THE INVESTMENT ISSUE IN WTO: A DEVELOPMENT PERSPECTIVE

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A. BACKGROUND TO THE DOHA DECISION

At the Singapore WTO Ministerial (1996), Ministers agreed to form a **working group** to study the relationship between trade and investment. It was explicitly stated **there was no commitment to negotiate an agreement.**

For the next five years (1997-2001) the WTO Working Group on Trade and Investment held several discussions. Major developed countries pressed very hard to have the working group be transformed into a negotiating group that would negotiate an investment agreement in WTO. However, the majority of developing countries were extremely reluctant to agree to this. Some of these countries were strongly opposed.

Ministerial Conferences of the LDC group (Zanzibar Sept 2001), of the African region under the OAU (Abuja October 2001) and the ACP group (Brussels, November 2001) issued statements stating the view that they were not prepared to enter negotiations on the issue. At the WTO in Geneva, the majority of developing countries also made clear their opposition. However the draft Declaration sent from Geneva to Doha reflected the EU-led position that negotiations should start on investment.

At the Doha Ministerial, the opposition of developing countries continued, as can be seen in formal plenary statements made by many Ministers as well as in the informal meetings on new issues. Even on the last scheduled day (13 November 2001), the Africa, LDC and ACP groups issued a set of proposals to replace the draft text on investment and other new issues. The new text proposed by these countries stated that most developing countries lack the capacity to engage these issues with full aprreciation of the implications for their countries and people, that the relevant bodies undertake further work and that the 5th Ministerial "shall determine the desirability or otherwise of negotiations in these areas." It was clear from this proposal that the countries wanted the study process to continue (i.e. that they did not want a negotiation process to begin) and that the next Ministerial would decide "on the desirability or otherwise" of negotiations on these areas.

However, as a result of pressures and tactical measures, including the convening of a marathon Green Room session on the last night at Doha (6pm to 5am), a draft Declaration was issued on the morning of 14 November which in para 20 "recognized the case for a multilateral framework" on investment and which agreed that "negotiations will take place after the 5th Session of the Ministerial Conference on the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations."

Then, and even now, it is not clear at all how the new text was drafted or by who. It certainly was not drafted in an open, transparent session where all countries could be present and put forward their position or alternative formulations. The text was put before an informal plenary meeting in the afternoon of 14 November. India supported by a dozen countries, requested changes to the text to the effect that the consensus required was for negotiations and not merely on modalities. The compromise reached was that the draft Declaration would be adopted unmodified but that the Conference chairman would clarify that the position of India and the dozen other countries was accepted. At the final formal session, the Chairman made the following statement:

"*I would like to note that some delegations have requested clarification concerning Paragraphs 20, 23, 26 and 27 of the draft declaration. Let me say that with respect to the reference to an 'explicit consensus' being needed, in these paragraphs, for a decision to be taken at the Fifth Session of the Ministerial Conference, my understanding is that, at that session, a decision would indeed need to be taken by explicit consensus, before negotiations on trade and investment and trade and competition policy, transparency in government procurement, and trade facilitation could proceed.*

In my view, this would also give each member the right to take a position on modalities that would prevent negotiations from proceeding after the Fifth Session of the Ministerial Conference until that member is prepared to join in an explicit consensus."

Statement by Conference chairman, Hon'ble Mr Youssef Hussain Kamal, Minister of Finance, Economy and Trade, Qatar at the closing plenary session of the Doha Ministerial Conference, 14 November 2001

According to the renowned authority on international trade, Bhagirath Lal Das (2002), the Chairman's statement has legal standing and force in the WTO context. According to Das:

> The Chairman has made this statement in response to the requests of some delegations to have "clarification concerning paragraphs 20,23,26 and 27". Hence his statement is in the nature of the "clarification" of the language in these paragraphs. Also the Chairman has termed the first part of it as "(his) understanding". Normally a chairman gets such understanding by a process of consultations with the participants in the meeting and he/she includes agreed formulations in his/her understanding. If there is no objection or reservation from the participants after the chairman has expressed his/her understanding, it is considered to be the collective wish of the meeting. In this plenary during this Conference, there was no objection or reservation from the participants after the Chairman expressed his understanding. All this makes this part binding on the WTO process unless it is modified by a later WTO Ministerial Conference.
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> This part of his statement will be considered to interpret the meaning of the language in these paragraphs (i.e., paragraphs 20,23,26 and 27). Hence it is necessary to have an explicit consensus before negotiations in these four respective areas "could proceed". The text in the relevant paragraphs in the Declaration speaks about the decision by explicit

