The Regulation of International Trade
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A third issue arises from the interaction of the emerging international environmental law with respect to biodiversity and international intellectual property law. One dimension of this issue that is not yet explicitly addressed by international legal rules is the use of patentable technology that exploits genetic resources found in nature in developing countries; there is a concern that these resources themselves be protected as intellectual property, so that the contribution of farmers and local communities to their conservation can be compensated. A report of the WTO Trade and Environment Committee appears to take the view that nothing in the TRIPs Agreement would prevent a Member from requiring that a user of these resources provide compensation for their use. Thus, while a Member would normally have to grant a patent on an innovation based on use of genetic resources in nature, it could decide to restrict access to the resources themselves in its domestic law. Yet it is foreseeable that some kinds of restrictions (particularly onerous ones) might be seen as a circumvention of TRIPs rights with respect to patent protection itself. In general, however, we tend to support the Trade and Environmental Committee's reading of the TRIPs Agreement - a right to unrestricted access to genetic resources in nature would amount to a claim to be able to patent, and use exclusively, the resources themselves, which is clearly not provided under the TRIPs criteria for patentability.

CONCLUSION

While trade theory provides little basis for mandating uniform standards of intellectual property protection across all countries, intellectual property rights is an issue that is here to stay on the international trade agenda. The Uruguay Round TRIPs Agreement, while at the level of general principle promoting a uniform approach, in fact allows for a balance to be struck between countries' legitimate interests in limiting intellectual property rights for consumer welfare and economic and social development reasons, and the interests of their trading partners in sustaining adequate incentives for innovation. Maintaining this balance through monitoring and dispute settlement will be a major challenge for the World Trade Organization.
States, that traditionally complained about illiberal attitudes elsewhere towards foreign investment. As well, increased interest in foreign investment in Japan by nationals of other major industrialized countries, especially the United States, has focused attention on a range of domestic policies and practices in Japan that (including competition policies that provide few constraints on domestic cross-ownership of enterprises) supposedly create obstacles to foreigners wishing to acquire business assets there.

The issue of foreign investment is closely linked to the role of multinational corporations in the global political economy. Some see such corporations as powers unto themselves, capable of buying or intimidating governments, or at least with the capacity to spread production and other functions around the globe so as to exploit regulatory differences between states – taking advantage of one country's cheap labour, another's tax haven, and yet another's favourable rules on intellectual property, and perhaps creating a race to the bottom. Others view the multinational corporation as a logical and desirable extension of the inherent logic of comparative advantage, combining the benefits of organizing production within a single firm with the gains from free trade.

Much of the contemporary controversy over foreign investment has surrounded measures that aim not to exclude investment but to direct it in a manner that benefits the economic development of the host country. In fact, measures aimed at channelling foreign investment to benefit the economies of host countries actually challenge two of the major assumptions that have traditionally underpinned hostility to foreign investment and the multinational firm: first and most obviously that foreign ownership is necessarily harmful to development; and second, that developing countries are powerless to determine the way in which foreign firms exploit their productive resources. Also of significance are incentives to attract foreign investment, such as tax holidays or subsidies. Indeed, incentives are often used in conjunction with export performance or local sourcing requirements, and may have the effect of offsetting some or all of the disincentive effects of such restrictions or conditions on foreign investment.

As will be described in the next section, in a world completely free of restrictions on the movement of goods, services, and capital, any measure that distorts the global allocation of productive resources would be world-welfare reducing from the perspective of neo-classical economic theory. However, within the GATT, the focus of attention has been on investment measures that have direct effects on trade in goods, such as measures that require or encourage foreign-owned firms to discriminate between domestically produced and imported inputs in production in the host country (local content requirements), as well as measures that require that a certain percentage of the foreign firm's output be exported. The investment provisions of the Uruguay Round Final Act would subject some investment measures with direct effects on trade to more explicit scrutiny against existing GATT norms. These are relatively modest disciplines on investment disincentives and incentives in comparison with those found in the Canada–US FTA and the NAFTA, both of which include a National Treatment obligation with respect to foreign investors, as well as a general right to invest (right of establishment) subject to certain limitations and exceptions. Finally, the equivalent of a right to establishment is also entrenched in the OECD Code of Liberalisation of Capital Movements (1991) and a National Treatment obligation with respect to foreign investors is contained in the OECD 1976 Declaration on International Investment and Multinational Enterprises.

FOREIGN INVESTMENT AND TRADE THEORY

The theory of comparative advantage outlined in Chapter 1 shows the gains to both domestic and global economic welfare from specialization of each country in the production of those goods in which it has a comparative advantage. However, most goods – including Ricardo's classic examples of wine and cloth – can be understood as composites of other goods and services. It is unlikely that a country that has an overall comparative advantage in the production of a particular good also has a comparative advantage with respect to all the inputs required to produce the good in question. To return to Ricardo's example, England's comparative advantage in cloth may arise from the skill of its weavers, and in fact Portugal may have a comparative advantage in the production of wool or cotton; similarly, Portugal's comparative advantage in wine may arise from the quality of its grapes, and would not exclude English comparative advantage in the production of wine-making technology. In such a case, it may still make sense for Portugal to make wine and trade it for English-produced cloth, but it will also make sense for Portugal to export its cotton or wool to England and for England to export wine-making technology to Portugal.

Such an outcome need not, of course, lead to any foreign investment. Wholly Portuguese companies may make wine with technology produced by wholly British companies. However, just as it may make sense to produce domestically a good through internalizing different activities required for production within a given firm, rather than through contracts between discrete individuals or firms, so too it could make sense for Portuguese vineyard-owners to purchase British producers of wine technology, or for the British producers to buy Portuguese vineyards. According to the modern theory of the firm, production will be organized within a given firm where the agency costs of internal contracting between the firm's owners, agents, and employees are lower than the costs of external contracting between independent producers or providers of each component or element required to make the final product. The rapid growth in intra-firm trade over the last few decades testifies to the economic logic of transboundary internal contracting.

Increasingly, the production of complex goods may entail both cross-boundary internal and external contracting. For instance, many of the activities required to produce an automobile may be subsumed within a given auto-maker, which in turn will locate production facilities globally in order to maximize comparative advantage, but other important components will be obtained through external contracting with both domestic and foreign firms. Nicolaides suggests that there may be some archetypal cases where cross-boundary
internal contracting will occur, rather than in addition to external cross-boundary contracting (trade): the multinational company (MNC) exists precisely because it is not easy to trade intangible assets in open markets. It is difficult, for example, to write contracts for experience and newly-developed technology which is in the process of being adapted for commercial applications. The reasons that encourage corporate integration are that production costs are reduced, information flows faster and actions of individual units are more effectively coordinated. Some of the reasons for engaging in foreign investment as opposed to or in addition to external contracting may be endemic to, or particularly salient to, the international context. For instance, the greater difficulty in enforcing external contracts across borders may lead to increased agency costs of contracting. As well, intellectual property and related laws in other countries may provide inadequate protection of firm-specific innovations or knowledge, leading to a reluctance to transfer these to domestic firms through arms-length external contracts (e.g. licensing arrangements or direct sale of technology or processes).

Dunning has analysed a vast literature on the theory of the multinational firm and the globalization of production, and has developed what he calls an 'eclectic' theory, which emphasizes a wide range of factors, including transportation and wage costs, greater suitability of internal contracting to the development and dissemination of firm-specific technology and processes, and hedging of the political risk of locating in a single country in a volatile world environment. In many respects, this pluralistic approach is quite consistent with contemporary views on the nature of comparative advantage in trade, which take into account a wide variety of factors that may determine the comparative advantage or disadvantage of a particular country, including dynamic factors that change with changes in governments’ domestic policies, technologies, consumer preferences and other rapidly evolving domestic and international realities.

**ECONOMIC RATIONALES FOR GOVERNMENT INCENTIVES AND DISINCENTIVES TO FOREIGN INVESTMENT**

Do the combined insights of the neo-classical theory of free trade and the modern theory of the firm suggest that economic welfare could actually be increased by government incentives or disincentives with respect to foreign investment? In a world where (apart from background rules of contracting) government action does not influence the allocation of productive resources, markets themselves should generate optimal levels of foreign investment. In such a world, government intervention would, almost by definition, distort the allocation of productive resources, inasmuch as disincentives reduced the level of investment below the market optimum, or incentives increased the level above that optimum.

A number of important qualifications to this view have been proposed by trade scholars and merit serious examination.

For example, according to one prominent theory of industrial competitiveness—that of Michael Porter and his associates—much economic development is attributable to the creation of 'clusters' of industries in a given country or region. Clusters are groups of industries that are interdependent or complementary. According to Porter, many industries develop in response to the needs of other industries within a particular region or country. Most firms form part of an industry cluster in their home base—they have developed over time a complex web of relationships with suppliers and customers, including suppliers who have incurred sunk costs in developing or adapting products and services to the needs of the particular firm. When a firm establishes operations abroad, it or its foreign subsidiary, is likely to continue to source many inputs from the firm's 'home base', thus failing to help build a cluster in the host country. On this view, local content or sourcing requirements may have desirable domestic welfare effects, if they can effectively counter the 'home base' bias identified by Porter, and lead to the development of functioning clusters in the host country.

