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Assessing the Case for Extending WTO Disciplines on Investment-Related Policies

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Abstract

In this paper we evaluate the potential benefits of international disciplines on policies towards foreign direct investment, paying particular attention to developing countries. We conclude that, at present, the case for initiating negotiations on investment policies is weak. Negotiations that center on improving market access on a nondiscriminatory basis, especially in services, are likely to be more fruitful: although imperfect, existing multilateral instruments such as the General Agreement on Trade in Services, are far from fully exploited and provide significant opportunities for governments to improve market access.

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I. Introduction

The value of sales by foreign affiliates of multinational firms now exceeds global exports of goods and services (UNCTAD, 1997). Firms are increasingly

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servicing world markets through foreign direct investment (FDI) rather than through exports. The increased importance of FDI is a consequence of multiple factors. Falling costs of communication have eased the constraints on global rationalization of production, leading to greater geographic specialization and international slicing of the production (value added) chain. Furthermore, increased outsourcing and the information technology revolution have created markets for an ever expanding set of new services. Efficient provision of such services often requires suppliers to have a physical presence in all of their markets, further expanding FDI flows.[1]

Market-driven changes in the economic environment have been complemented by changes in the policy environment. Perceptions about multinational firms and their effects on host countries have undergone a transformation. Most countries are now quite eager to attract FDI and many have concluded bilateral investment treaties (BITs) with important source countries. As of 1999, over 1,600 BITs had been negotiated, compared to some 400 at the beginning of 1990 (UNCTAD, 1997). On the other hand, many countries continue to subject multinationals to performance requirements. For example, multinationals may have to comply with local content, export or technology transfer requirements. In fact, it is not unusual to find that investment incentives (such as tax breaks/holidays and outright subsidies) are offered in conjunction with performance requirements and other restrictions on FDI, perhaps to partially offset the negative impact of the latter on the likelihood of investment by multinationals. The schizophrenic nature of the overall policy environment reflects the guarded optimism with which many countries continue to view the entry of multinational firms into their territory.

At the 1996 ministerial meeting of the World Trade Organization (WTO) in Singapore, a working group on trade and investment was created to examine the relationship between trade and investment policies. Currently, a number of countries are in favor of introducing disciplines on investment policies into the WTO; others are opposed. Differences in views precluded the establishment of a negotiating group on investment at the 1999 ministerial meeting held in Seattle-WTO members simply agreed to continue studying the issue as a working group.

[1]Interestingly, it is not (yet) the case that sales of services by foreign affiliates exceed the value of services sold cross-border. So-called foreign affiliate sales of services (FATS) stood at $820 million in 1997 for the world as a whole, compared to $890 million worth of trade in commercial services (which excludes tourism-related expenditures) (Karsenty (2000)). Of course, FATS are low in part because many countries impose restrictions on FDI in services.

This paper assesses the case for the creation of a multilateral agreement on investment. We conclude that although some potential rationales are compelling in principle, none justify multilateral negotiations on investment policies at this time. Ample room exists to pursue liberalization via existing WTO agreements and to lock in reforms on investment policy through bilateral agreements and unilateral commitments to abide by the provisions of international arbitration. Thus, priority should be given to continuing the process of multilateral trade liberalization.

As far as investment (establishment) policies are concerned, attention should focus on sectors where FDI is critical as a mode to contest markets, i.e., services. The General Agreement on Trade in Services (GATS) already covers investment as a mode of supply for which market access and national treatment commitments can be made on a sector-specific basis. Thus, a large proportion of the potential gains from negotiations regarding FDI policies can be realized through better exploitation of existing multilateral instruments. Given the limited use of existing agreements, one must question the *marginal value* of negotiating yet another multilateral agreement and ask whether governments really have the appetite for accepting significant restrictions and commitments with respect to the use of their FDI policies. If the answer is negative, and the failure of the OECD negotiations on a multilateral agreement on investment (MAI)) suggests that such may be the case, there seems to be no strong rationale for pursuing such an agreement at this time.

In what follows, we begin with an overview of the current policy environment, paying particular attention to trade-related investment measures and issues of market access (Section II). We then turn to the international spillover case for international cooperation, which hinges on the existence of externalities imposed by a country on others (Section III). This discussion is followed by an assessment of rationales for international agreement that are based on credibility and transaction costs arguments (Sections IV and V). Section VI focuses on the grand bargain argument, which derives from the need for issue linkage to maximize gains from cooperation. This analysis leads us to consider the need to strengthen the architecture of the WTO by treating trade and investment policies symmetrically (Section VII). The implications of our analysis for the value to developing countries of a stand-alone multilateral agreement on FDI are summarized in Section VIII. We end with some concluding remarks (Section IX).