> consensus on modalities of negotiations. A question arises whether the negotiation will automatically proceed when the modalities are agreed to by explicit consensus. Here the text in the Chairman's statement comes into play. It speaks about decision by explicit consensus on the negotiation to proceed. All this considered together suggests a two-stage decision by explicit consensus, one stage for the modalities for negotiation and another stage for the negotiation to proceed. It should be noted that there is no prescribed sequencing in these two stages; for example, even before the modalities are taken up for a decision (by explicit consensus), the matter of negotiation itself can be taken up for decision (by explicit consensus).
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> Decision by consensus is defined in the footnote 1 to Article IX of the Marrakesh Agreement Establishing the WTO as a situation when "no Member, present at the meeting when the decision is taken, formally objects to the proposed decision". Thus technically speaking, even one Member can withhold consensus on modalities and thereby withhold the negotiation in this area thereon. Also even one Member can withhold consensus on negotiation to proceed.
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> In actual practice, it will depend on the motivation of the Members and the political situation existing at that time. The Fifth Ministerial Conference will be technically within its rights to alter the situation created by this understanding."

Thus, from a legal viewpoint, the two texts (Declaration and Chairman's statement) have to be read together, and the Doha Ministerial has not mandated that there will be negotiations on an investment agreement. Moreover, although the Declaration recognizes the need for a multilateral framework, it does not say what kind of framework (in substance or whether legally binding or non-binding) nor what is the appropriate venue.

B. POST DOHA WORK IN WTO

Between Doha and the 5th Ministerial, the working group and the General Council would have to undertake discussion on three categories of issues: (1) the working out of the issue of modalities of negotiations, that had been mentioned in para 20 of the Doha Declaration; (2) subjects mentioned in para 22 "for clarification", ie clarification of scope and definition, transparency, non-discrimination, modalities for pre-establishment commitments based on a GATS-type, positive list approach, development provisions, exceptions and balance of payments safeguards, consultation and the settlement of disputes; (3) other subjects mentioned in para 22, ie any framework should reflect in a balanced way the interests of home and host countries, take account of development policies and objectives of host governments and their right to regulate in the public interest. There is mention also that the special needs of developing countries should

be taken into account; due regard to other relevant WTO provisions; and account should be taken of existing bilateral and regional investment arrangements.

Since Doha the Working Group has procceded to discuss the issues mandated by Doha for clarification, as well as other issues, notably the obligations of foreign investors and of their home states (following a paper submitted on this by a group of developing countries).

Comments and suggestions on how to deal with the above issues from the perspective of developing countries' interests have been made in a paper by B.L. Das (2002). The relevant part of Das's paper is annexed to this paper (See **Annex 1**).

A reading of the 2002 report of the Working Group clearly reveals that there is no consensus among the Members on the various issues discussed. Even in relation to the WTO as a suitable forum some members have doubts regarding propriety of WTO being the right forum for the discussion of an issue whose relationship with trade is only tenous. On scope and definition, there is a major split between countries like the United States that want a comprehensive coverage, including portfolio investment, whilst most other countries want to restrict the discussion to foreign direct investment. There are many points of disagreement regarding development provisions, with many developing countries wanting maximum flexibility for development policies whilst developed countries want a much more restrictive approach. On non-discrimination, the developed countries insist this is a core principle, and several developing countries doubt its appropriateness in relation to investment. On investor and home country obligations, some countries insist this issue must be included including for the sake of having some balance, whist others do not think it even belongs in an investment framework. (See **Annex 2** for a preliminary listing of areas of differences in the working group among WTO Members).

Since the Working Group's work is near completion, and there are hardly a few months before Cancun, the reaching of an explicit consensus on modalities based on the substance of the issues would appear to be an impossibility, with so many wide and serious disagreements on all the key issues. It remains to be seen if the proponents can still "manufacture" a consensus even when substantially there is none.

C. HISTORICAL BACKGROUND

The EU and Japan are the main developed economies seeking to upgrade the study process into a negotiation for an agreement. Since many developing countries are opposed to introducing an investment agreement in WTO, the EU and Japan etc are attempting to portray their aim as one intended to produce a development-friendly investment agreement. A large number of developing countries remain opposed or reluctant to move into negotiations.