In addition, host-country local content requirements, or local hiring and manufacturing requirements, may offset the cumulative effects of subsidies or other governmental measures in the 'home base' of the investing firm. The pressures to source in the 'home base' may come less from the market than from government. These pressures may be informal, as well as formal. Formal pressures would include subsidies linked to job creation in the domestic economy and local content requirements in 'home base' government procurement contracts. More informally, the perception that a firm is a good local 'corporate citizen' may be viewed as important in effectively lobbying 'home base' governments on a wide variety of regulatory matters of concern to the firm, whether environmental standards, labour policies, or taxation issues. Often, the treatment a firm receives from its 'home base' government may be linked to the perception and reality that the firm really 'belongs' to that country.

Finally, it may make sense to impose special burdens or requirements on foreign firms where these firms are able to elude more general or neutral forms of redistributive regulation. For instance, multinational corporations, especially those characterized by high levels of intra-firm trade, may find it easy to manipulate transfer pricing so as to avoid taxation on actual earnings in a foreign country. Many developing countries, in particular, do not have the sophistication in the design and enforcement of corporate tax regimes required to counter effectively this kind of conduct. As well, manipulation of transfer pricing may allow a multinational corporation to 'cheat' on tariff restrictions by significantly underpricing imports of inputs. Seen as a response to this kind of behaviour, local content or sourcing requirements may be viewed as a substitute for ineffective tariff protection.

These various considerations do not, admittedly, add up to a decisive argument in favour of local content and related requirements, which may have negative consumer welfare and allocative efficiency effects within the host country. This does, however, weigh against any kind of general assumption that trade would be undistorted, or less distorted, in the absence of such requirements.
Investment and trade protection

There is a complex interaction between foreign investment and trade protection. First of all, foreign investment may occur as a means of jumping tariff walls or avoiding harassment of imports under the trade remedy laws of the host country (so-called 'cooperative protectionism'). If much of its comparative advantage is portable, consisting of know-how, processes and technology, a company may avoid border restrictions simply by manufacturing within the domestic market. Enhanced access to host country markets generally ranks high among the factors that industries cite as reasons for foreign investment.21

Protection-avoiding foreign investment has both opportunities and risks attached to it. One such opportunity is the strategic use of tariffs or, more likely, administered protection, to encourage foreign investment. Where a tariff (or other trade protection) induces a foreign producer to relocate production facilities to the protecting state, new jobs in that state are created, and in fact there is a possibility of shifting some of the foreign firm's comparative advantage itself to the host country. For instance, when Honda or Toyota sets up production in Canada or the United States, it brings with it the processes, know-how, and so forth, that arguably constitute much of its comparative advantage.

It is important, however, to note that in one important sense consumers in the protecting state will still be worse off than under conditions of liberal trade, because the foreign firm that does relocate will be able to price up to tariff or other trade barriers (e.g. VERs), thereby still charging consumers prices higher than would be the case without trade restrictions.

A simple example will illustrate this point. A and B are both foreign car manufacturers who have been exporting cars into C. A and B both produce a mid-sized car that would sell, in the absence of protection, for £6,000 and C's consumers are indifferent as between the car produced by A and that produced by B. Assume that a tariff of 30% is imposed on imports and an elasticity of demand for this kind of car that results in two-thirds of the tariff being passed on to the consumer in higher prices. If A and B both export their cars to C, C's consumers will pay £7,200 per car. If A starts to produce the car in C, and comes inside the tariff wall it may be able to underprice B while still earning more than the non-tariff price per car. As long as consumers are indifferent between A's car and B's, A will be able to outcompete B at any price below £7,200. The end result will be somewhat less of a consumer welfare loss than if both A and B's cars are imported and subject to tariffs, but consumers will still be somewhat worse off than they would be if there were no protection.

At the same time, because some of the rents of protection have been shifted from domestic firms to the foreign firm producing domestically, this may compensate in whole or in part for additional costs incurred in shifting some production to the importing country, including compliance with export performance, technology transfer or other requirements imposed by the host-country government. A disturbing implication, especially for consumer welfare, is that the higher the amount of protection, the more attractive the shift of production is, because the rents from protection that accrue to the domestically-producing foreign firm are correspondingly higher.22

The dynamic effects of foreign investment in protected markets

In reality, when foreign firms have come within a tariff wall, they have often found it to be something less than a safe haven. Domestic firms are apt to petition government for relief from the increased competition, frequently arguing that the foreign plants are little more than screwdriver operations aimed at circumventing tariffs or other border restrictions, and that they create less employment per car sold, for instance, than domestic firms, which source domestically to a greater degree and thus create jobs in a wider range of sectors that produce inputs. As a consequence, once inside the tariff wall, foreign firms may well find themselves confronted with new obstacles to exploitation of the domestic market. A prominent example of this has been the effort of the European Union to limit the market share of cars manufactured by Japanese producers within Europe, claiming that these are not really European automobiles.23 Quite commonly, local content requirements are imposed upon the foreign firm.

At one level, such ex post adjustments of the 'bargain' between the protecting country and the foreign firm could be viewed as opportunism — once it has sunk substantial costs in the creation of factories or other production facilities, the foreign firm may have little choice but to stay. On the other hand, it is arguable that domestic welfare is improved by such measures — some of the rents from protection against competing foreign firms that accrue to the investing firm are clawed back in the form of boosted sales for domestic providers of inputs.

In theory, there are losses in allocative efficiency since otherwise uncompetitive manufacturers of inputs are being kept in business. However, in the case of inputs for some complex products, arguably the effect is to transfer comparative advantage to input providers as well. Where a firm is unhappy with the quality of domestic inputs but must use them to circumvent the tariff wall through foreign investment, it may still be in the firm's interest to produce locally but also to work with domestic input providers on quality control, making their products genuinely competitive with imported inputs.

Alternatively (or additionally), the host country may find a way of increasing the rents from protection to compensate the investing firm for the costs of complying with new local content or local sourcing requirements. Quotas and VERs, because of their discriminatory potential, are a simple way of increasing such rents. In return for local content requirements, for instance, a foreign car manufacturer producing domestically could be offered larger quotas on models that it continues to produce offshore. Consumers will benefit from the increased quota (a larger supply will result in somewhat lower costs), but will of course not benefit as much as when quotas on all imported cars in a similar category or competing for the same market are increased or at the limit eliminated. Conversely, the foreign firm with the increased quota benefits from greater sales, but at the same time loses
fewer of the scarcity rents than it would if the supply of its foreign competitors' comparable products were also increased.

The dynamics of the relationship between trade protection and foreign investment described above have broader implications that should dampen the enthusiasm of advocates of strategic protection. First of all, a clear consequence is to reinforce the dominant position of the strongest firms in a given industry, thereby reducing global competition. In order to play the game, a firm must be large enough and have sufficient resources to expand production globally, investing large amounts of capital in new production facilities. Second, in the host country, a whole new set of jobs is created that, in effect, depends upon continued protection. If comparative advantage has genuinely been transferred to the host country, of course it may still make sense to continue production even after the removal, or reduction, of protection. But the closing of American branch plants in Canada, and their relocation to the United States, that has occurred in the wake of the Canada–US Free Trade Agreement, is a powerful reminder that jumping the tariff wall may remain a decisive consideration in a plant's continuing operation in the host country. Arguably, as well, this suggests that if protection is to be used to induce foreign investment, then it is important to attach conditions that actually assure a real transfer of comparative advantage (such as requirements for reinvestment and renewal of the plant, training of workers, and technology transfer).24

NON-ECONOMIC RATIONALES AND EFFECTS OF INVESTMENT POLICIES: SOVEREIGNTY AND THE FOREIGN FIRM

The discussion so far has focused exclusively on economic and trade policy dimensions of foreign investment measures. Traditionally, however many of the reasons for which states have imposed restrictions on foreign investment have been connected with political arguments about sovereignty. These arguments concern a wide range of specific harms that are believed to flow from ownership of a country's productive resources by foreigners. They include national security and defence considerations; the supposed difficulty of subjecting foreign or multinational firms to domestic jurisdiction; concerns that foreign investors or foreign firms will become a vehicle for inappropriate influence by their home governments on politics and society within the host country; and concerns about the protection of cultural autonomy or distinctiveness.25 We will briefly consider several of these preoccupations with the potential drawbacks of foreign investment.

Defence and national security

A traditional dictum of security policy, at least since Machiavelli,26 is that no state should rely on others to furnish the weapons needed for its own defence. Nevertheless, the global arms trade flourishes, and only a handful of relatively industrially advanced nations are capable of manufacturing sophisticated weapons systems in any quantity.

The concern about having one's own arms often extends to autarchy with respect to the inputs necessary to produce those arms, whether steel or computer chips. For instance, as Japan and some European countries have become world leaders in the development and manufacture of products and technologies considered to have critical defence applications, the United States has become increasingly concerned that it may be placing its vital security interests in the hands of foreigners. This concern has been deployed as a rationale for trade protection to sustain uncompetitive national industries considered vital to the security of the United States. It has also resulted in measures intended to control foreign ownership of productive assets in the United States. The United States has justified prohibitions or restrictions on foreign investment in many sectors on national security or related grounds (i.e. vital national interest). These sectors include: air transportation, coastal shipping, commercial fisheries, communications, energy resources, and real property.27

In 1988, an amendment was added to the Omnibus Trade and Competitiveness Act (the Exxon–Florio Amendment, named after the US legislators who proposed the bill providing the President of the United States with the authority to block mergers or acquisitions involving foreign firms on grounds that US national security interests would be impaired by the resulting foreign ownership.28 The Committee on Foreign Investment in the United States (made up of representatives of various agencies in the US government, including the State Department, the Defense Department, the Commerce Department and the office of the United States Trade Representative) is given the authority to conduct investigations of mergers, acquisitions and takeovers that may threaten US national security. On the basis of these investigations, the Committee makes recommendations to the President as to whether national security interests justify blocking a transaction or altering its terms. Until recently, at least, there have been few investigations, and even fewer instances where the result has been Presidential intervention in a transaction.29 Nevertheless, the need to avert the threat of such intervention may, in a wider range of cases, lead to various 'voluntary' undertakings by the potential investor, making the terms of the investment more favourable to American interests.30 However, as Graham and Ebert note,31 there is strong pressure in Congress to make investigation of proposed investments mandatory, at least with respect to some sectors.

