production systems, require a liberal trade environment to lower trade transactions and operating costs and facilitate imports and exports. Therefore, host country support for the multilateral *trading* system is of fundamental importance.

Thereafter the focus for host developing nations should be *domestic regulatory reform* (or what Hoekman, 2002, terms the “behind the border” agenda). The starting point is clearly to get the basics right, meaning policies to ensure macroeconomic stability; strong financial systems; and sound public and corporate governance. A second level of required policy intervention concerns industry policies (and the necessary institutional support facilities) designed to improve competitiveness and support the development of the market economy. These include areas of industrial strategy relating

to technological capabilities; human resource development; entrepreneurship and small- and medium-sized enterprise development; and rural industrial development.

In respect of improving the contribution of FDI, much of the recent policy debate at the national level concerns competitive enhancement policies and the promotion of localization within an increasingly globalized world economy (Hood and Young, 2000; Dunning, 1997, 2000). These require the encouragement of national innovative systems, technologically advanced locational milieu and industrial clusters, public infrastructure, skilled and flexible labour, and coordinated macro-organizational strategies.

In addition, regulatory reform to provide an enabling environment and institutional reform to ensure implementation are now seen as critical elements (UNCTAD, 2002).⁶ Issues of significance include actions, first, to achieve better regulation, including, for instance, fiscal reform; land planning and allocation; business licensing and registration; and import/export procedures. Second, improvements in commercial dispute resolution, such as enhancing the accessibility of courts and simplifying court procedures; and implementing anti-corruption procedures. Third, changing the culture of government through training. And, fourth, facilitating private sector advocacy. Such internal restructuring is essential to provide micro-level support to programmes focusing upon macroeconomic stability and structural reform.

Improvements in import / export procedures and associated services such as transport and distribution, as well as the strengthening of trade-related institutions (e.g. customs authorities), are essential to reduce transactional inefficiencies and corruption and facilitate trade and FDI (as well as private sector activity more generally).

In summary, the objectives of domestic regulatory reform are to assist the emergence and development of market economies and

⁶ The material that follows relates to an interesting programme that has been recommended for the United Republic of Tanzania called the BEST (Business Environment Strengthening for Tanzania) programme. See UNCTAD, 2002, pp. 65.

a growing and internationally competitive private sector. Such a reform agenda will in turn provide the conditions for successful FDI attraction (Lin, 2001). These are areas where the WTO has rather little to contribute, although multilateral level policy issues have a significant bearing on the economic fundamentals that are so important in attracting and benefiting from FDI. For example, IMF and World Bank programmes have a role in promoting macroeconomic stability, economic reform and restructuring and the development of private enterprise. The International Finance Corporation (World Bank affiliate) plays an important role in FDI by taking equity stakes in invested enterprises.

Where now for developing countries?

The findings of this article can be summarized as follows:

1. While there are strong economic arguments in favour of a multilateral investment agreement at the global level, the asymmetric nature of investment flows creates problems in ensuring a fair distribution of benefits at the country level.
2. Weaknesses in supranational governance have created opposition to all multilateral institutions; the WTO has been strongly criticized because of its decision-making processes and bargaining power that favour developed States, despite the one-member one-vote system.
3. There is opposition to multilateral rules because of the adverse effects on national sovereignty and the ability to pursue domestic priorities. Institutional and regulatory harmonization derived from WTO rules is costly and may be inappropriate for developing countries, as well as diverting resources from higher priorities in development, and acting as a barrier to experimentation.
4. The spread of BITs (and regional integration agreements) has weakened the requirement for multilateral investment rules.
5. Although evidence is lacking, it is hypothesized that a multilateral investment regime is relatively unimportant as a locational determinant for investors.
6. The emphasis in developing countries should be on a *domestic regulatory reform agenda* that will provide the conditions

for successful FDI attraction, while supporting the evolution of the multilateral *trading* system to facilitate the development of TNCs' regionally and globally integrated production systems (and, indeed, the internationalization of domestic enterprises).

The perspectives presented here should not be regarded as a retreat from multilateralism. On the contrary, the multilateral trade and investment regime needs to be supported and strengthened. In particular, and despite difficulties, there should be an unwavering commitment to the multilateral trading system. Developing countries have much to gain from reductions in the trade restrictions imposed both by the industrialized countries and themselves.