There is a long history of developed countries attempting to persuade developing countries to agree to a binding international investment treaty. During the Uruguay Round, the developed countries included investment rules in the TRIMS negotiations. However, developing countries were unable to accept this and succeeded in restricting the TRIMS agreement to only trade-related measures. The developed countries tried again in 1995-96 to have the WTO negotiate an investment agreement but the Singapore Ministerial only agreed on setting up a working group for discussion on trade and investment. They tried again through the OECD to have an investment agreement, but this failed. The efforts to have the negotiations in the WTO intensified after the OECD failure and this intensified before and at the Seattle Ministerial of 1999.

In the Draft Ministerial Text for Seattle Ministerial (dated 19 Oct 1999), the position of an influential group of developing countries (the like-minded group) on investment is laid out in para 56. In brief it says that the investment working group shall pursue its present mandate, and further work should focus on issues of interest to developing countries, in particular the effects of FDI (positive and negative) on the development objectives of host countries, the obligations of foreign investors to host countries, and the obligations of home countries in respect of disciplines on their investors. The working group shall report to the next Ministerial Conference on the results of its work. On the other hand, para 41 presents the developed countries' position, that "negotiations shall aim to establish a multilateral framework of rules on foreign direct investment", with eight points on the framework.

The collapse of the Seattle Ministerial meant that there was a two-year "reprieve." However, the Doha decision has re-opened the prospect of negotiation, albeit if there is an explict consensus. And that is a very big “IF”.

D. MAIN DESIGN AND STRATEGIC AIM OF PROPONENTS

The main features of a possible international investment agreement as advocated by the major developed countries are rather well known and have remained constant in the past many years, although there may be differences in some of the details. Among these main features are the following:

- Obligations on the right to entry and establishment: These provide foreign investors the rights to entry and establishment in member countries without (or with minimal) conditions and regulations and to operate in the host countries without most conditions now existing.
- “Non-discrimination” principle: National treatment and MFN status would be given to foreign investors and investments. This would apply at the pre and post establishment phases.
- Scope and definition: The original definition of investment has been very broad (eg in the proposed OECD MAI it covers FDI, portfolio investments, credit, IPRs and even non-commercial organisations, and in all sectors except security and defence. According to the

Doha Declaration, cross-border FDI is mentioned as an issue for clarification. However in the discussions, some countries, notably the US, have proposed a broad definition of investment and investor, to include portfolio investment.

- Performance requirements (eg. regulation on limits and conditions on equity, obligations for technology transfer, measures for using local materials and for increasing exports or limiting imports) would be prohibited or disciplined.
- Investors' rights and funds transfer: Obligations to allow free mobility of funds into and out of the country, thus restricting or prohibiting regulations/controls on funds transfer.
- Investors' rights and expropriation: There would also be strict standards of protection for investors's rights, in relation to "expropriation" of property. A wide definition is given to expropriation in the MAI model; it includes "creeping expropriation". The NAFTA experience is very pertinent. The developed countries are likely to advocate both direct and indirect expropriation; the latter is likely to include the loss of goodwill and future revenue/profits of a company or an investor, as a result of a government measure or policy.
- It is advocated that the agreement be legally binding, with a dispute settlement system. In NAFTA and the proposed OECD-MAI, the dispute settlement system would also enable investors to bring cases against a state.

Most of the elements above are in the original EC paper (1995) proposing an international investment agreement, or in the OECD draft of the MAI, or in NAFTA.

Although several of the above elements are not directly mentioned in the Doha Declaration as issues for clarification, some of them have entered the discussion under one item or another. The developed countries will most likely try to ensure that all these elements, and some more, will be part of the negotiations and the outcome.

Due to the unpopularity of this extreme model, including with citizens in the North that successfully opposed the OECD-MAI **,** some of the major proponents are now putting forward watered-down versions. These versions would not be so extreme, and would not enable the proponents to reach the ultimate goals immediately. Instead, step-by-step or stage-by-stage approaches are now proposed, whereby Members of WTO will agree to negotiate an agreement, and in the agreement they can have the choice of which sectors and how fast to liberalise. (This is presumably what the "GATS-type" approach refers to). The approach adopted is to first persuade developing countries to agree to the **concept** that investment rules belong to the mandate of WTO; and then to draw them into negotiations for an agreement which appears not to be so harmful and where there is some space to make choices (especially when compared to the original models); and then later on expose them to the pressures of increasing commitments for liberalisation in more sectors and for obligations in a wider range of policy measures.