Does foreign ownership of strategically-sensitive enterprises really jeopardize security? First of all, if in fact foreign producers do have a monopoly over products or processes that are vital to a country's security interests, the country in question is certainly better off having those products or processes developed within its borders. Dependency on imports is much riskier since a foreign government can, in effect, control the export of the needed materials. In a national emergency, by contrast, domestic production facilities (even though foreign-owned) could be commandeered by the government, or made directly subject to its orders.

What, however, of the case where there currently exist two suppliers of a given
technology or product, one domestic and one foreign, and where the foreign supplier chooses to buy out the domestic supplier? Here, the acquisition may be motivated by the desire to obtain a monopoly, and in fact could result in all production, or much of it, being moved offshore. In such an instance, it may be quite justifiable to weigh carefully national security implications within any overall review of the impact of such an acquisition.

In addition, foreign firms in the defence sector are likely to have particularly close relationships with their home-country government – often reflected in the presence of former politicians and senior bureaucrats on their board of directors, government subsidies, procurement and R&D contracts, or partial government ownership. Where this is the case, some concern that foreign powers will be able to exercise influence or control over the firm’s strategy, and have privileged access to its products or research, may be warranted. Again, however, this concern would be justified mainly where a merger or acquisition results in a monopoly in a particular product or process.

In the instances just discussed, national security concerns may in fact be warranted with respect to foreign investment. However, in the United States in particular, the national security argument has been extended far beyond the case of very sensitive defense industries to sectors that produce a wide variety of inputs into military products, or whose production facilities might, in war time, need to be converted to military uses (steel, cars, civil aircraft). In most of these instances, a variety of producers, domestic and foreign, currently exist. Taken to its logical conclusion the argument would end up justifying something close to complete autarky, since there are few sectors of civilian production that do not contribute something of importance to the materiel needed, in the broadest sense, to sustain an all-out war effort.

Furthermore, blocking a foreign takeover or merger will itself be far from guaranteeing either the continuation of a domestic source of supply for the products in question or protection against foreign influence. For example, where the merger or acquisition is required to rescue the domestic firm, or to ensure its continuing viability, the alternative may well be bankruptcy, with the result that the foreign firm becomes the monopolist anyway but produces abroad, and hence the source of supply becomes even more insecure. Hence, in a number of instances, one suspects that national security arguments against foreign acquisitions are disguised attempts to attract a government supported bail-out at home, or more protection. Once the firm is considered a domestic producer vital to national security, the logical consequence is not just that foreigners should be prevented from acquiring it, but that its survival as a domestic firm should be guaranteed by the state.

**Inadequate regulatory or political control over the foreign investor**

The multinational firm is often described as a kind of power unto itself, able to slip through the normal control of national jurisdictions through the global diffusion of its activities. There are few inherent legal constraints on the application of domestic jurisdiction to the activities that multinational corporations engage in within a particular country; however, there may be significant practical constraints, where the bulk of the firm’s assets and much of the information about its activities and decision-making are located abroad. Of course, while it is true that offshore activities and decisions of a foreign multinational may affect the regulatory interests of its host country, so may the foreign activities and interests of the host country’s own firms. Thus, the problem concerns both inward and outward foreign investment.

In some sectors the regulatory issues may be particularly acute. In the case of financial services, for instance, regulators may be concerned with the overall stability of an institution, the quality of its investments, etc. Ultimately, domestic deposit holders are dependent upon the stability of the overall institution, including the soundness of its lending practices and other activities abroad. As is illustrated by the Bhopal disaster, regulatory issues may also arise where multinationals are engaged in high-risk activities in a host country, but where they retain elsewhere the assets necessary to satisfy potential liabilities for these risks, or information about the risks.

These kinds of regulatory issues may justify some kinds of differential treatment of foreign investors – the requirement to carry liability insurance, to maintain a minimum level of assets within the host country, or to post a bond or a deposit to guarantee regulatory compliance.

**Extraterritoriality**

Another set of concerns about foreign investment may be considered the 'mirror image' of the concern about lack of domestic control of the foreign-owned company or subsidiary, that is, the possibility that foreign ownership will result in the extraterritorial application of the laws and regulatory authority of the firm's home country to its activities in the host country. Extraterritoriality has been particularly a concern raised by the explicit extraterritorial sweep of a number of US regulatory regimes. One important example is export controls. The United States has sought to prevent foreign subsidiaries of American firms from exporting products to countries that are embargoed by United States law, such as Cuba. From the perspective of the law of the GATT, this can rightly be seen as an interference with the trade relations of another Contracting Party. However, export controls based upon national security considerations are explicitly exempted from normal GATT rules by Article XXI, although, it is highly questionable whether even Article XXI provides scope for a Contracting Party to interfere with exports and imports flowing between another Contracting Party and a third state.

It bears emphasis that extraterritoriality is not a problem that is limited to the context of foreign investment. Ownership by nationals is but one basis among many that the United States, for instance, uses as grounds for exercising jurisdiction beyond its borders. For instance, US antitrust law is applied extraterritorially not just to American-owned companies, but to any activity that materially affects United States commerce, including for example participation of foreign-owned firms in cartels with US firms that restrict competition in the US market.
The most promising avenue for resolving problems of extraterritoriality is not restrictions on investment, but the evolution of multilateral processes to deal with particular cases of conflicting exercise of jurisdiction, and eventually to evolve a set of detailed principles or guidelines broadly consistent with international law norms on state sovereignty. In this regard, it should be noted that a 1991 Decision of the OECD Council allows any Member State of the OECD to refer to the Committee on International Investment 'any problem arising from the fact that multinational enterprises are made subject to conflicting requirements'. With respect to extraterritorial application of antitrust laws, the OECD has developed a separate process intended to address directly issues of restrictive business practices and the multinational enterprise. A number of constructive approaches to inter-jurisdictional conflict have been suggested, including harmonization of domestic competition laws and designation of a lead jurisdiction for review of international mergers.

In addition to the matters discussed above, developing countries have traditionally had an additional (although often overlapping) range of concerns about foreign investment, which have been used to justify severe restrictions on the activity of foreign firms. These have included concerns that foreign investors often will deploy technologies that are inappropriate for exploitation of and development of local skills for best advantage, that may aggravate or create balance of payments problems by heavy reliance on imported inputs in the production process; and that foreign investors will perpetuate existing patterns of Southern dependency in exploiting cheap, unskilled labour in developing countries without transferring the skills and technologies required for economic development.

On balance, the recent empirical evidence seems to suggest that foreign direct investment has had a positive impact on growth and development in LDCs. It appears that a comparative basis developing countries with relatively restrictive policies towards foreign investment have experienced much lower rates of economic growth over the last 30 years than those (e.g. Malaysia) with relatively open policies. However, it may be that what distinguishes, at least in part, the countries with more open policies, is that instead of placing general (and severe) restrictions on, for example, repatriation of earnings or the right of establishment as such, these countries negotiated specific agreements on issues like technology transfer and local employment with individual firms. Thus, instead of adopting either a generally negative stance towards FDI, or a completely open attitude, they proceeded in a more selective fashion to impose requirements or conditions on some foreign investors, where it was believed this would serve the interests of domestic economic development. This case-by-case approach, however, is more transaction-cost intensive and heightens the risk of corruption in the administration of foreign investment policies.

This being said, in the aftermath of the LDC debt crisis (which has resulted in substantial reduction of new debt financing available to many developing countries) and given what many observers consider to be a world shortage of capital (considering, for instance, the substantial needs of the Newly Liberalizing Countries in Central and Eastern Europe), many developing countries have adopted a much more liberal attitude towards foreign investment, and see the issue for governmental policy much more as that of attracting foreign investment rather than restricting or limiting it. This led The Economist magazine to remark, in a recent survey of multinationals, that too many governments see foreign investment as a shortcut to prosperity, bringing in skills, capital and technology to push their countries rapidly from the 1950s to the 1990s. Those governments that rely too heavily on multinationals are likely to look for a foreign scapegoat when inflation heads for triple figures, unemployment fails to drop and demonstrators surround the ministry.