II. The Policy Environment

The overall policy environment toward FDI has two broad features. First, in recent years, government policies toward FDI have been liberalized across the world (Moran 1998), reflecting an increasingly sanguine view of the impact of FDI on host countries. Second, despite such liberalization, many countries continue to subject foreign investors to performance yardsticks, operating restrictions, and market access barriers. Such policies are sometimes coupled with restrictive trade-related investment measures (TRIMs) such as export requirements, domestic content requirements, and technology transfer requirements. The specific type of policy used often depends on whether FDI is resource-seeking, domestic market oriented, or export-oriented (see Caves, 1996).[2]

What does the economics literature tell us about the possible effects of such policies? First, absent domestic distortions and externalities from FDI, the optimal FDI policy is no policy at all-that is, governments should allow for unfettered market transactions. For example, under perfect competition, domestic content protection lowers welfare by raising the price of domestic inputs: the resulting benefits to input suppliers are outweighed by the costs incurred by final goods producers (Grossman, 1981). For there to be a rationale for policies restricting FDI there must be domestic policy distortions or market failures. Since multinational firms typically arise in oligopolistic industries, the presence of imperfect competition in the host economy is an obvious candidate.[3]

Analyses of content protection and export performance requirements under conditions of imperfect competition illustrate that the welfare effects of such policies are not necessarily negative (Hollander (1987); Richardson (1991) and

[2]Market-seeking FDI is often be driven by either market size or trade policy. If either factor is influential enough, a government may be able to impose TRIMs. Domestic incumbents can be expected to seek the imposition of TRIMs to make tariff-hopping FDI less attractive. Export-oriented FDI will often be sensitive to TRIMs that increase costs, and can be expected to demand offsetting subsidies or similar incentives. See Caves (1996) for a comprehensive discussion.

[3]However, this is not required. The standard example of a policy distortion is trade protection. Consider a developing country with protection on the capital intensive good in a standard two sector, two factor model. Allowing in foreign capital causes the output mix to shift towards the capital intensive sector, so that imports of the capital intensive good and therefore tariff revenues fall. This reduces welfare because each unit of imports is worth more inside the country than its cost from world markets (Hamada, (1974)). This is an example of second-best policy. The optimal policy would be to remove the protection on the capital intensive sector.

(1993); Rodrik (1987)). However, the standard normative prescription applies: more efficient instruments can be identified to address a distortion. In the case of anti-competitive practices resulting from market power or collusion, appropriate competition policies need to be used. Similarly, domestic policy distortions such as tariffs should be removed at the source. If the distortion is due to market failure, an appropriately designed regulatory intervention is required. Further, such intervention must be applied on a nondiscriminatory basis to both foreign and domestic firms. This approach is implicit in the WTO, which not only aims at progressive liberalization of trade, but also imposes national treatment and most favored nation (MFN) constraints on policies. The adoption of these principles entails a prohibition on the use of most trade-related investment measures (TRIMs).

In the Uruguay Round, an agreement on TRIMs was negotiated. This agreement prohibits measures that are inconsistent with national treatment (Art. III GATT) and the GATT ban on the use of quantitative restrictions (Art. XI). The agreement contains an illustrative list of prohibited measures, including local content, trade-balancing, foreign exchange-balancing and domestic sales requirements. Furthermore, it requires that all non-conforming policies be notified within 90 days of entry into force of the agreement and that these be eliminated within two, five or seven years, for industrialized, developing and least developed countries, respectively. The agreement is to be reviewed in the year 2000 at which time consideration may be given to the addition of provisions relating to competition and investment policy (Low and Subramanian, (1996).

The TRIMs agreement does not go beyond existing GATT rules. It simply re-iterates the GATT national treatment principle and the prohibition of quantitative restrictions in the context of certain investment policies that are deemed to be trade-related.[4] The GATT has been a constraint on countries using TRIMs, and can be expected to become a more serious source of discipline in the future as Uruguay Round transition periods for developing countries expire. A case brought by the EU, Japan and the US against provisions of the National Car Program introduced by Indonesia in 1996 may be indicative of the future. Under the contested program, the government granted National Car company status to Indonesian companies that met specified criteria regarding ownership of facilities, use of trademarks, and technology. National Car companies that satisfied

[4]Note, however, that export performance requirements are not covered by the TRIMs agreement.

(increasing) local content requirements over a three year period were exempt from the prevailing luxury tax on sales of cars and import duties on parts and components. National Cars manufactured in a foreign country which fulfilled the local content requirements prescribed by the Minister of Industry and Trade were also exempt from import duties and the luxury tax. Such imported National Cars were deemed to comply with the 20 per cent local content requirement for the end of the first production year if the value of counter-purchased Indonesian parts and components accounted for at least 25 per cent of the value of the imported cars (WTO, 1998b). The WTO panel found that this program violated the national treatment principle. More disputes may arise under the TRIMs agreement once the transition periods for full compliance on the part of developing countries have expired. A major reason Indonesia was targeted was that the policy measures were introduced after the TRIMs agreement had entered into force. A number of countries apply similar policies but are currently sheltered by the transition period agreed in the Uruguay Round.

The economic literature on TRIMs notes that there may indeed be circumstances where, from the viewpoint of an individual country, its optimal second-best policy toward inward FDI has a restrictive flavor. However, such policies typically have a beggar-thy-neighbor effect. If all countries pursue such policies, the outcome will be inefficient from a world welfare point of view.[5] Cooperation that involves agreement to not restrict FDI can then be Pareto improving. Alternatively, the situation may be zero sum, in which case there are no gains from cooperation. If so, any international agreement must extend beyond investment policies to allow side payments to be made (more on this below).

In many cases, surveys show that investment measures require firms to take actions that they would have taken anyway. For example, a policy that requires firms to export is inconsequential if firms find it advantageous to export even in the absence of such a requirement. Surveys by the US Department of Commerce for 1977 and 1982 indicated that only six percent of all the overseas affiliates of US firms felt constrained by TRIMs such as local content or export performance requirements, although a far greater percentage operated in sectors where such TRIMs existed. In other words, TRIMs often failed to bind (UNCTC, 1991). These surveys did *not* take account of the firms that may have refrained from

[5]See Glass and Saggi (1999b) for an analysis where such policies have distributional consequences across countries.

investing in countries with TRIMs. By discouraging FDI and distorting the allocation of global capital, the use of TRIMs by an individual country may have efficiency consequences for the world.