Thus, although the current proposals of the EU in the WTO are said to be "different" from the original models, in reality the elements remain the same, albeit in a diluted form.

The EU's GATS-type positive list approach is meant to cover pre-establishment as well. Though in theory GATS allows each country can choose the timing, sectors and degree for liberalisation,

in reality there is pressure for accelerating the pace and depth of liberalisation in many sectors. Also, countries that have made a commitment would be unable to "roll back" or backtrack, unless with compensation. Moreover the services agreement also has general rules that apply across all sectors (whether or not they are on the schedule for liberalisation) and these rules are being expanded. Presumably the investment framework would also have general rules that apply, irrespective of what the countries have committed on a sectoral basis.

Moreover, it is also clear that the US would advocate a "higher standard" agreement, and this could be closer to the MAI or NAFTA models. So it is very possible that if negotiations were to begin, some members will advocate for the elements, scope and high standards of the extreme models.

F. THE NEED FOR SPACE AND FLEXIBILITY FOR INVESTMENT AND DEVELOPMENT POLICIES AND THE EFFECTS OF AN INVESTMENT AGREEMENT

Foreign investment is a complex phenomenon with many aspects. Its relationship with development is such that there can be positive as well as negative aspects. There is an important need for the role of government and government policy to regulate investments so that the positive benefits are derived, while the adverse effects are minimized or controlled. The experience of countries shows that governments have traditionally made use of a wide range fo policy instruments in the formulation of investment policy and in the management of investment. It is crucial that developing countries continue to have the policy space and flexibility to exercise their right to such policies and policy instruments.

Due to its particular features, foreign investment can have the tendency towards adverse effects or trends that require careful management. These include:

(a) possible contribution to financial fragility due to the movements of funds into and out of the country, and to some types of financially destabilizing activities;
(b) possible effects on balance of payments (especially increased imports and outflow of investment income, which has to be balanced by export earnings and new capital inflows; if the balance is not attained naturally, it may have to be attained or attempted through regulation);
(c) possible effects on the competitiveness and viability of local enterprises;
(d) possible effects on balance between local and foreign ownership and participation in the economy.
(e) possible effect on the balance of ownership and participation among local communities in the society.

On the other hand foreign investment can make positive contributions, such as:

(a) use of modern technology and technological spillovers to local firms.
(b) global marketing network
(c) contribution to capital funds and export earnings
(d) increased employment

In order that these potential benefits be realized, and that a good balance is attained between the negative and positive effects, so there be a overall net positive effect, there is a crucial role for governments in a sophisticated set of investment and development policies.

An investment agreement of the type envisaged by the proponents would make it much more difficult to achieve a positive balance as it would severely constrain the space and flexibility for investment and development policies.

An international agreement on investment rules of this type is ultimately designed to maximise foreign investors' rights whilst minimising the authority, rights and policy space of governments and developing countries. This has serious consequences in terms of policy making in economic, social and political spheres, affecting the ability to plan in relation to local participation and ownership, balancing of equity shares between foreign and locals and between local communities, the ability to build capacity of local firms and entrepreneurs, etc. It would also weaken the position of government vis-à-vis foreign investors (including portfolio investors) in such areas as choice of investments and investors, transfer of funds, performance requirements aimed at development objectives such as technology transfer, protecting the balance of payments, and the formulation of social and environmental regulations.

It is argued by proponents that an investment agreement will attract more FDI to developing countries. There is no evidence of this. FDI flows to countries that are already quite developed, or there are resources and infrastructure, or where there is a sizable market.

A move towards a binding investment agreement is thus dangerous as it would threaten options for development, social policies and nation building strategies. It is thus proposed that the strategy to be adopted, should be to prevent the investment issue from entering the mode of "negotiations." In the working group, cogent points should be put forward on why an agreement on investment rules is not suitable nor beneficial for the WTO. In the discussion on "clarification" and on "modality", points should be made towards this end.