The impact of the Mexican Peso crisis of 1994–5 and the crisis in Asian capital markets in 1997 on FDI suggests that this prediction of The Economist was overly pessimistic. These crises involved massive outflows of portfolio equity investment, but neither crisis has led to a devastating impact on FDI flows or the FDI climate in the affected countries. A joint report of the International Chamber of Commerce and UNCTAD notes: ‘total portfolio investment flows to Mexico fell from $12 billion in 1994 to $7.5 billion, with portfolio equity investment flows falling from $4.5 billion to $0.5 billion in 1995. FDI inflows, in contrast, which had more than doubled in 1994, fell by only 13% in 1995. With respect to the Asian crisis, the report notes: ‘The financial crisis in East and South-East Asia has involved a sharp decrease in private external capital flow to some developing countries in the region. . . . FDI flows in 1997 to the five most affected Asian countries as a group, however, are estimated to have remained close to the level attained in 1996.’ The report entitled a survey of almost 200 major transnational corporations operating in the region concerning how the crisis would affect their future plans; the vast majority responded that their confidence in the region as an investment destination had remained unchanged. One concern, however, is that in the wake of the crisis some countries might impose restrictions on the ability of investors to purchase domestic company assets at ‘fire sale’ prices. In general, however, the crisis has not resulted in a reversal or rethinking of the trend towards liberalizing FDI regimes. In fact, in dramatically illustrating the dangers of reliance on external bank lending and portfolio equity investment to finance economic growth, the crisis may actually reinforce positive attitudes towards FDI.

**ALTERNATIVE APPROACHES TO INTERNATIONAL DISCIPLINE OF FOREIGN INVESTMENT MEASURES**

**The pre-Uruguay GATT**

**Investment measures and the General Agreement: an overview**

Our discussion in 'Foreign investment and trade theory' and 'Economic rationales' (this chapter) has emphasized the complexity of the relationship between foreign
investment measures, liberal trade and protectionism. The dramatic expansion in foreign investment in recent years has depended heavily on liberal rules governing trade in goods, yet this expansion has also provided new opportunities and incentives to exploit the rents from protection, thus leading to new kinds of protectionist pressures. At the same time, the interdependencies created by the globalization of production have brought into being new interests that would lose enormously from a fundamental unravelling of the liberal trading order.

As a matter of law, only a few of the investment measures that can be deployed strategically along with trade protection arguably fall within the ambit of the GATT. The most clear-cut example is that of local content or sourcing requirements, which explicitly discriminate against imports and in favour of like domestic products, hence violating the National Treatment obligation of the GATT (Article III:4). Export requirements are a somewhat more complicated case. As will be discussed below, a GATT panel decision with respect to Canadian foreign investment measures held that export requirements did not per se violate any provision of the General Agreement. However, as we will argue, export requirements linked with a subsidy to the foreign investor may in some circumstances constitute an export subsidy, the only kind of subsidy explicitly banned in the General Agreement (Article XVI). Export requirements may also lead to dumping, inasmuch as they lead to the product being exported below cost or at a price lower than that which applies in the domestic market.

In addition to local content and export requirements, the law of the GATT may be violated by trade balancing requirements, which typically limit the value of what a foreign investor is allowed to import into the host country to the value of exports. Here, two sets of provisions in the GATT are relevant. First of all, the limitation on imports might be considered, like a domestic sourcing requirement, as a form of discrimination against imported goods. However, it might be argued that this need not be the result, since with a trade balancing requirement (unlike a direct local sourcing requirement) a foreign firm wishing to import more inputs will be permitted to do so if this is balanced by an increase in exports of finished products (and, as we have just mentioned, export requirements are not as such illegal under GATT). A stronger case can be made that trade balancing restrictions violate the Article XI ban on quantitative restrictions, as they place (albeit variable) quantitative limits on imports. Because Article XI bans restrictions on exports as well as imports, a prima facie violation of Article XI might also occur where the host country places limits on the percentage or amount of production that it can export, i.e. requiring that a portion of the production be set aside for the domestic market. Such a requirement might be imposed where, perhaps for technology transfer reasons, a country wishes domestic users to have access to what is being produced by the foreign firm. The requirement might go hand in hand with an additional provision that the percentage of production in question be made available to domestic users for local currency or at a lower than world market price.

Additional investment measures that implicate GATT law are requirements that foreign investors re-invest a percentage of earnings within the host country and, conversely, limitations on the repatriation of profits in convertible currency. In the former communist countries (of which several were long-standing GATT Members) such requirements were commonplace, and they still exist today in many developing countries. Arguably, both re-investment requirements and limitations on the repatriation of profits could constitute violations of Article XV of the GATT, which requires Contracting Parties to adhere to IMF rules with respect to balance of payments and exchange arrangements. However, as has been discussed in detail in Chapter 3, these rules allow considerable scope for developing countries to restrict foreign exchange, including exchange of local earnings into foreign currency. In addition, it should be noted that trade-balancing requirements or other investment measures that would otherwise be in violation of Article XI of the GATT may nevertheless be saved by Article XII, which permits some, mainly non-discriminatory, quantitative restrictions where necessary to address a balance of payments crisis. Although the drafters clearly had temporary measures in mind, Article XII has been used to sustain much longer-term restrictions. In addition, Article XVIII: 9 explicitly authorizes a broader range of quantitative restrictions — including discriminatory quantitative restrictions — where these are measures undertaken by developing countries to protect or enhance their balance of payments.

The FIRA Panel Decision

The FIRA Panel Decision represents the only case where foreign investment measures were the central focus of a panel prior to the WTO, and therefore deserves detailed analysis. At issue were various undertakings obtained from foreign investors pursuant to Canada’s Foreign Investment Review Act. The Act established a governmental agency, the Foreign Investment Review Agency, to screen investment proposals by foreign interests. The Agency was to review the proposals and either accept, reject, or modify them. The essential criterion was whether the investment would be of significant benefit to Canada, significant benefit being defined to include increases in employment and exports, technology transfer, and advancement of "national industrial and economic policies". Under the Act, foreign investor applicants were able to make undertakings with respect to any aspect of the operation of their business in Canada, with a view to more favourable treatment of their application. Such undertakings were not, however, mandatory or a formal prerequisite for the success of an application. Once an investment application was approved, however, the undertakings were legally enforceable.

The United States argued that three kinds of undertakings violated provisions in the GATT: local content, local manufacturing, and minimum export.

Local content and local manufacturing requirements

With respect to local content requirements, the main argument was that these undertakings violated Article III:4 of the General Agreement (National Treatment). Given that the undertakings were not formally required by the Canadian law, a threshold issue was whether they could be considered, for purposes of Article
III, as 'laws, regulations, or requirements'. The United States argued that such undertakings could not be viewed as simply voluntary, since no firm would make them unless it would gain some advantage or avoid some penalty by doing so. The panel, however, sidestepped the issue of voluntariness, simply stating that 'private contractual obligations entered into by investors should not affect the rights which contracting parties, including contracting parties not involved in the dispute, possess under Article III:4'.

A second issue was raised by the Canadian argument that these undertakings merely constituted predictions of what foreign investors intended to do based upon commercial considerations.

The panel rejected this argument, pointing out that the specific content of some of the undertakings showed that firms were expected to act in a manner not consistent with commercial considerations or in explicitly discriminatory terms, for instance binding themselves always to purchase a Canadian product when available on similar terms to an import. The panel's approach seems justified in light of the economic analysis developed earlier in this chapter. Because the foreign firm producing domestically can capture rents from protection by pricing up to the tariff, there are good reasons to believe that commitments investors make about how much local sourcing they will undertake are not simply in the order of a prediction about how they will behave in future in accordance with market forces, but also reflect a 'price' investors are willing to pay to capture some of the rents of protection.

A further important issue raised by the economic effects of local content or local manufacturing undertakings is that of injury. The panel chose to sidestep this issue, noting that 'under standing GATT practice, a breach of a rule is presumed to have an adverse impact on other contracting parties (para. 6.4). It is not obvious that foreign investors who make undertakings are worse off under a scheme for screening foreign investment than under circumstances where investment is impeded. As discussed earlier, the rents from protection that a foreign investor gains from coming within the tariff wall (i.e. from being able to price up to the tariff) may be substantial, and may more than compensate for the costs of compliance with domestic content or other performance requirements. Also, such requirements may in some situations be balanced with explicit subsidies or other incentives to investment (such as tax holidays). There is clearly, however, a trade-related injury from local content and local manufacturing requirements that is borne by producers and suppliers of imported goods that would otherwise compete favourably with locally produced imports. These producers may, of course, include the foreign investor itself, or other firms from its 'home base' country – but they may be entirely from other countries.

Thus, it is incorrect to conceive of the debate over the trade effects of these measures as simply a conflict between host country and home country interests. Even though developed countries are more likely to be home than host countries, developing countries or other countries that are not major sources of foreign investment still can lose significantly from investment restrictions in the nature of local content requirements, if the result is discrimination against their exports.

Export performance requirements

The FIRA panel also considered the legality of export performance requirements under the GATT. The United States had argued that these requirements violated the obligation in Article XVII:1 of the GATT for certain enterprises to act 'in accordance with commercial considerations'. The panel found that this obligation only applied to state-trading enterprises as defined in the general provisions of Article XVII, and therefore was not relevant to foreign investors. However, the panel also found that 'there is no provision in the General Agreement which forbids requirements to sell goods in foreign markets in preference to domestic markets. In particular, the General Agreement does not impose on contracting parties the obligation to prevent enterprises from dumping' (para 5.18).

Here, the panel seems to have overlooked the spirit (although perhaps not the strict letter) of the prohibition of export subsidies in Article XVI:2 B of the General Agreement. The panel's general position – that undertakings are not made gratuitously but in exchange for a benefit that flows from the host country government to investor – would argue in favour of the view that in fact export undertakings are likely to be subsidized, at the very least by the rents from protection that the host government 'grants' to the investor in authorizing the investment. Article XVI:4 B, furthermore, prohibits Contracting Parties from granting 'directly or indirectly any form of subsidy' on exports, at least where the result is a lower price for exports than the domestic price of the product.