In respect of a multilateral investment regime, the position is more complicated. Economic perspectives indicate welfare gains from a multilateral framework, but any agreement would have to recognize equity issues and the distribution of benefits between nations to be acceptable. Additionally, investment rules would need to provide an appropriate balance between the rights and responsibilities of firms and countries. This means rules that ensure predictability and security for foreign investors, and flexibility for host nations to follow their own development objectives; as well as tackling investment distortions caused primarily by developed country practices. Finally, multilateral rules should in general not extend into areas of domestic regulation, unless there are clear net benefits to all parties from so doing.

There is clearly additional work to be undertaken here, but the establishment of a set of principles along these lines could form the basis of a work programme that is acceptable to all parties. The objective would be a gradualist approach to a multilateral investment accord over the long term. Even this will be no easy task in the light of the dissension and polarization of views that exist at present. However, many years ago, when trade talks commenced, the reduction of tariff and non-tariff barriers also seemed impossible. Alongside this general approach, it will still be possible to make progress on deeper integration in services through the GATS, and to learn lessons that can apply to other investment areas.

This article has highlighted gaps and deficiencies in empirical research. To support and inform the work programme, therefore, a number of research questions should be addressed, including the following (see also Rugman and Verbeke, 1998; Wells, 1998; Sauvé and Wilkie, 2000; Srinivasan, 2002):

- Do TNCs take WTO rules into consideration in their decision-making and how important are they relative to bilateral and regional and national rules?
- How important have multilateral rules been in liberalization processes in developing countries?
- What is the evidence on the extent, nature and economic impacts of investment incentives, performance requirements, rules of origin and antidumping regulations?
- What are the experiences of developing countries with regulatory and institutional reform, and what are the implications for inward FDI?
- How far do the interests of developing countries depend upon their stage of development (including their institutional development)?

Concluding remarks

Little progress has been made with multilateral investment rules over a period of nearly 60 years, and little can be expected from the Doha Round. In the light of this experience, the present article has attempted to identify the reasons for lack of progress and to establish what lessons can be drawn for policy priorities in developing countries.

The conclusion that developing countries should address a domestic regulatory reform agenda is a very pragmatic but also important one. The potential gains from a multilateral investment regime are worth pursuing over the long-term, but positions are now so entrenched and frequently antagonistic that a period of reflection would be useful. During this time a research agenda might be devised and implemented, and begin to address controversial issues on which opinions are numerous and varied, but on which objective empirical

data are highly deficient. In parallel a framework of principles could be developed and from this a long-term programme that is acceptable to all parties put into place. This might, over the long-term, produce a comprehensive multilateral investment regime; but, with a realistic agenda from the start, expectations would be managed. ■

References

- Ahn, D. (2000). "Linkages between international financial and trade institutions, IMF, World Bank and WTO", *Journal of World Trade*, 34(4), pp. 1-35.
- Barrell, R. and N. Pain (1999). "Trade restraints and Japanese direct investment flows", *European Economic Review*, 43, pp. 29-45.
- Berglöf, E. and E.-L. von Thadden (2001). "The changing corporate governance paradigm: implications for developing and transition economies", in S.S. Cohen and G. Boyd, eds., *Corporate Governance and Globalization* (Cheltenham, UK: Edward Elgar), pp. 275-306.
- Besley, T. (2000) 'Political institutions and policy competition'; website: www.dse.de/ef/instn/besley.htm.
- Blomström, M. and A. Kokko (2003). "The economics of foreign direct investment incentives", *NBER Working Paper No. 9489* (National Bureau of Economic Research: Cambridge, MA), February, mimeo.
- Bonaglia, F., J.B. de Macedo and M. Bussolo (2001). "How globalisation improves governance", *Technical Papers No. 181. OECD Development Centre* (Paris: OECD), November.
- Boughton, J.M. (2002). "Globalization and the silent revolution of the 1980s", *Finance & Development*, 39(1), pp. 40-43.
- Brewer, T.L. and S. Young (1997). "Investment incentives and the international agenda", *The World Economy*, 20(2), pp. 175-198.
- _____ and S. Young (2000). *The Multilateral Investment System and Multinational Enterprises* (Oxford: Oxford University Press).
- _____, S. Young and S.E. Guisinger, eds. (2003). *The New Economic Analysis of Multinationals: An Agenda For Management, Policy and Research* (Cheltenham: Edward Elgar).