G. CONCLUSIONS

Investment is not a trade issue, and thus bringing it within the ambit of WTO would be an aberration and could cause distortion to the trade system. The principles of WTO (including national treatment, MFN) that apply to trade in goods are inappropriate when applied to investment. Instead, their application would be damaging to the development interests of developing countries. Traditionally developing countries have had the freedom and right to

regulate the entry and conditions of establishment and operation of foreign investments; restricting their rights would cause adverse repercussions. An agreement in WTO is likely to be of the type proposed by developed countries. It would be profoundly anti-development.

Whilst Doha recognised the case for a multilateral framework on investment, it can be argued that it can also be recognised that there is a case against a multilateral framework, depending on what the framework is. If the framework is located in the WTO, with the elements and obligations proposed by the advocates, it would be an imbalanced one and thus should not be accepted. A more appropriate framework must be a balanced one, with the main aim of regulating corporations (instead of regulating governments); it could be one that is not legally binding; and it could be one that is located in the UN and not the WTO.

The WTO agenda is already over-crowded, with delegations unable to cope. Introducing investment and other "Singapore issues" on the negotiating agenda will divert the time and resources of the Members from the urgent uncompleted tasks, including the implementation and other development issues that Members had pledged to give priority to, but which the developed countries have so far not shown a commitment to make progress on.

The establishment of an investment agreement which in fact gives unprecedented rights to foreign investors would cause the already imbalanced WTO system to become much more imbalanced. Since most international investments are owned by the developed countries, they will obtain the overwhelming share of the benefits, whilst developing countries as a whole would bear the costs, including the loss of flexible space for development policy. The proposed investment framework would not be reciprocal in benefits.

For these reasons, and the fact that there is no consensus on the substance of the issues even as Cancun draws near, the Ministers should not take a decision to launch negotiations on investment at Cancun. They should mandate that the process of study and clarification continue. Or better still, they should come to the conclusion that the investment issue has been divisive and has for too long diverted the attention of the WTO Membership from the real issues of trade and development, and that the issue should be dropped after Cancun.

Annex 1

COMMENTS ON THE WORK ON INVESTMENT IN THE WTO BY BHAGIRATH LAL DAS

(Excerpted from book by BL Das on The New Work Programme of the WTO).

WORK UP TO FIFTH MINISTERIAL CONFERENCE

It is given in paragraph 22 of the Declaration. The Working Group on the Relationship between Trade and Investment has been examining this relationship since 1996. Now the Declaration says that the Working Group will focus on certain specific elements. Besides, as mentioned in paragraph 20 of the Declaration and also in the Statement of the Chairman, "modalities of negotiations" will be worked out. What will be the essential subjects of the "modalities" has not been spelt out. The Declaration is silent on this point.

Paragraph 22 of the Declaration asks the Working Group to focus on the clarification of certain elements, viz., (i) scope and definition, (ii) transparency, (iii) non-discrimination, (iv) modalities for pre-establishment commitments based on GATS-type positive list approach, (v) development provisions, (vi) exceptions and balance of payment safeguards, and (vi)consultation and dispute settlement.

Then the Declaration goes on to give some guidelines on the possible framework, for example, the framework should reflect balanced interests of home and host countries, take account of development policies and development objectives of the host governments, take into account the special development, trade and financial needs of developing countries including the least developed countries, etc. It should be noted that these are the guidelines for a "framework", and negotiation on the "framework" can take place only after the Fifth Ministerial Conference, if the conditions mentioned above are fulfilled. Hence the relevance of these guidelines to the current work of the Working Group is not clear.

SUGGESTED ACTION

Background

The objective of the proponents of this subject in the WTO is to ensure and strengthen the protection of the rights of foreign investors in the host countries and to curtail the role of the host government in putting conditions on foreign investors' entry and operation. It has serious implication for the developing countries. They have priorities of development and they would like to channelise foreign investment in the areas of their priority, for example in building of infrastructure, in production of exportable goods and services and in sectors which will instill

innate strength to the country's economy. They would also like to have proper geographical spread of the foreign investment so that the under-developed regions of the country get priority attention. Further, they will prefer that the operation of the foreign investment is carried out in such a way that it links with the domestic economic activity in a positive manner with mutual benefit to both the investor and the domestic economic activities. They will be keen to guard against any adverse effects of the foreign investment on their economic, social and political process. All these objectives need concrete government policies and measures.