The case for deeming export performance requirements as equivalent to an export subsidy is, of course, particularly strong where an investor is attracted to the host country by explicit financial incentives to establish operations there. However, at the same time, the GATT rules on subsidies do not refer explicitly to investment incentives as such. Some such incentives may constitute countervailable subsidies under the WTO Subsidies Agreement, but only because domestic products are being subsidized, not because of the impact of such subsidies on the location decisions of foreign firms.

The evolution of the GATT rules: TRIMs and the Uruguay Round

Clearly, the GATT rules extend only to a relatively narrow range of investment measures with direct and immediately identifiable impacts on trade. In the Uruguay Round of GATT negotiations, the United States in particular sought a much more comprehensive GATT code on investment based upon the principle of free access to foreign markets. On this free access approach, the investment measures disciplined by the GATT would no longer be limited to measures such as local content requirements that discriminate against imported products, but would extend to a potentially vast range of domestic policies of Contracting Parties that create barriers to in-bound foreign investment regardless of whether specific trade impacts are present. The free access approach, it should be noted, gains some normative weight from the allocative efficiency arguments for liberal investment
policies explored in ‘Foreign investment and trade theory’ (earlier in this chapter). These imply that, in principle, almost any incentive or disincentive to investment can be regarded as a distortion of the optimal global allocation of productive resources. However, under real world conditions of imperfect competition and tariff and other trade restrictions, important qualifications exist on these allocative efficiency arguments – qualifications explored earlier in this chapter. In addition, the free access approach provides no obvious means of weighing against allocative efficiency considerations the non-economic rationales for investment restrictions discussed above in ‘Non-economic rationales’ (this chapter).

Unlike the United States, most other Contracting Parties were sceptical of the free access approach, and saw the task of the Uruguay Round negotiations on TRIMs as that of developing more detailed and explicit rules with respect to measures that appear inconsistent with well-established GATT principles, such as National Treatment with respect to products. This suggests a cautious extension of the kind of analysis undertaken by the FIRA panel to a somewhat broader set of measures (such as trade balancing requirements or export performance requirements) that directly affect trade flows. A concrete example will elucidate how the much more comprehensive US view of what is trade-distorting conflicts with the more text-bound view of other Contracting Parties. The US views technology transfer requirements as distorting trade, in that a possible result is to transfer to the host country the capacity to develop products and processes that it would otherwise have to import from the home country. Other countries question whether this impact is very well established: it might be the case, for instance, that absent such a transfer, some developing countries would not be able to afford such products and processes at all, and therefore that imports would be negligible.

The Uruguay Round Final Act reflects a rather subtle compromise between these differing perspectives. On the one hand, there is a binding obligation not to apply any investment measures ‘inconsistent with the provisions of Article III or Article XI of the General Agreement’ (Article 2(1)). There is thus a clear reaffirmation of the principle that existing GATT provisions do apply to some investment policies. Moreover, an ‘illustrative list’ of such measures is provided, which includes local content, sourcing, and some trade balancing requirements (which violate National Treatment) and import and export restrictions (which violate the ban on Quantitative Restrictions, in Article XI of the General Agreement).

On the other hand, the illustrative list does not contain any of the measures with more indirect or questionable effects on trade for which United States negotiators had been seeking explicit disciplines, such as technology transfer requirements. In addition, the existing exceptions with respect to Article XI that apply to developing countries are re-affirmed (Article 4). As well, developing countries are provided with substantial transition periods (five years and seven years in the case of the least-developed countries) for elimination of TRIMs that offend Article III and/or Article XI (Article 5).

However, it should also be noted that the illustrative list is just that – the text leaves it open for GATT panels to find that measures not on the list violate the GATT, and in addition, the fact that no list of ‘green light’ or explicitly non-GATTable measures is provided, means that no further protection is extended to Contracting Parties against unilateral retaliatory action by the United States on the basis of its market access approach. Indeed, additional legitimacy could well be conferred on the US approach in that the Final Act provides for a five-year review of the provisions on TRIMs, possibly with a view to including new provisions on ‘investment policy and competition policy’ (Article 9). The Final Act Agreement on Trade Related Investment Measures also calls for the creation of a Committee on TRIMs whose functions are, inter alia, to ‘monitor the operation and implementation of’ the Agreement. In the Indonesian Autos case (not appealed), the panel held that the TRIMs Agreement has ‘an autonomous legal existence’ from the GATT (para. 14.62). It also held that the Agreement could apply to performance requirements that were a condition for receipt of subsidies, even if the subsidy measures themselves might be covered by the Agreement on Subsidies and Countervailing Measures – (paras. 14.47–14.55). The panel further found that the local content requirements could be covered by the TRIMs Agreement, even if these requirements, or the advantages conditioned upon meeting them, were not targeted at foreign investors, but rather generally applicable to enterprises, whether domestically or foreign-owned (para. 14.73).

The NAFTA

Articles 1102 and 1103 of NAFTA, respectively, establish National Treatment and MFN obligations with respect to investors and investments of other NAFTA Parties. National Treatment is required with respect to establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments. Thus, in effect, the National Treatment obligation embodies a right of establishment. These obligations may be subject to various reservations and exceptions, listed in various Annexes to the NAFTA (especially Annexes I–III) and in the case of Mexico include measures related to the following sectors: transportation, telecommunications, petrochemicals, the postal service, professional services, and social services. Canada and the United States, however, have also included reservations with respect to some of these sectors in Annex II, in some cases out of specific policy concerns and in others simply to preserve reciprocity or symmetry between the obligations of Mexico and its NAFTA partners. Where not reserved, existing non-conforming measures must be eliminated within ten years.

In addition, there is a general provision in the introductory section of Chapter 11 stating that nothing in this Chapter shall be construed to prevent a Party from providing a service or performing a function such as law enforcement, correctional services, income security or insurance, social welfare, public education, public training, health and child care in a manner that is not inconsistent with this Chapter (Article 1101.4). This reflects Canadian as well as Mexican concerns that some provisions of the Investment Chapter, particularly the right of establishment, could be interpreted as providing to private investors of other NAFTA partners a right to compete in areas that are characterized by complete or substantial public sector provision in Mexico and Canada, but where some or all of delivery is provided by the private sector in the United States. One may question,
however, the legal significance of this clause, since it protects only those measures that are *in any case* ‘not inconsistent’ with the provisions of Chapter 11, and thus does not override the application of Chapter 11 to public provision of essential services. In addition, on its terms, the clause only seems to apply to direct governmental provision: thus, once a government begins contracting out some of these functions, even to the non-profit sector, it might be required to permit a direct business presence in that sector by private interests in other NAFTA countries, on a National Treatment basis. The effect may be to deter governments from innovative experiments with delivery through non-governmental actors such as non-profit community groups, for fear of losing adequate scope for regulatory control or being required to allow competition on essentially commercial criteria.

The NAFTA prohibits various kinds of performance requirements, including minimum export, domestic content, domestic purchasing, and technology transfer requirements (Article 1106(1)). The prohibition on technology transfer requirements is somewhat qualified by the fact that requirements for the domestic conduct of Research and Development and training of workers are explicitly permitted (1106(4)). The NAFTA does not discipline investment *incentives*. From an allocative efficiency perspective, it is just as undesirable to encourage a higher level of investment than would occur on the basis of market forces alone, as to discourage investment that would occur on the basis of such forces alone – thus the failure to discipline incentives is a major defect of the NAFTA Investment Chapter. However, Article 1106(3) provides that some of the requirements listed in Article 1106(1) cannot be stipulated as *conditions* for the receipt of subsidies, which may discourage to some extent the use of investment incentives.

The NAFTA provides some protection for investors from non-NAFTA countries who already have substantial business activities in the territory of one of the NAFTA Parties. These investors from non-NAFTA Parties are to enjoy the full rights of NAFTA country investors if they choose to expand their activities into the territory of another NAFTA Party (Article 1113.2). Thus, for example, a German-owned company operating in Canada that wishes to engage in business activities in the United States would be entitled to the same benefits of the NAFTA as would be a Canadian-owned company operating in the United States.

Article 1110 of NAFTA prohibits ‘direct or indirect’ expropriation of an investment unless certain criteria are met. These are: that the expropriation be for a public purpose; undertaken on a non-discriminatory basis; in accordance with due process; and with payment of full compensation at market value. As Jon Johnson notes, the NAFTA lacks a definition of *expropriation*. The American view of the meaning of expropriation is deeply influenced by the ‘regulatory takings’ doctrine in US domestic law, under which, in some circumstances, changes in general laws and regulations that affect the value of property may be considered as *expropriation*, thus triggering some right of compensation, even if title to property is in fact retained. While as Johnson correctly notes, in interpreting this Article of NAFTA ‘the relevant body of law is international law and not the domestic law of any Party’, he also acknowledges that ‘international jurisprudence on the subject of taking versus regulation is not nearly as well developed as

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Canadian or U.S. jurisprudence. In 1997, a challenge to a Canadian environmental law was launched by a US investor under Article 1110 of NAFTA, claiming that a ban on the importation and inter-provincial transport of a gasoline additive which is a neurotoxin and also interferes with anti-pollution devices in automobiles (MMT). The investor, the Ethyl Corporation, which manufactures MMT, claimed that the ban amounted to an ‘expropriation’ and sought $350 million in damages but eventually settled the case for a lower amount. Ethyl was able to take the Canadian government to arbitration due to what is arguably the most innovative feature of the NAFTA investment provisions – the establishment of investor-state dispute settlement processes based on arbitration according to international arbitral rules, in particular those of ICSID, the International Convention on the Settlement of Investment Disputes. The NAFTA Parties consent to submission to arbitration of investment disputes under Chapter 11, at the request of the private investor itself. This makes NAFTA the first comprehensive international trade treaty to provide to private parties direct access to dispute settlement as of right.