-
- Casson, M.C. (1997). *Information and Organization* (Oxford: Clarendon Press).
- Caves, R.E. (1996). *Multinational Enterprise and Economic Analysis* (Cambridge and New York: Cambridge University Press).
- Dewatripont, M. and G. Roland (1995). "The design of reform packages under uncertainty", *American Economic Review*, 83(5), pp. 1207-1223.
- Driffield, N. (2000). "Regional policy and spillovers in the UK" (Birmingham: University of Birmingham), mimeo.
- Dunning, J.H. (1997). *Alliance Capitalism and Global Business* (London and New York: Routledge).
- _____ (2000). *Regions, Globalization, and Knowledge-Based Economy* (Oxford: Oxford University Press).
- Fagre, N. and L.T. Jr. Wells (1982). "Bargaining power of multinationals and host governments", *Journal of International Business Studies*, 32(1), pp. 23-39.
- Finger, J.M. and J. Nogués (2001). "The unbalanced Uruguay Round outcome: The new areas in future WTO negotiations", *Discussion Paper No. 2732, Centre for Economic Policy Research* (London: CEPR).
- Ganesan, A.V. (1998). "Developing countries and a possible multilateral framework on investment: strategic options", *Transnational Corporations*, 7(2), pp. 1-38.
- Graham, E.M. (1996). *Global Corporations and National Governments* (Washington, D.C.: Institute for International Economics).
- Hallward-Driemeier, M. (2003). "Do bilateral investment treaties attract FDI? Only a bit...and they could bite", *World Bank Working Paper No. 3121*, August, <http://econ.worldbank.org/view.php?id=29143&topic=2231>
- Hart, M. (1997). "The WTO and the political economy of globalization", *Journal of World Trade*, 31(5), pp. 75-93.
- Hoekman, B. (2002). *Economic Development and the WTO After Doha*, Discussion Paper No. 3374 (London: Centre for Economic Policy Research), May.

-
- _____ and K. Saggi (2002). "Trade versus direct investment: modal neutrality and national treatment", *Discussion Paper No. 3375. Centre for Economic Policy Research* (London: CEPR), May.
- Hood, N. and S. Young (2000). *The Globalization of Multinational Enterprise Activity and Economic Development* (London: Macmillan and New York: St. Martin's Press).
- De Jonquières, G. (2003). "Modest goals in Cancún", *Financial Times*, 4 September.
- Karl, J. (1998). "Investment protection in the era of globalized firms: the legal concept of 'transboundary harm' and the limits of the traditional investment treaties", *Transnational Corporations*, 7 (3), pp. 53-84.
- Kline, J.M. and R.D. Ludema (1997). "Building a multilateral framework for investment: comparing the development of trade and investment accords", *Transnational Corporations*, 6(3), pp.1-31.
- Kobrin, S.J. (1987). "Testing the bargaining hypothesis in the manufacturing sector in developing countries", *International Organization*, autumn, pp. 609-638.
- Kwa, A. (2003). "Power politics in the WTO", Focus on the Global South, CUSRI, Chulalongkorn University, Bangkok, Thailand, <http://www.focusweb.org/publications/books/power-politics-in-the-wto.pdf>.
- Lecraw, D.J. (1984). "Bargaining power, ownership and profitability of transnational corporations in developing countries", *Journal of International Business Studies*, 15(1), pp. 27-43.
- Lengyel, M. F. and V. Ventura-Dias (2004). *Trade Policy Reform in Latin America. Multilateral Rules and Domestic Institutions* (London: Palgrave Macmillan).
- Lim, E.-W. (2001). "Determinants of, and the relation between, foreign direct investment and growth: a summary of the recent literature", *IMF Working Paper WP/01/175* (Washington, D.C.: International Monetary Fund), December.
- Marceau, G. and P.N. Pedersen (1999). "Is the WTO open and transparent?", *Journal of World Trade*, 33(1), pp. 5-49.
- Markusen, J.R. (2001). "Commitment to rules on investment: the developing countries' stake", *Review of International Economics*, 9(2), 287-302.