The objective of the proponents of this subject is to restrict the options of the government in this regard so that the investor has freedom of entry and operation. It can have serious adverse impact on the host country's economy and its economic structure. The developing countries are particularly vulnerable in this regard. Hence it is quite natural that a large number of them have been extremely reluctant to let this issue enter the WTO, where the binding commitments cannot be annulled or modified without giving commensurate compensation. The approach of the developing countries to the work in the Working Group should be guided by these real apprehensions.

Elements for clarification included in paragraph 23 of the Declaration

The Work Programme has identified certain elements for clarification as the focus of the work. Two important points need to be emphasized. Firstly, the items are mentioned for "clarification". Thus the existence of an item here does not mean that it has already been accepted as an appropriate subject in a multilateral framework. After the exercise of clarification, it may be decided that the item should be treated in a certain way or that it should not be included at all. Secondly, it should be noted that these are not the exclusive elements for clarification, since these have been identified for the focus of the work and not as exclusive work. Hence if the developing countries identify some other elements for consideration or clarification, this paragraph of the Declaration does not prevent them from doing so. In fact, it will be useful if the developing countries, apart from giving their ideas on these elements, also put up some other elements which they consider important from their point of view.

There may be a doubt whether the developing countries should actively engage in this exercise as they have been objecting to an expansion of the work on Investment and Competition Policy in the WTO. It is important for them to engage fully in this exercise at this stage; otherwise the work on clarification of these elements will go on without their contribution and they will thus lose an opportunity to place their ideas on the table and have an effective say in determining the content and relevance of these elements. The advantage for them lies in active participation and placing other elements for clarification which they may consider relevant.

Some preliminary ideas are given below in respect of the points for clarification identified as the focus of work in the Work Programme.

Scope and definition

Considering that this whole exercise is aimed at curtailing the government's options and role, it is important for the developing countries to have the scope and definition in such a way that it is limited, well defined and not amenable to future expansion. For example, it is desirable to limit the scope to foreign direct investment (FDI) and not to include portfolio investment, loans or credit, short term deposits, speculative funds and other such flow of funds. It should be ensured that the definition of foreign direct investment is fully clear and totally unambiguous.

Transparency

Transparency should be limited to automatic or easy availability of the relevant rules, procedures and decisions. It should not transgress into the area of substantive decision making process.

Non-discrimination

Non-discrimination has two elements, viz., one, non-discrimination as between the investors of the territories of different Members (MFN principle) and two, non-discrimination as between the foreign investor and domestic investor (national treatment principle). Both these principles are dangerous in respect of the developing countries; and, between the two, the second is much more dangerous. They should have the flexibility to give preference to investments from particular countries, based on the past experience and past linkages as also on the basis of the perception of future trends of cooperation. It will be extremely harmful for the developing countries to include national treatment, i.e., non-discrimination as between the foreign investor and domestic investor, in a possible framework for investment. Domestic investors stand on a different footing altogether. For example, they do not repatriate the returns on investment to foreign countries, they are more inclined to have domestic linkages with their investment, thus generating further domestic economic activities, etc.

It will not be enough if the developing countries are given some differential treatment in this respect. Past experience in the GATT/WTO system has shown that differential treatment do not have the safeguard of real and stable protection. What should be ensured is that the principle of non-discrimination as seen in the WTO sense, as explained above, should not have a place in a framework for investment at all.

Modalities for pre-establishment commitments based on GATS-type positive list approach

Here the reference is to the specific commitments in the GATS. A country chooses which sector to include in its commitments and what conditions to apply for the entry and operation. In the context of investment, it would perhaps imply that a country will undertake obligations on the entry of investment in areas specified by it and also will be able to prescribe conditions for entry and operation. At the surface it may appear safe. But the experience with the GATS

negotiations on specific commitments has shown that it does not give adequate protection to the developing countries.

Though in theory a country is free to choose sectors for inclusion in its commitments, in actual practice, its commitments, including its choice of sectors, will be the result of a series of bilateral and plurilateral negotiations with other countries, in particular the major developed countries. In these negotiations, individual developing countries are put to intense pressures from the latter and are often unable to limit their commitments to the sectors of their choice.

Development provisions

A desirable development provision will be that a developing country will be totally free to apply conditions on the entry and operation of the foreign direct investment in accordance with its own perception and decision on its development process. A developing country should have total freedom to make its own autonomous decision and thus it should not be required to justify it either bilaterally or multilaterally.