The Codes of Conduct approach: negotiating the rights and responsibilities of multinationals and sharing the costs and benefits of foreign investment

A third approach to international discipline of foreign investment measures is embodied in the various multilateral and bilateral Codes of Conduct that have been negotiated between states as well as between states and multinational firms themselves. The Codes of Conduct generally aim at striking an explicit balance between concerns of investors (compensation for expropriation, repatriation of earnings) and concerns of host countries about the conduct of foreign firms (whether corruption and bribery, avoidance of domestic regulatory and tax regimes, or unfair labour practices). In return for commitments of ‘fair treatment’ from the host country the firm commits itself to behave there as a good corporate citizen. Reflective of this approach are the 1976 OECD Guidelines for Multinational Enterprises and the United Nations Draft Code on Transnational Corporations, as well as Guidelines for Investment developed by international business groups such as the International Chamber of Commerce for inclusion in negotiated agreements between multinationals and individual countries.

One attractive feature of the Codes and Guidelines is their inherently pluralistic character, involving an explicit balance of economic and a variety of political, ethical, and social concerns in the regulation of foreign investment. Another, often cited advantage with respect to some Codes and Guidelines is that they result from a multilateral process where there is a relative equality of bargaining power between large and small countries, and between the developed and developing world. This is particularly true of instruments developed within the UN system, including the UN Draft Code on Transnational Corporations.

Often, however, the language of these instruments reflects a high level of generality and diplomatic vagueness. They therefore often provide very limited
guidance for the resolution of specific disputes or conflicts. For instance, an obligation to abstain from bribery is specific enough, but what of the obligation on multinationals by the OECD Guidelines "To take fully into account established general policy objectives of the Member States in which they operate?" How would one go about determining whether this vague obligation had been sufficiently complied with by a particular foreign investor? Despite their voluntary character, and the vagueness of many of their prescriptions, the Guidelines have been credited with improving channels of communication between multinational corporations and host country governments (as well as local trade unions) in OECD countries. Implementation of the Guidelines is monitored by the OECD Committee on Investment and Multinational Enterprises (CIME), which however does not serve the function of settling specific disputes between multinationals and host governments. The CIME does issue 'clarifications' of the Guidelines, and these 'clarifications' are usually triggered by specific disputes which involve disagreement about the meaning of the Guidelines.\(^{59}\)

In contrast to the Guidelines, two other OECD instruments contain strict substantive commitments by OECD Member States with respect to liberalization of investment measures. The OECD Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisibles contain specific disciplines on measures that impede the flow of capital between OECD Member States.\(^{60}\) Cumulatively, these disciplines are viewed by the OECD as the equivalent of a right of establishment.\(^{61}\) The Codes of Conduct are legally binding on OECD members. A commitment to National Treatment of foreign investors is contained in Article II of the OECD Declaration on International Investment and Multinational Enterprises (1976). Unlike the Codes, the Declaration is not binding in international law. Subsequent Decisions of the OECD Council (which are binding) have, however, required that Member States lodge with the OECD any exceptions to National Treatment in their national policies. Such exceptions are to be examined by the CIME at regular intervals (at least once every three years) with a view to "making suitable proposals designed to assist Members to withdraw their exceptions."\(^{62}\) In addition, any member country "which considers that its interests may be adversely affected by significant official incentives and disincentives to international direct investment" by another member country may demand consultations in the CIME "to examine the possibility of reducing such effects to a minimum."\(^{63}\) The National Treatment commitment in the Declaration is subject to "needs of member states" to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security.\(^{64}\) Member States are, nevertheless, required, for transparency purposes, to notify to the OECD measures that may be justified on these terms.

In contrast to these OECD instruments, most multilateral investment codes, especially those concerned with investment relations between developed and developing countries, only become effective through explicit or implicit understandings between host countries and individual multinational corporations. This is the case, for example, with the UN Draft Code on Transnational Corporations. Here, all the inherent difficulties of inequality of bargaining power between developing and developed countries - supposedly redressed in part through multilaterally-developed Codes - return as countries and firms bargain as to what sub-set of rights and obligations will be adopted and complied with in these explicit or implicit bilateral understandings.\(^{65}\) At the same time, some observers have noted that the Codes of Conduct have succeeded in influencing the settlement of some investment disputes through private litigation, due to the willingness of judges and arbitrators to invoke them as interpretative aids or sources of guidance on matters of international economic policy.\(^{66}\)

An attempt to remedy the problem of inequality of bargaining power, at least in part, is reflected in the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States (ICSID).\(^{67}\) ICSID provides a vehicle by which host countries, home countries and multinationals can agree to submit investment disputes to third-Party arbitration. ICSID responds both to the concerns of developed country foreign investors that they may not be fairly treated in the domestic legal processes of host countries and to the parallel concerns of the developing countries about investment disputes being adjudicated in, for example, American or British courts (as would often be provided in the choice of forum clause of an investment agreement, at the insistence of the developed country investor). While a variety of bilateral investment treaties and agreements between host countries and multinationals provide for arbitration through the ICSID process, it has rarely been resorted to in order to resolve investment disputes, for reasons that are not entirely clear.\(^{68}\) ICSID's future may now, however, be somewhat brighter by virtue of the incorporation of the ICSID arbitration process into the dispute resolution provisions of the NAFTA Chapter on investment. Finally, inasmuch as principles in the codes end up being part of bilateral, reciprocal bargains that strike a balance of interests between investors and host countries, they present the same kind of danger as any managed trade, bilateral reciprocity-based approach to liberalization. The balance of interests struck may ignore effects of investment measures on third countries (e.g. import substitution effects) with a global welfare perspective being lost sight of entirely.

At the same time, these dangers may be somewhat attenuated through the development of general norms of international law with respect to compensation for the expropriation of the property of foreign nationals and extraterritoriality, as well as more specific regimes that deal with inter-jurisdictional dimensions of corporate taxation or antitrust policies. As discussed earlier in the chapter, these matters are matters that loom large in investment relations between states, but overlap with other international and domestic regimes not specific to the foreign investment context.

**THE MULTILATERAL AGREEMENT ON INVESTMENT (MAI)**

**Background**

As noted earlier in this chapter, negotiations on investment in the Uruguay Round failed to yield a result even approaching a comprehensive set of rules on foreign
direct investment, the Uruguay Round TRIMs Agreement being little more than an affirmation and modest strengthening of the status quo of the 1947 GATT, particularly as interpreted in the FIRA panel ruling. This failure of the Uruguay Round (at least from liberal trade perspective) was often attributed to the recalcitrance of developing countries. Not long after the completion of the Round, thinking in Western trade policy circles began to turn to alternative venues and mechanisms for achieving a set of comprehensive liberalizing commitments on investment. This thinking suggested that among an increasing number of countries there was (in the words of one advocate) 'a convergence of attitudes' about the relationship of investment policy to the interests of the regulatory state, i.e. in the direction of economic liberalism. Among this expanding group of like-minded countries it would be easier to achieve agreement on far-reaching investment rules, beginning with already developed countries and soon extending to Newly Industrializing Countries, and then to others competing for foreign investment, which would not be able to afford not to go along. In 1995, thinking along these lines was reflected in an OECD Report to Ministers, which proposed the negotiation of a Multilateral Agreement on Investment within the OECD forum, but open to accession to non-OECD countries prepared to accept its strictures. The timing and venue could partly be justified on the rather benign grounds that the existing OECD Liberalisation Codes (discussed earlier in this chapter) required renewal, and one could build from these existing instruments towards a comprehensive agreement. Various drafts were produced from 1996 through April 1997, all of them reflecting a general architecture (including National Treatment, MFN, and Dispute Settlement) but all of them also with gaps and alternative texts indicating important areas where consensus was elusive. We have chosen to base our analytical overview of the initiative on the last draft text, indicating its relationship to some of the earlier versions, and also where agreement remains elusive, and so the text is bracketed or alternative wording are presented, neither or none of which has yet attained a consensus. In early December 1998, the MAI negotiations were formally halted.

An Introduction to the draft MAI text

The draft Multilateral Agreement on Investment has at its core the principle that governments must not discriminate against, or among, foreign investors from countries that have signed the Agreement – the obligations of National Treatment and Most Favoured Nation, respectively (Article III, 1–3). These obligations are subject to certain general exceptions, as well as reservations to be filled by individual signatories, which are in turn governed by the principles of standstill and (possibly) rollback. Standstill signifies the notion that any measures reserved may not be more restrictive of investment than existing measures. Rollback connotes the idea that, over time, countries' reservations will be subject to an ongoing process of scrutiny, and (hopefully) negotiated removal.