-
- Maskus, K. (2000). *Intellectual Property Rights in the Global Economy* (Washington, D.C.: Institute for International Economics).
- Moran, T.H. (1998). *Foreign Direct Investment and Development* (Washington, D.C.: Institute for International Economics), December.
- Mukand, S. and D. Rodrik (2002). "In search of the Holy Grail: policy convergence, experimentation and economic performance", *Working Paper 9134. National Bureau of Economic Research*, September, mimeo.
- North, D.C. (1994). "Economic performance through time", *American Economic Review*, 84(3), pp. 359-68.
- Nunnenkamp, P. and J. Spatz (2002). "Determinants of FDI in developing countries: has globalization changed the rules of the game?", *Transnational Corporations*, 11 (2), pp. 1-34.
- Ostry, S. (1997). *The Post-Cold War Trading System: Who's On First?* (Chicago: University of Chicago Press).
- _____ (2001). "The multilateral trading system", in A.M. Rugman and T.L. Brewer (eds.), *The Oxford Handbook of International Business* (Oxford: Oxford University Press), pp. 232-258.
- Oxelheim, L. and P. Ghauri (eds.) (2003). *European Union and the Race for Inward FDI in Europe* (Oxford: Elsevier).
- Ramamurti, R. (2001). "The obsolescing 'bargaining' model? MNC-host developing country relations revisited", *Journal of International Business Studies*, 32(1), pp. 23-39.
- Rodrik, D. (2000). "Institutions for high quality growth: What are they and how to acquire them", *Studies in Comparative International Development*, 35(3), pp. 10-28.
- _____ (2002). "Feasible globalizations", *Working Paper 9129, National Bureau of Economic Research*, September, mimeo.
- _____ (2003). *Growth Strategies*, Discussion Paper No. 4100 (London: Centre for Economic Policy Research), October.
- Roland, G. (2000). *Transition and Economics: Politics, Markets and Firms* (Cambridge, MA: MIT Press).

-
- Root, F.R. and A.A. Ahmed (1978). "The influence of policy instruments on manufacturing foreign direct investment in developing countries", *Journal of International Business Studies*, 9(3), pp. 81-93.
- Rugman, A.M. and A. Verbeke (1998). "Multinational enterprises and public policy", *Journal of International Business Studies*, 29(1), pp. 101-114.
- Sauvé, P. and C. Wilkie (2000). "Investment liberalization in GATS", in P. Sauvé and R.M. Stern, eds., *GATS 2000. New Directions in Services Trade Liberalization* (Washington, D.C.: The Brookings Institution), pp. 331-363.
- Sharma, S.D. (2000). "Constructing the new international financial architecture: what role for the IMF?", *Journal of World Trade*, 34(3), pp. 47-70.
- Srinivasan, T.N. (2002). "Developing countries and the multilateral trading system after Doha", *Center Discussion Paper No. 842. Economic Growth Center* (Yale University), February.
- Steinberg, R. (2002). "In the shadow of law or power? Consensus-based bargaining and outcomes in the GATT/WTO", *International Organization*, 56(2), pp. 339-374.
- Stiglitz, J. (2002). *Globalization and its Discontents* (London: Allen Lane).
- Strange, R. and H. Katrak (eds.) (2003). *WTO and Developing Countries* (London: Palgrave Macmillan).
- Tavares, A. T. (2001). "Systems, evolution and integration. Modelling the impact of economic integration on multinationals' strategies", unpublished Doctoral Thesis, University of Reading, May.
- Tita, A. (1998). "Globalization: a new political and economic space requiring supranational governance", *Journal of World Trade*, 32(3), pp. 47-55.
- United Nations Conference on Trade and Development. (1996). *World Investment Report 1996. Investment, Trade and International Policy Arrangements* (New York and Geneva: United Nations), United Nations publication, Sales No. E.96.II.A.14.
- _____ (1998). *Bilateral Investment Treaties in the mid-1990s* (New York and Geneva: UN), United Nations publication, Sales No. E.98.II.D.5.
- _____ (2002). *Investment Policy Review Tanzania* (New York and Geneva: United Nations), United Nations publication, Sales No. E.02.II.D.4.

-
- _____ (2003). *World Investment Report 2003: FDI Policies for Development: National and International Perspectives* (New York and Geneva: United Nations), United Nations publication, Sales No. E.03.II.D.8.
- Wells, L.T. Jr.(1998). “Multinationals and developing countries”, *Journal of International Business Studies*, 29(1), pp. 101-114.
- Wilkinson, R. (2001). “The WTO in crisis: exploring the dimensions of institutional inertia”, *Journal of World Trade*, 35(3), pp. 397-419.
- World Bank (2002). *World Development Report 2002: Building Institutions for Markets* (Washington, D.C.: World Bank).
- Young, S. (2004). *Multinationals and Public Policy* (vols. I and II) (Cheltenham: Edward Elgar).
- _____ and T.L. Brewer (2003). “Overview and public policy reflections”, in T.L. Brewer, S. Young and S.E. Guisinger, eds., *The New Economic Analysis of Multinationals: An Agenda For Management, Policy and Research* (Cheltenham: Edward Elgar), pp. 145-170
- _____ and N. Hood, N. (2003). “Alliance capitalism, FDI and developing countries”, in J.H. Dunning and G. Boyd (eds.), *Alliance Capitalism and Corporate Management* (Cheltenham, UK: Edward Elgar), pp. 249-274.