Also, a developing country should be enabled to apply domestic content requirement that is at present prohibited under the Agreement on TRIMs and Article III of the GATT 1994.

Exceptions and balance-of-payments safeguards

If a developing country has full discretion and flexibility about putting conditions on entry and operation of the foreign direct investment, it will not need exceptions and balance-of-payment safeguards. While allowing the entry of investment it will be retaining its options of actions in the situations needing exceptions or balance-of-payment safeguards.

Consultation and dispute settlement between Members

A possible framework will have a dispute settlement process to resolve the disputes between the Members. The investors should have no role in this process. The dispute settlement mechanism should be separated out from the normal Dispute Settlement Understanding of the WTO, in the sense that there should be no provision of cross-retaliation as is contained in Article 22.3 of the Dispute Settlement Understanding of the WTO.

Elements for clarification to be placed by the developing countries

As mentioned above, these are not the exclusive elements for clarification. Surprisingly, the selection of these elements has been very much one-sided. Several specific points made by

the developing countries in the Working Group which could have formed part of this list of elements have not been taken into account. Hence it is important for the developing countries to place their own points for clarification in this part of the work of the Working Group. Some proposals of this nature had been included by the developing countries in the draft for Seattle Ministerial Conference (para 56 of that draft). Suggestions are given below for some elements to be introduced by the developing countries in the Working Group .

Obligations of foreign investors

The foreign investors should have the obligation not to undertake what are considered restrictive business practices, for example, restrictive conditions on consumers or other users, transfer pricing, collusive pricing, predatory practices, etc. They should also have the specific obligation of total transparency in their dealings, particularly in respect of their raising of resource, sale of products and services, purchase of products and services, distribution and use of profits, etc. Further they should have the obligation not to act prejudicial to the social norms and economic interests of the host countries.There should be a provision for international blacklisting of the investors found to be defaulting on their obligations.

Foreign investors may also be obliged to: undertake technology transfer (including to domestic firms), train domestic personnel, allow domestic firms/persons participation in equity, bring specified amounts of capital, retain certain levels of profit in the country, etc.

Obligations of home government

The home government of the foreign investor should have the obligation to ensure that the obligations of the foreign investor are discharged fully.

These are only some examples. There may be other elements based on the experiences of the developing countries with the foreign investment over the years.

ANNEX II:

FOREIGN INVESTMENT, ITS EFFECTS, MANAGEMENT AND REGULATION

By Martin Khor

1. RESULTS OF SOME RECENT STUDIES ON EFFECTS OF FDI ON DEVELOPING COUNTRIES

There are various categories of foreign investments. It is important that these be distinguished because the MAI defines investments in a very broad way that includes foreign direct investment (FDI), portfolio investment, loans, contracts, and many other forms of property owned by foreigners in the host country, including intellectual property.

This section deals only with FDI, which is usually considered the best component of foreign investment. The supposed benefits of portfolio investment and short-term capital flows (including loans) have now been called into question as a result of the series of financial crises starting with Thailand in mid-1997. However, there is a dominant assumption that FDI brings only benefits, and its costs are much less known generally. A balanced and objective perspective on FDI and on investment liberalisation is thus important, especially in view of the attempts to establish an international investment regime.

This is especially so when little seems to be known of the effects of investment liberalisation. At an OECD-organised workshop on FDI and the MAI in Hongkong in March 1996, the keynote speaker, Dr Stephen Guisinger of University of Texas, said in a paper that: "Very little is known about repercussions of foreign direct investment liberalisation on host economies...The link between investment liberalisation and macroeconomic performance has received scant attention from researchers."

The following is a summary of some studies on the effects of foreign investment on developing countries that may throw some light on the issue.

(a) Effects of FDI on balance of payments and growth (Study by Ghazali Atan)

Recently a seminar paper was presented by a leading Malaysian economist, Dr Ghazali Atan, on the effects of FDI on trade, balance of payments and growth in developing countries.

The paper is based on a PhD thesis which examines the literature
and empirical evidence on the subject, with a detailed case study of Malaysia, one of the few developing countries that have received a large inflow of FDI in the past few decades and which therefore presents an interesting case for study on the effects of FDI. Whilst many studies deal with

one aspect of FDI's effects, Dr Ghazali's study empirically examines various facets (effects on savings, financial inflows and outflows, trade and growth). Using these, he constructed a model **(Figure 1)** with equations on each aspect and a simultaneous equation to capture the total or combined effects of the various aspects.