Whatever the economic rationality of restrictive policies, the available empirical evidence suggests that local content and related policies are costly to the economy. Furthermore, they often do not achieve the desired backward and forward linkages, encourage inefficient foreign entry, and create potential problems for future liberalization: those who successfully enter a market when it is subject to some investment measures lobby against a change in regime (Moran, 1998). However, a case can be made that as long as trade barriers on final goods are low enough to allow foreign firms to access markets via exports, TRIMs may not be particularly costly (more on this below).

TRIMs are just part of the relevant policy landscape: investment policy measures that affect entry and operations are often general, not tied to trade performance or trade policy. Many countries impose licensing and related screening and approval regimes. These are often associated with related red tape costs for foreign investors. Some countries may also prohibit entry through FDI altogether, or impose equity limitations. Such policies may reflect welfare-enhancing attempts to shift foreign profits to the domestic economy or welfare-reducing rent-seeking activities by bureaucrats and special interest groups. Sometimes the effect of policies is simply to waste real resources (so-called frictional costs-see Baldwin (1994)). The TRIMs agreement does not apply to such non-trade-related policies, nor does it affect service industries. The latter are covered by the GATS, however, which extends to FDI policies if countries make specific market access and national treatment commitments for this mode of supply.

The remainder of this paper discusses situations where FDI policies are either economically rational (first best) and/or policies (whether rational or not) that impose negative spillovers on the rest of the world. These are two cases where there is a prima facie potential case for international cooperation.

[6] A selective use of investment incentives can also have strategic consequences. An exporting foreign firm from a third country (or a local host firm) may find itself at a disadvantage with respect to a foreign firm that experiences a decline its cost due to an investment subsidy. Thus, the dichotomy between incentives and strategic investment policies is not clear cut. The distinction is made here to isolate the primary motivation behind each policy: incentives are intended to lure in multinationals, while policies restricting their behavior are meant to alter the distribution of rents.

III. International Spillovers: A Rationale for Cooperation ?

Investment-related policies may reflect attempts to shift rents from source to host countries (strategic policies) or a desire to secure benefits for the local economy that otherwise might not materialize (incentive policies). Both types of policies can create international spillovers and provide a basis for international cooperation.[6]

A. Investment Policies with Strategic Objectives

Since multinational firms are pervasive in oligopolistic industries, governments might have incentives to shift rents from multinationals to the host economy. As is well known, it is certainly feasible to design policies that in theory can improve local welfare by altering the distribution of rents between domestic and foreign firms. If one extends the analysis beyond the product market the firms compete on, it is easy to see how such policies may also have distributional effects.[7]

The distribution of rents between governments, host country firms, and large multinationals has always been a classic source of tension. In contrast to industrialized countries, where two way flows of FDI are large, developing countries are large net importers of FDI and it is precisely in developing countries that multinationals have been most controversial. Since developing countries mostly represent the host country view of FDI, the implication is that it will be difficult to devise an international agreement on investment without expanding the negotiating agenda to include other issues of interest to developing countries. Of course, it is not clear how large the rents are or how many countries do in fact employ strategic policies. As has been emphasized repeatedly in the literature, in practice it is rather difficult to design strategic policies that are effective. The informational requirements for formulating a successful policy are substantial and such policies invite lobbying and other socially-wasteful activities. Account must also be taken of the reactions of affected foreign firms and their home governments. The best rule of thumb for policy-makers is to refrain from pursuing strategic policies.[8]

[7]As Glass and Saggi (1999a and 1999b) have argued, inward FDI increases demand for labor thereby raising wages and damaging profits of host firms. The tension between wages and profits implies that government policies toward FDI benefit one group at the expense of the other. The relative importance of the welfare of the two groups in the governments objective function then determines the policy stance implemented by the government.

[8]It is easy for governments to make a mistake even if the optimal policy appears to be straightforward. Madagascars failed policy towards controlling exports of vanilla is a good example (see De Melo, Olarreaga and Takacs, 2000).

Investment policies with strategic objectives may be ineffective if the products involved are tradable. If output is tradable, the realization of profit-shifting objectives via clever investment policies will also require the use of trade policy instruments. If a country pursues free trade, a restrictive FDI policy will not transfer any rents as foreign firms will not engage in FDI. Instead, they will contest the market through exports. From a global welfare point of view, this perspective suggests priority be given to trade liberalization and trade facilitation efforts (lowering trade costs by enhancing the efficiency of customs clearance and port services). If trade barriers are low, domestic industry will have less of an incentive to support restrictive FDI regulations (restrictions on inward FDI may be motivated in part by the existence of high trade barriers, as this provides an incentive for tariff-wall hopping FDI). Only to the extent exports are a second-best means of servicing a market will investment policies be able to shift rents toward domestic firms. Hoekman and Saggi (2000) present a simple model that formalizes the above arguments. Their model also raises the point that a restrictive investment policy, when coupled with a liberal trade policy, may lead a firm to serve a market through exports when FDI is actually the socially efficient method. This result suggests that symmetric treatment of trade and FDI might be needed to ensure that inefficiencies with respect to the mode of supply chosen by firms do not arise because of policy distortions. However, in such cases restrictive FDI policies are patently irrational. As trade policy is required to pursue rationally-motivated strategic investment policy, the implication of their analysis is that the existing WTO is a vital instrument through which to discipline strategic FDI policies for tradable industries. From this perspective it is not surprising that TRIMs are covered by the GATT (and have been from the very start).[9]