The rules on performance requirements in the draft MAI are quite similar to those in NAFTA – minimum export, domestic content, and domestic sourcing requirements are all prohibited (it will be recalled that these last two kinds of requirements were already found to violate the GATT by the FIRA panel, an approach reinforced by the illustrative list in the Uruguay Round TRIMs Agreement). More controversially, especially in light of the potential adoption of this text by developing countries, the draft MAI contains a prohibition on technology transfer requirements as well, except as a competition law remedy. Initially, it was intended that the MAI would also cover, in addition to requirements, investment incentives, which would have been a major advance over NAFTA. However, disagreement on how to do this proved intractable, with some Parties objecting to any meaningful disciplines. Therefore, the draft MAI text is silent on these measures.

In some areas, such as movement of key personnel, the MAI goes appreciably beyond NAFTA in securing a liberal investment regime. In other areas, such as protection of investments against 'expropriation' and dispute settlement, there are important issues to resolve, issues which however are already present in the NAFTA in a not dissimilar form. Finally, the interface between MAI obligations and legitimate domestic policies in areas such as environment and culture – and the relationship between liberal investment and labour rights – was not resolved.

The movement of key personnel

One of the areas in which the MAI has made significant progress is with the movement of key personnel. To support the globalization of production, it is important for multinational enterprises to be able freely to exchange managers and specialists between entities in different countries for efficient deployment of human capital. While the notion of key personnel is not always precisely defined, most OECD countries have national laws that contain special provisions relating to the temporary entry of this category of foreign personnel. Regulations affecting visas, residence and work permits remain part of the country's immigration policy, which is strongly influenced by the country's national political and economic considerations. However, a recent OECD survey points out that despite any potential immigration problems that may arise, most members recognize that the 'ability to quickly and easily move key personnel between countries is an important element of investment decisions, technology transfers as well as research and development activities of MNCs. Nevertheless, key employees are still put through tests and procedures which may adversely affect firms' competitiveness or investment flows. There have been some attempts – in other investment instruments – to address the issue of key personnel. For example, the NAFTA sets out commitments by its three members to facilitate on a reciprocal basis, temporary entry into their respective territories of business persons who are citizens of Canada, Mexico or the United States. As noted elsewhere in this book, each NAFTA country maintains its rights to protect the permanent employment base of its domestic labour force, to implement its own immigration policies and to protect the security of its own borders. The NAFTA categories are rather broad – business visitors, traders, intra-company transferees and certain categories of professionals – which provides
NAFTA members with a great degree of flexibility. Thus, NAFTA has in many ways been able to strike the difficult balance of broadening the category of key personnel while maintaining sovereignty in the area of immigration. For example, the United States and Mexico have agreed to an annual numerical limit of 5,500 Mexican professionals being allowed to enter the United States. While the provisions of this agreement are quite innovative and far reaching, the obvious limitation of this treaty is the number of its members. In devising the MAI, the OECD has borrowed ideas from this treaty and extended its breadth to encompass all of its members.

The MAI reflects a 'wider' and 'deeper' conception of the notion of key personnel. First, this agreement will apply to all of the Contracting Parties of the MAI. Although, each Contracting Party has made a number of reservations, there is an overall consensus on the importance and necessity of such a provision in the treaty. The agreement demonstrates respect for state sovereignty in that the key personnel provisions remain subject to the application of Contracting Parties' national laws, regulations and procedures affecting the entry, stay and work of natural persons. At the same time, however, this agreement has broad application, with its scope extending to groups such as investors seeking to provide essential technical services to the operation of an enterprise to which the investor has committed, employees working in the capacity of an executive, manager or specialist, and spouses and minor children of these 'key personnel'.

**Investment protection**

The OECD subcommittee studying the broad issue of investment protection, concluded quite early on in the negotiating process, that additional protection under an MAI may be of limited interest to MNCs unless it goes beyond the parameters established in existing instruments and domestic laws. This includes finding a definition of investment expropriation that is as broad as possible, namely, 'all measures adopted by a state whether direct or indirect that have the effect of depriving the investor of its investment'.

A major concern with this broad approach to expropriation is that it could conceivably lead to investor claims against signatory states where regulatory changes, whether in environment, safety, other areas, negatively affect the value of the investment. This could make regulatory reform extremely costly, but is an interpretation of the meaning of expropriation quite common in US domestic takings jurisprudence. As noted above, under a similar provision in NAFTA, a US investor obtained a multi-million dollar damages on the grounds that a ban on international and interprovincial trade in a substance that it produces in Canada constitutes 'expropriation'. Language was apparently agreed, subsequent to the publication of the most recent working draft, to deal with this issue. Thus, it was proposed to include the following qualification in the Investor Protection provisions of the MAI: 'the MAI will not inhibit the exercise of the normal regulatory powers of government and the exercise of such powers will not amount to expropriation.'

**Dispute settlement**

The 24 April 1998 Draft of the MAI contains provisions on both state-to-state and investor-state dispute settlement (earlier versions had dealt only with investor-state processes).

In the case of state-to-state dispute settlement, the procedures are clearly modelled on the kind of dispute settlement reflected in trade agreements such as the WTO and NAFTA. If a Party has failed to resolve its dispute with another Party by consultations, after a 60-day period it may request the establishment of an arbitral panel, which is to be appointed by agreement between the Parties to the dispute within 30 days of a request for consultations. In the absence of agreement between the Parties, the Secretary General of the OECD may intervene to name the panelists. Other Member States ("third Parties") may make oral or written submissions to the panel, and are entitled to access to documents pertaining to the proceedings, with the exception of designated 'confidential and proprietary information'. The panels may also consult technical and scientific experts. Unlike the case with the WTO, arbitral panels are to be given explicit authority to grant pecuniary compensation or even restitution in kind (this last remedy being subject to the consent of the Party against which it is made). A right of appeal to another panel is also contemplated, on grounds such as corruption, that the panel manifestly exceeded its jurisdiction, or that 'the award has failed to state the reasons on which it is based'.

With respect to investor-state dispute settlement, MAI provides investors with a right to arbitration in accordance with various international commercial arbitration regimes, including ICSID (on which NAFTA investor-state dispute settlement is based), UNCITRAL, and the International Chamber of Commerce rules.

The arbitration rules that apply to investor-state dispute settlement under the MAI contemplate a secret process, where neither the pleadings, nor the hearing before the arbitrator, nor the reasons for decision are public unless permitted by both Parties. This practice might be entirely appropriate in the kind of commercial disputes between private Parties for which arbitration was originally designed, or even in investor-state contexts where what is at issue is, for example, the interpretation of a contract between the state and an enterprise. None the less, it seems highly questionable where arbitration is being used to interpret public international law, in whose meaning many Parties have a stake. Also, many of the issues surrounding interpretation of the MAI are likely to pertain to the relationship of investor rights to domestic public policies - thus there are important democratic concerns about the absence of publicity and transparency. The 24 April draft attempts to address this in several ways. First of all, third Party rights of intervention are created for investor-state dispute settlement - the arbitral tribunal is required to notify the Parties Group (the institution overseeing the MAI compromised of all its Member States) of its formation, and 'may give to any Contracting Party requesting it an opportunity to submit written views on the legal issues in dispute, provided that the proceedings are not unduly delayed thereby'. This being said, there is no requirement that such an opportunity be provided, and the Parties
activists obtained a confidential version, and began circulating it to like-minded
groups, using the Internet as an effective dissemination tool. In April 1997,
accounts of the MAI began to appear in the popular press, and governments were
placed on the defensive to justify their negotiating positions to the public at large.87
Some of the groups in question had unsuccessfully challenged the Canada–US
FTA and the NAFTA, often making grossly exaggerated and hypothetical claims
about the damage likely to flow from these agreements to the social welfare state.
With the MAI, their approach was shrewder and more careful. They linked a
more general critique of globalization driven by corporate interests with a highly
plausible analysis of specific provisions of the draft MAI, or omissions from it,
as well as a critique of the way it was negotiated. While many groups took different
and overlapping positions, the thrust of the overall attack is well expressed by
Tony Clarke and Maude Barlow:

We do not wish to leave the impression that we reject the idea of a global
investment treaty. We are well aware that transnational investment flows have
been accelerating at a rapid pace and that there is a need to establish some
global rules. But the basic premise on which the draft versions of the MAI
have been crafted is, in our view, largely flawed and one-sided. It expands the
rights and powers of transnational corporations without imposing any corre-
sponding obligations. Instead, the draft treaty places obligations squarely on
the shoulders of governments. . . . Meanwhile the MAI says nothing about the
rules that transnational corporations must follow to respect the economic,
social, cultural, and environmental rights of citizens.88

However much the rhetorical tone of this attack may reflect an unjustified
conspiratorial or even paranoid view of transnational corporations, its substance
could be defended on the basis of concrete features of the negotiating texts (espe-
cially the earlier versions). While, as discussed in an earlier part of this chapter,
the OECD had promulgated voluntary guidelines for the conduct of multina-
tional enterprises, the MAI allowed such enterprises to sue governments, but not to be sued in
kind based upon the breach of behavioural norms contained in the Guidelines.
The secrecy surrounding the negotiations and the usual cloak and dagger behav-

ior by foreign ministries when faced by early enquiries about the course of the
negotiations, gave prima-facie credence to a conspiratorial view of the whole
undertaking. The fact, noted above, that the draft MAI did not contain an
environmental or health and safety exception even comparable to that existing in
the 1947 GATT lent credibility to the notion that only the interests of capital were
reflected in the Agreement. With respect to the provisions on investor protection,
a powerful legal case could be made that the definition of expropriation might
extend to regulatory changes that affected the value of an investor’s assets, thereby
holding legitimate regulatory activity of national governments hostage to huge
compensation payments to foreign investors.89 The fact, noted above, that just
such a claim had been made in the Ethyl case with respect to environmental
regulations under a comparable provision of the Investment Chapter of NAFTA,
The regulation of international trade

lent an air of reality to this legal interpretation. The secrecy of investor-state dispute settlement (partly addressed, as noted above, in the very latest draft), combined with the secrecy of the process itself and the failure to provide any democratic control on corporate activity to make the case that there was a serious democratic deficit.