When FDI is the only means of contesting a market as is the case for many services firms may have to suffer the consequences of strategic investment policies.[10] In the case of nontradables, liberalization of entry and operating restrictions is therefore crucial for providing market access. The desire of

[9]If FDI is in the import-competing sector, then the trade policy to use to tax FDI is an import-subsidy, something that is not of concern to the WTO. If FDI is in the export-competing sector, a tariff can shift resources from foreign affiliates to domestic factors in other sectors (Olarreaga, 1998). A binding free trade regime locked in through the WTO would not allow this.

[10]One common policy has been to favor joint ventures relative to wholly owned subsidiaries. Whether such policies are motivated by the desire to force multinationals to share rents with local partners or to encourage technology transfer to local firms (or both) is not clear. However, if left free to choose, multinationals usually prefer wholly owned subsidiaries.

foreign firms to achieve market access can be used as a tool to promote liberalization and constitutes a potential rationale for multilateral negotiations. However, as noted earlier, there may be a need to expand the negotiation set to include issues other than market access in order to achieve agreement (see also section VII). The question then becomes what can one expect from an investment agreement relative to the existing WTO agreements dealing with the industries where most nontradable activities are found. We take up this issue further below.

B. Investment Incentives

Incentives to attract FDI may be justified if host countries enjoy externalities from inward FDI. For example, developing countries may hope that FDI will generate technological spillovers for local firms thereby improving productivity. There exists a large literature that tries to determine whether or not host countries enjoy spillovers from FDI (see Blömstrom and Kokko (1997), Markusen (1998), and Saggi (1999) for surveys). The central difficulty is that spillovers, by their very nature, often do not leave a paper trail-they are externalities that the market fails to take into account. The elusive nature of spillovers makes it difficult to justify the use of investment incentives on the scale they are being used today.

Even if one accepts the notion that there exists an economic rationale for providing incentives to FDI due to the positive externalities it generates, empirical evidence regarding the efficacy of financial incentives to attract FDI is ambiguous. Furthermore, while pursuing a policy of promoting inward FDI *via* incentives, countries may find themselves in a bidding war with each other. Such competition for investment will generally be to the detriment of parties involved and may even lead to excessive payment to investors. The possibility of such an outcome supports the case for international cooperation to ban or discipline the use of investment incentives.

Clearly a key issue is whether financial incentives are effective in actually altering the pattern of global FDI. Many studies have concluded that incentives are not effective once the role of fundamental determinants of FDI have been taken into account (see Caves (1996) and Moran (1998) for a discussion of these studies). An implication of this finding is that incentives may end up as transfers to multinationals without influencing their location decisions. From an efficiency stand point, if fiscal incentives fail to alter the pattern of FDI, they are not distortionary.[11] In principle, if incentives are ineffective, there is no rationale for

seeking multilateral disciplines prohibiting their use-it is in each countrys self-interest to not offer them to investors. In such situations they are pure transfers from developing countries to multinationals and developing countries will have the most to gain from refraining to use them. Of course, this argument assumes full information on the part of governments. In practice, investors can be expected to indicate to governments that incentives are required.

Government officials are often not convinced of the inefficacy of incentives, as illustrated by statements by a number of representatives in the WTO Working Group on Trade and Investment (WTO, 1998a). To some extent this may reflect differences in views regarding what is meant by an incentive. It is important to distinguish between fiscal and financial incentives (that are usually firm-specific) and more general policies that promote business activity. That the latter matter a lot in attracting investment is uncontested.[12] Policies that encourage the adoption and adaptation of know-how and other such general incentives that apply across-the-board are important determinants of the economic fundamentals of an economy (*e.g.*, effective enforcement of contracts, the absence of red tape, adequate infrastructure, training and education programs, etc.).

That being said, there is some evidence that suggests fiscal incentives do affect location decisions, especially for export-oriented FDI, although they seem to play a secondary role (Guisinger *et al.* (1985), Hines (1996), Devereux and Griffiths (1998)).[13] Several models in the economic geography and development literature generate low-level equilibrium traps. The existence of such traps provides a rationale for incentives in order to get over a critical mass (agglomeration) threshold required to attract firms to a location. Given the difficulty of quantifying the positive externalities associated with inward FDI, determining the optimal incentive scheme is obviously very difficult. But in principle, if governments compete for FDI, this can help ensure that FDI goes to those locations where it is most highly valued. For example, Bond and Samuelson (1986) argue that temporary tax holidays can act as an efficient signaling device: high productivity

[11]Note also that incentives may be ineffective precisely because they are small in magnitude. If so, the case for cooperation on these grounds is weak to begin with.

[12]In a recent empirical analysis of the effect of US state-level policies on the location of manufacturing investment, Holmes (1998) found that the share of manufacturing in employment in states with a pro-business regulatory environment increases by one third compared to a bordering state without one.

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

countries can signal their productivity to uninformed potential investors via tax holidays. It is rational for the country to make temporary tax concessions to an uninformed foreign investor since the initial loss in revenue can be recouped in the future: the investor is willing to tolerate high subsequent tax rates only in a high-productivity country. One possible interpretation of their argument is that competition for inward FDI among countries may help improve the allocation of capital across jurisdictions by ensuring that FDI moves to those countries where it has the highest social return.

The use of incentives for FDI is by no means restricted to developing countries. In fact, the absolute magnitude of such incentives is larger in industrialized countries, where they result from competition between jurisdictions within states. Of particular concern are incentive policies that reflect efforts by high income countries to retain or attract FDI that would be more efficiently employed in developing countries. Labor unions and groups representing the interests of local communities may oppose plant closures and efforts by firms to transplant facilities. Similar motivations underlie the use of trade policy instruments such as antidumping. It is important therefore to distinguish between locational competition which may be efficiency-enhancing and the use of investment and trade policies (such as antidumping) that alter the incentives for outward FDI. The latter policies are inherently inefficient in focusing on the protection of industries that are no longer competitive and inducing a variety of ancillary distortions that are well documented in the literature (*e.g.*, Finger, 1993).

The foregoing discussion suggests there may be valid reasons to question the rationale for a multilateral agreement that seeks to discipline incentives designed to attract FDI. If such incentives are ineffective, there are no real negative spillovers (although there are costs incurred by governments). If they are effective, a case can be made for subsidy freedom for developing countries. However, investment incentive programs in high-income countries to retain or attract FDI can de detrimental to developing countries, and provide a potential rationale for negotiation. It must be recognized that any agreement on this will be difficult to achieve and difficult to enforce, given that governments have multiple instruments at their disposal to attract FDI or to retain investment.

IV. Enhancing Policy Credibility *via* an Investment Agreement

It is sometimes argued that from a national perspective a multilateral investment

agreement may help countries enhance the perceived credibility of their FDI policies. For example, it is conceivable that countries of Central and Eastern Europe sought to conclude Association Agreements with the EU in part to overcome perceptions by foreign investors that they were countries where there was a high risk of policy reversals and policy uncertainty.[14] In order to assess the relevance of the credibility argument for an investment agreement, it is necessary to identify how much of what might be embodied in such an agreement can be pursued and implemented unilaterally. The experience of transition economies re-confirms that economic fundamentals are the crucial determinants of FDI. Some countries with Association Agreements have attracted very little FDI (*e.g.*, Bulgaria) in large part because privatization was not pursued with any vigor, the political environment was uncertain, and the macroeconomic policy such that inflation attained triple digits. The Czech Republic, Hungary and Poland have attracted significant FDI inflows, but it is unclear what role the investment provisions of the Association Agreements have played. A case can be made that fundamentals drove these inflows, including privatization, re-establishment of private property rights, and geographic proximity to Europe (especially Germany) (Hoekman and Djankov, 1997). Of course, at the margin, the investment provisions of the Association Agreements may have played a role in reducing investor uncertainty, leading to lower risk premia (Francois, 1999).

Many countries that seek FDI have made use of a variety of existing credibility-enhancing institutions. One such method is to commit to accept as binding arbitration of disputes under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID), by the International Chamber of Commerce (ICC), or by the UN Committee on International Trade Law (UNCITRAL),[15] depending on the preferences of the investor. Sometimes such commitments are also embedded in regional integration agreements (RIAs) such as the North American Free Trade Agreement (NAFTA). Furthermore, countries may also negotiate bilateral investment treaties with the major source countries of FDI.

Countries seeking to enhance their credibility with investors can also use the

[14]See Markusen (1998) for a discussion of the credibility case for an investment agreement; Francois (1997) and Fernandez and Portes (1998) for discussions of how international agreement may support credibility.

[15]An International Centre for the Settlement of Investment Disputes operates under the aegis of the World Bank to apply the Convention. The ICC has a Court of Arbitration. UNCITRAL has adopted a set of Arbitration and Conciliation Rules that can be used in the settlement of commercial disputes.

existing WTO disciplines (such as the GATS) to schedule policies that improve market access in services (including granting of the right of establishment), and choose to lock in low tariff regimes by binding these under GATT rules. There is still great scope for developing countries to use the WTO as a credibility enhancing instrument-the coverage of services commitments is quite limited, and tariff bindings for merchandise imports are often significantly higher than applied rates. Although credibility with respect to investment-related policies can certainly be pursued via a multilateral investment agreement, those governments that have a need to use external instruments to achieve such objectives could, or perhaps should, start by exploiting existing instruments much more fully. In other words, the question to be posed is how the option of signing on to a WTO investment agreement will help enhance credibility, given that there already exist agreements with respect to trade and investment in goods and services that can accomplish a similar, if not the same, task? Proponents of the credibility argument must believe that the *marginal value* of a multilateral investment agreement in enhancing credibility is substantial. Skeptics can certainly question whether this is indeed the case, given the limited use of the WTO to lock in policies, the existence of international arbitration, and the widespread use of BITs.[16]

V. Transactions Costs Arguments for Harmonization of FDI Policies

Policies toward FDI differ across countries and investors may be subject to idiosyncratic regulations. As a result, investors that need to establish presence in multiple jurisdictions are confronted with higher transactions costs than would be the case if there existed a harmonized set of global rules. As mentioned earlier, some 1,600 BITs are in force, and these differ across countries and country-pairs, so that foreign investors must contend with differences in the legal security offered by these instruments. Similarly, host governments are confronted with negotiating costs associated with having to establish a series of BITs with the major source countries. In such negotiations, industrialized country partner governments may seek to exploit their greater market power to shift the terms of trade to their advantage (*e.g.*, by insisting on

[16]Multinationals also have strategies at their disposal which reduce the ability of governments to renege on their policy commitments. See Janeba (2000) for a lucid analysis of how multinationals can install capacity in multiple countries and thereby generate tax competition for capacity utilization among the host countries.

provisions that are detrimental to the host country).