In the wake of this public controversy, a number of governments responded by indicating that their final approval of any MAI text would be conditional on the Agreement addressing concerns of this nature. In a valiant effort to preserve or regain momentum in the negotiations, the Chair of the negotiating group succeeded in putting together a package of proposed amendments on labour and environment, which has been annexed to the 24 April draft. It is claimed that a ‘large majority’ of the negotiating Parties ‘expressed support for the overall approach and believed that it could be a basis for future work’ (footnote 1). Among the proposals is a provision that states: ‘A Contracting Party may adopt, maintain or enforce any measure that it considers appropriate to ensure that investment activity is undertaken in a manner sensitive to health, safety or environmental concerns, provided such measures are consistent with this agreement’ (Para. 3). This is a highly unsatisfactory provision, since the main issue is in fact that of exempting measures that would otherwise be inconsistent with the Agreement – it is useless to state that Parties may take environmental measures consistent with the Agreement, since any measure consistent with the Agreement is in any case ipso facto permissible. A similar proposal with respect to labour rights or standards suffers from the same fundamental defect. With respect to expropriation, the language is slightly more satisfactory, stating that the MAI does not establish ‘a new requirement that Parties pay compensation for losses which an investor or investment may incur through regulation, revenue-raising and normal activity in the public interest undertaken by governments’ (para. 3). Even here, however, the qualification ‘new’ creates a difficulty – it refers to the existing international law baseline concerning expropriation, which is far from clear, and therefore does not shut the door to arguments that existing international law requires compensation for ‘regulatory takings’.

While activist groups have recently been given credit or blamed (depending on the perspective of the observer) for ‘killing’ the MAI, informed sources close to the negotiations had been predicting failure long before a public debate on the draft MAI was provoked. As noted, the initiative to proceed with evolving investment rules in the OECD was based on the premise (often unstated) that developing countries had been the main obstacle to the achievement of a comprehensive TRIMs agreement in the Uruguay Round, and that without them consensus would be much easier to reach. In fact, before public controversy became intense, differences of views among OECD countries about culture and labour rights were already surfacing. As well, concern about the Helms–Burton legislation, led to a number of proposals concerning extraterritoriality and conflicting requirements, which would have surely met with total rejection by the United States. Further, the removal of investment incentives from the coverage of the Agreement represented a major disappointment for some negotiating Parties. The MAI negotiations are, in fact, an illustration of the fallacy that agreement is likely to be easier when negotiations are limited to a smaller group of countries, with supposedly more comparable economic systems, discussed in Chapter 5 of this book.

Of course part of the MAI strategy – an essential part – was that developing countries would be invited to accede to the MAI, and that those who were seeking to attract FDI would find themselves unable to agree not to. However, the rapid growth in FDI, including and especially inflows to developing countries, cited earlier in this chapter shows that investor confidence is not dependent upon adherence to this kind of agreement. Moreover, the notion of simply signing up these countries betrays a naive view of the accession process, as is well illustrated by attempts to ‘extend’ NAFTA to other countries in Central and Latin America. In any Agreement such as the MAI, any accession is likely to involve country-specific reservations, that will potentially change the balance of concessions in the overall agreement. Also, the proposed accession of a country to this kind of agreement is unlikely to take place without affected economic and other interests raising issues about the commercial policy as well as environmental and labour rights performance of the country in question.

Another major difficulty with the MAI as a self-standing treaty, noted even by some of the more insightful and cautious supporters of global investment rules, such as Pierre Sauve and Ed Graham, is the relationship of such a Treaty to overlapping existing multilateral rules as reflected in the GATT, and the WTO TRIMs, Services, and Intellectual Property Agreements. This raises serious issues concerning the respective jurisdiction of MAI and WTO (and perhaps NAFTA) dispute-settlement bodies, in addition to substantive and temporal issues with respect to the applicability of provisions of the various Agreements and their interaction. Effort is made in the draft MAI text to be sensitive to these problems, but they are far from being resolved. In fact, at the outset an MAI separate from multilateral rules would create considerable uncertainty.

Against the drawbacks of the MAI, supporting governments have had few decisive arguments to make on the positive side. First of all, in an environment where, as already noted, FDI is growing at a rapid pace (much more rapidly than average global economic growth generally) the idea that the gains from FDI crucially depend on a new agreement would seem hard to sustain. Second, since most of the OECD countries already conform in large measure to the main disciplines of the MAI (and since in sensitive areas they will continue to reserve many measures) the specific market-opening benefits of the Agreement, absent developing countries accession, are quite limited. Those developing countries likely to accede have already significantly liberalized their investment regimes, at least to the extent necessary to attract investment and/or satisfy the demands of the IMF and World Bank.

CONCLUSION

In light of all these considerations, in our view, it makes sense to place the evolution of investment rules squarely in the WTO forum, as an issue for the next negotiating ‘round’. The MAI text can be simply regarded as useful preliminary
work for a genuinely multilateral negotiation – here, as noted in Chapters 10 and 11 on these subjects in this book, agriculture and services are precedents to bear in mind; in both cases much preliminary conceptual and technical work was done at the OECD, which then was channelled into the Uruguay Round negotiations. We think that the starting point for such negotiations might be agreement on the following:

1 The basic architecture of an investment agreement must include MFN, National Treatment, and Transparency obligations (the MAI process produced a broad consensus on this), subject to appropriate exceptions and limitations to protect legitimate regulatory interests, including labour and the environment.

2 Disciplines on incentives as well as performance requirements should be subject to negotiation, but the aim should be a balanced set of constraints, that reflects legitimate arguments that some kinds of measures may be appropriate for the situations of some countries, including measures to promote technology transfer.

3 As among the OECD countries, those provisions of the draft MAI text that have now attracted consensus should be applied as ‘soft law’, the equivalent of a non-binding code (as Daniel Schwanen of Canada’s C.D. Howe Institute has recently suggested).

4 In any future agreement, if private investors are to have the benefit of dispute settlement through binding arbitration, they should have to agree to abide by the investor conduct rules of the OECD Guidelines on Multinational Enterprises or some other instrument of this character; this reflects the principle of reciprocal rights and responsibilities for transnational corporations of so much concern to critics of the MAI. On the other hand, a corporation would remain free not to accept these responsibilities, as long as it did not wish a direct right of action, and was willing to rely on traditional state-to-state dispute settlement to protect its interests under a WTO investment agreement.

It is inevitable that differences between nations will remain about the balance between values of economic efficiency, and competing or sometimes competing, considerations in some sensitive sectors, like cultural industries. A policy dialogue should begin now, before any negotiations, on the alternatives to investment restrictions that are available to governments to vindicate these considerations, and the relative desirability of various policy instruments. In the end, some countries may still consider it necessary to reserve investment measures in this area, but a sense that there are often better ways of achieving these legitimate public goals could better inform debate on these issues in many countries.

14 Trade and developing countries

INTRODUCTION

Developing countries currently account for about a quarter of world exports, and about the same percentage of world imports. Although some developing countries were included within GATT from the outset, they had a marginal influence on the original Bretton Woods negotiations. By the 1960s, developing countries had come to predominate numerically in the GATT, and during the 1960s and 1970s their share of world trade, and particularly of exports grew rapidly, although in this respect the performance of some developing countries was vastly superior to that of others. Indeed, there is substantial heterogeneity amongst developing countries including differences in size, levels of development, levels of indebtedness, composition of trade, degree of concentration of trading relationships, etc. Throughout this period, developing countries complained that their influence on the design and functioning of the GATT rules remained marginal, and increasingly pressed demands for more preferential treatment within GATT, as well as attempting to evolve fora for the creation of rules on trade (particularly, UNCTAD – the United Nations Conference on Trade and Development) where they could wield greater influence.

While some developing countries continued through the 1970s to experience considerable growth, particularly those with more open or outward-oriented trade policies, the strategy that was adopted by most LDCs and that predominated in the development literature at the time – import substitution and protection of infant industries – yielded disappointing results. The conclusion most often drawn was that the rules of the game of international trade and finance were so heavily skewed to the disadvantage of the LDCs that a radically new strategy was necessary, based upon a fundamental redistribution of wealth and opportunities between North and South. Developed in UN fora such as UNCTAD, the strategy was termed the New International Economic Order (NIEO). While the NIEO remained at the level of ideology or at most the ‘soft law’ of UN resolutions, the developed countries did, at a practical level, respond to these pressures by granting further tariff preferences to developing countries on a non-reciprocal but also a non-binding basis (the Generalized System of Preferences). At the same time the availability of recycled petrodollars promised to give the strategy of protected, state-assisted rapid industrialization a new lease on life.