Clearly the need to negotiate BITs will give rise to transactions costs for firms and governments, but it is not clear how significant these costs are relative to the counterfactual situation of a global investment treaty. This issue is especially relevant if there are reasons to doubt the outcome of such negotiations, as there should be given the recent experience of the OECD. Furthermore, most BITs are rather similar in that they deal with ensuring non-discriminatory treatment for investors once they have established/invested, and address issues such as dispute settlement and arbitration. With the notable exception of BITs negotiated by the US, they do not generally address the question of improving market access. Even assuming that a global BIT would do the same, a case can be made for diversity, and letting countries design and negotiate BITs in an unconstrained way. This will ensure that host governments retain their freedom to reflect differences in national preferences and conditions. Given the existence of international institutions that provide arbitration services such as the ICC and ICSID, governments can decide unilaterally what the substantive rules should be, leaving enforcement to binding arbitration.

Regarding the costs imposed by the multitude of BITs on multinational firms, the major proportion of the transactions costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country. Familiarizing oneself with the investment laws of a country seems trivial in contrast to these more daunting challenges that exist regardless of whether the country is a signatory to a multilateral or a bilateral investment agreement. Thus, in our view, the transactions cost argument for harmonization of FDI policies is a weak one.

VI. The Grand Bargain Argument

The grand bargain argument is one of the raisons d'être of the WTO. In a nutshell, the WTO process allows countries to define a negotiating set within which a variety of potential tradeoffs and deals can be crafted that are superior in welfare terms to the status quo. Because countries are restricted to the equivalent of barter trade in multilateral trade negotiations, to achieve a Pareto superior (cooperative) outcome, issues must be linked. Determining when such linkage is necessary and designing globally-beneficial packages is a non-trivial task, given that this task must be accomplished in the face of rent-seeking lobbying (Leidy

and Hoekman, 1993).

In the FDI context, the grand bargain argument is quite simple-FDI policy is assumed to be a valuable negotiating chip for net capital importers (mostly developing countries). Insofar as governments are in a situation where domestic political constraints inhibit the abolition of inefficient restrictive FDI policies, using this chip comes at zero cost as a multilateral agreement can help the government move in the desired liberal direction. For most developing countries outward FDI (export of capital) is largely a non-issue. Thus, a good case can be made that the *quid pro quo* for accepting disciplines such as national treatment, MFN, and the right of establishment should be sought outside the investment area. Examples that have been suggested include antidumping and restrictive rules of origin (Moran, 1998). While this is a valid argument, it is not clear how valuable investment policies are as a negotiating chip for developing countries. Other policies are likely to be more powerful in inducing offsetting concessions from developed countries. Among these, further liberalization of trade under existing agreements (GATT and GATS) figure prominently. Much can already be (and will have to be) brought to the negotiating table by developing countries through utilization of existing WTO mechanisms and instruments. However, investment policies may prove useful at the margin, especially for large countries who can offer an attractive market. More generally, all developing countries stand to gain from any agreement that restricts the ability of high income nations to use FDI subsidies to retain or attract investment.

VII. Strengthening the Architecture of the WTO

The current architecture of the WTO is quite complicated: the WTO is an apex institution that oversees (embodies) three major multilateral agreements (GATT, GATS, and TRIPs), membership of which is mandatory, and several plurilateral agreements in which membership is voluntary. All three multilateral agreements focus on trade or trade-related policies. As is often emphasized in the literature, trade and investment have increasingly become complementary. This recognition is reflected in the WTO in various ways, perhaps most clearly in the GATS under which the definition of trade includes commercial presence (*i.e.*, FDI) as a mode of supply covered by the agreement. Furthermore, it may become increasingly difficult to maintain a clear distinction between trade in goods and trade in services, as technology may give producers the choice of delivering their products

in tangible or in disembodied (digitized) form. A priori, it would appear that any multilateral disciplines should apply equally to international transactions regardless of the mode of delivery.

A case can be made that WTO members may wish to develop disciplines that distinguish between trade and investment, with trade in goods or services being subject to a set of common rules, and movement of factors of production being subject to another set of rules. This in effect has been the approach taken in the NAFTA, which includes a separate chapter on investment (in goods or services), which is distinct from the rules relating to cross-border trade (in goods and services). Emulating this approach would result in much greater consistency and clarity of the applicable rules and disciplines.

The argument for making a distinction between goods and factors provides a compelling rationale for launching negotiations on FDI-related policies. An immediate implication of accepting this rationale is that movement of labor should also be put on the table. Purely from an economic viewpoint, the arguments for free movement of labor are no weaker than those for the free movement of capital.[17] Clearly, countries that play the role of *source* countries in the movement of capital will likely play the role of *host* countries in the movement of labor. A popular developing country perspective is precisely that if investment is to be put on the agenda of the WTO, why not also add the movement of natural persons ? This is clearly a difficult political issue. Even if there is a willingness to confront it, the implications of following such a path are far-reaching, as it requires a complete re-design of the WTO. Furthermore, the arguments involved would extend quite far from the usual political-economy considerations that figure prominently in liberalization of trade in goods and services. It is unlikely that industrialized countries will be prepared to far down this path, given the fact that the WTO has only just been created and that the issues involved become considerably more thorny once labor mobility is introduced into the mix.[18]

VIII. Towards a WTO Agreement on FDI-Related Policies ?

With the recent demise of OECD-based efforts to negotiate a Multilateral

[17]An optimal allocation of resources requires free mobility of capital and labor. Free trade in products can deliver the first best under factor price equalization, but not otherwise (Krishna and Panagariya, 1997).

[18]See Panagariya (1998) for arguments in favor of movement of natural persons being part of the negotiating agenda from the developing country perspective.

Agreement on Investment (MAI) which did not include developing countries (see Kobrin, 1998)-the WTO is the main game in town for those seeking to negotiate general rules on FDI, although some have argued in favor of the United Nation's Conference on Trade and Development (UNCTAD). Regional integration agreements (RIAs) are clearly an alternative, but are inferior instruments from a global perspective as they may distort the pattern of FDI flows (either by discriminating against investors located in non-members, or by creating incentives for FDI from any source to locate in a specific country).

Substantial stocks of inward FDI exist in most high-income countries, reflecting two-way FDI flows that occurred in the *absence* of any multilateral disciplines on FDI. This fact raises immediate questions regarding the relevance of a multilateral investment agreement. Of course, one can argue that FDI flows would have been still higher if multilateral disciplines had existed. Furthermore, the policy environment across the developed world is on the whole more uniform than it is across developing countries, so that the value of implementing common rules governing FDI in developing countries is potentially high. Here too one must note that, the absence of a multilateral investment agreement notwithstanding, FDI flows into developing countries have increased substantially in the last decade; they now attract some thirty percent of global FDI flows (UNCTAD, 1996). However, the distribution of FDI is very skewed, reflecting that what matters in terms of attracting FDI are economic fundamentals such market size, political stability, geography, natural endowments, an efficient infrastructure, good human capital, and liberal trade policies. An investment treaty will do little good for countries in attracting FDI if such fundamental requirements are not in place.[19]

Increasing access to foreign markets through FDI is not a priority issue for most developing countries. The important questions therefore are whether an agreement can help reduce or offset the political impediments that constrain the adoption of welfare-enhancing domestic policies and procedures towards FDI, and whether it can address international policy spillovers.

A. Restrictive Policies

The TRIMs agreement of the WTO does not address purely domestic policy

[19]Of course, not all of these will have to exist. A very large (potential) market can do much to compensate for inadequate infrastructure, and may make an investor less sensitive to trade policy (or even prefer protection).

regimes that raise the cost of market access or restrict establishment by foreign investors (including red tape). To be useful to countries that face difficulties in abolishing bad investment policies, the negotiation process for an investment agreement must allow issues to be brought to the table that are of sufficient interest to domestic constituencies so that they invest resources to fight for a better investment regime. Foreign pressure for market access may be enough in itself, but generally source country interest groups seeking such access will have to bring something to the table to motivate constituencies in host countries to assist them. The regional experience suggests that as far as developing countries are concerned it may not be easy to devise such an agreement-most RIAs do not go much beyond the WTO. The OECD's recent failure to obtain agreement among supposedly like-minded countries suggests the same conclusion: limiting attention to investment policies only can be a recipe for failure-the agenda needs to be broader to allow tradeoffs and issue linkages.[20] If so, a multilateral agreement might prove valuable to developing countries that confront difficulties in removing red tape unilaterally. The need for linkage and side-payments is of course greater if FDI policies are welfare-enhancing, as the required compensation then extends beyond what is required to mobilize domestic political forces to push through reforms.

That said, one can ask what deserves priority. From an economic perspective we would argue that priority should be given to the elimination of entry restrictions facing multinational firms producing nontradables. Such restrictions are mostly binding in service industries. As noted previously, red tape on inward FDI may be motivated in part by the existence of high trade barriers. If so, priority should be given to trade liberalization to facilitate imports. Liberalization of FDI restrictions and procedures is most important for non-tradables-mostly services. The key need therefore is to continue the process of multilateral liberalization of trade in goods and services, focusing particular attention on reducing the extent of discrimination by expanding the coverage of specific commitments for services markets under the GATS, which already covers investment as a mode of supply.

[20]Countries submitted long lists of derogations and exceptions to the general provisions of the proposed MAI. This reduced interest by the business community in the negotiation and was one reason for the breakdown of the talks. Another factor was that many non-governmental organizations (NGOs) were vehemently opposed to the MAI draft because they perceived it as giving too much power to foreign investors to contest host country regulatory policies that would have a detrimental impact on their investments through provisions on investor-State dispute resolution. See Kobrin (1998) and Vallianatos (1998) for discussion of the role of NGOs and their views; Henderson (1999) for a more comprehensive description and assessment of the MAI story.

B. International Policy Spillovers

Turning to the issue of international policy spillovers, a potentially strong argument in favor of a multilateral agreement is that it could help avoid mutually destructive policies from the viewpoint of developing countries eager to attract FDI. As noted previously, the economics of the negative spillover case is not that strong. A number of studies find that fiscal incentives have little, if any, impact on the location decisions of foreign investors. Even if one does not accept this conclusion-and clearly the jury is still out-it is not clear there is an international public good case for cooperation. Competition (non-cooperation) could be welfare improving for the world as a whole (Caves, 1996). Of course, one should be careful to distinguish the efficiency issue from the issue of transfer of rents: competition for FDI may lead to an efficient outcome but not be in the interest of the developing countries competing for such investment. The argument for policy coordination then amounts to collusion between developing countries in order to restrict transfers to multinational firms, and is therefore, on weaker grounds.

To be effective in disciplining the use of firm-specific fiscal incentives, any agreement arguably would need to be quite comprehensive. It would need to cover not only firm-specific investment incentives, but also taxation, competition regimes, and deal with the discrimination that is created by RIAs to ensure countries cannot side-step the disciplines on financial incentives through the use of such policies. The GATT/WTO negotiating and implementation history illustrates that agreement on subsidy and related disciplines is hard to obtain, and that disciplines are easily circumvented. Even RIAs such as the EU-which go much further than the WTO in this area-have encountered recurrent difficulties associated with government policies intended to attract FDI. NAFTA does not even try to tackle this issue, nor did the MAI.

IX. Concluding Remarks

Negotiating a WTO agreement on investment policies may prove useful in arriving at a grand bargain that extends to issues of particular interest to developing countries. The point is that if multilateral negotiations on investment policies are to assist governments seeking to liberalize or improve FDI policies, the negotiating agenda will have to include topics that are of sufficient interest to

the relevant domestic groups to induce them to support a pro-reform agenda. Limiting tradeoffs within the investment policy area is unlikely to be effective in this regard for most developing countries as they are primarily importers of FDI. Given an absence of FDI export interests, the necessary carrots lie outside the investment area. Developed countries with large stocks of two-way FDI should in principle find it easier to achieve gains from cooperation that is limited to FDI policies.

This grand bargain argument for putting investment on the WTO agenda must be considered carefully, as there may be significant scope for obtaining large returns in other areas as a *quid pro quo* for participating in an investment agreement. If countries are stuck with bad policies for political reasons, such that unilateral reforms cannot be implemented, there is also scope for gains on the FDI front. The same conclusion applies to an agreement that would discipline the use of incentives in high-income countries to attract and retain FDI. While these are all valid arguments for putting investment on the WTO agenda, in our view devising a grand bargain will be difficult. For one, account must be taken of the potential downside-issue linkage can be a two-edged sword. Efforts to expand the agenda may allow groups in society to seek cross-issue linkages in areas such as the environment or labor standards that could be detrimental to the original raison d'être of the WTO: to progressively liberalize international trade. Bhagwati (1998) has argued that this Pandora's box possibility provides a powerful justification for leaving general investment rules off the WTO agenda.

More generally, the failure of the OECD to reach an agreement on a MAI illustrates the practical difficulties that will affect the negotiations for an investment agreement. The diversity in the policy environment across countries creates significant room for skepticism regarding the success of such negotiations. If the OECD countries, with their much more uniform policy environment and similar goals fail to reach an accord, how can one expect developing countries that differ more substantially from one another to agree on a common set of principles regarding investment ? An important issue for developing countries-the use of OECD investment incentives-was left off the MAI table: no agreement could be reached to discipline such policies.

In our view priority should be given to the pursuit of trade liberalization to ensure that markets for tradable goods are contestable through exports. This should include efforts to liberalize access to service markets on a nondiscriminatory basis, an area where establishment (FDI) is often crucial. A

multilateral instrument to pursue this already exists. Continued nondiscriminatory liberalization of trade barriers for goods and services will also help reduce possible locational distortions for FDI resulting from RIAs and discipline the ability of countries to pursue strategic policies, as trade policy is a vital element of any such strategy (Hoekman and Saggi, 2000). While the elimination of trade policy as an instrument to transfer profits is in theory possibly detrimental to developing countries, in practice such policies are very difficult to design and implement. Any potential losses are likely to be more than offset by the efficiency gains from trade liberalization. Moreover, countries obtain compensation in a mercantilist sense as well, as trade liberalization in foreign markets will be obtained as a *quid pro quo*.

The fact that the GATS includes establishment as a mode of supply on which commitments can be made significantly weakens the economic case for making a stand-alone investment agreement in the WTO a negotiating priority. Once substantial further progress has been made to liberalize trade in goods and services on a nondiscriminatory basis, including market access through establishment in (nontradable) service activities, it will become much clearer whether the potential benefits of seeking general rules on investment policies are large enough to justify launching a multilateral negotiation in this area. While we support the applicability of general WTO principles such as national treatment, MFN, transparency etc. in the area of investment, our point is simply that such principles can already be implemented within existing agreements. The rather limited applicability of the national treatment instrument in the GATS suggests that this is not the appropriate time to consider launching negotiations on investment policies.

Although we are pessimistic about the need for and feasibility of-negotiating a multilateral agreement on investment at this time, the conclusion that new multilateral rules are not really needed is a positive one. It implies that governments can achieve much of what is beneficial unilaterally-including application of the principles of national treatment and MFN, and adoption of the right of establishment in national law. It also implies governments do not have to invest resources to negotiate in (another) new area and can instead use existing institutions and mechanisms to liberalize access to markets. Over time, the architectural argument in favor of common disciplines for trade in goods or services, and common rules relating to the treatment of foreign factors of production, will become stronger. The more

trade barriers and barriers to establishment in services are reduced in the interim, the greater will be the feasibility of undertaking a general overhaul of the WTO.

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