Among the main conclusions of the study are that:

** Successful growth in developing countries is premised essentially on raising the domestic savings rate to a high level and productively investing the savings. This is more important than the role of foreign capital, including FDI. The East Asian growth success is based mainly on high domestic savings rather than FDI.

** Foreign capital can help to supplement domestic savings but this has its downside. There are three types of foreign capital inflow: aid, debt and FDI. FDI has many advantages (bringing in productive capital, foreign expertise, brand names, market linkages, aiding in industrialisation, exports, employment).

** However there are also disadvantages or costs to FDI. These impacts need to be managed to ensure a net positive outcome.

** The study found that FDI has a negative effect on domestic savings, as it gives room for the recipient country to increase its consumption.

** FDI generates positive and negative effects on the flow of foreign exchange on two accounts: financial and trade. The effects from these two accounts are summarised in **Table 2.**

** On the financial side, FDI brings in capital, but also leads to a stream of outflows of profit and other investment income. This outflow increases through time as the stock of foreign capital rises. Thus, FDI has a tendency to lead to "decapitalisation".

Comparing aid, debt and FDI, the study finds that because of the much higher rate of return of FDI compared to the rate of interest paid on aid or debt, the "decapitalisation" effect of FDI is greater than of aid or debt.

For instance, in the illustrative case shown in **Table 1**, at 1.5% interest, the outflow due to aid would be less than inflow even after 17 years; at 5% interest it would take 17 years for outflow to exceed inflow; at 10% interest on debt, it would take 6 years before outflow exceeds inflow; whilst at 15% return on FDI it would take only 3 years before outflow exceeds inflow. By year 17, the outflow of $6,300 far exceeds the new inflow of $2,000. The Graph (in **Figure 2**) shows this decapitalisation effect as the rising gap between inflow of FDI and outflow of investment income, as FDI stock rises. This illustrative example of FDI's decapitalisation effect is conservative, as the paper used a rate of return of 15%. In most cases the rate of profit is far higher and thus the decapitalisation effect would be more severe. The decapitalisation effect is shown by several empirical studies, as well as Dr Ghazali's own study on Malaysia.

** On the trade side, FDI has a positive effect through higher export earnings and a savings on imports (for products locally produced), but a negative effect through higher imports of intermediate and capital goods. It may also have a negative effect in raising imports of consumption goods. In many cases, FDI is heavily reliant on large imports of capital and intermediate goods.
The high import content reduces the positive trade effect. Ghazali's study shows that generally there is a weak positive trade effect from FDI, and in some cases a negative trade effect.

** In order for FDI to have a positive effect on balance of payments, there must be a strong enough positive trade effect to offset the negative decapitalisation effect. However, due to the weak positive trade effect, or even a negative trade effect in some cases, there is a tendency for FDI to cause a negative overall effect on the balance of payments. Without careful policy planning, the negative effect could grow through time and be serious as profit outflow builds up.

** Too rapid a buildup of FDI could also lead to "de-nationalisation", where the foreign share of the nation's wealth stock increases relative to local share. To avoid economic or social problems that this may cause, Ghazali proposes obeying "Moffat's rule", that the rate of growth of domestic investment should exceed FDI growth.

** Regarding the effect of FDI on economic growth, there are direct effects (which are generally positive) and indirect effects (which are generally negative, due mainly to the decapitalisation effect). Whilst the inflow of new FDI exerts a positive effect, the outflow of investment income arising from the accumulated foreign capital stock exerts a negative effect.

** The use of the general model (Figure 1) for the Malaysia case (1961-86) using equations for the impact of FDI on variables such as investment, savings, exports, imports and factor payments show that there was an overall negative impact on growth. (Ghazali 1996: p21). Each percentage increase in the FDI to GDP ratio slowed growth down by 0.03%. Looking at the long term impact of FDI, debt and aid on growth over time, the study finds that: "For FDI the effect starts off from a negative position and worsens over time; for debt the effect starts off being positive but turns progressively negative in the longer term; the effect of aid shows the opposite tendency, i.e. negative on impact but turning more benign later. The key dynamic influence was found to be the factor payment effect (ie the decapitalisation effect)." (Ghazali 1996: p21).

Table

SUMMARY OF FDI EFFECTS ON INFLOW/OUTFLOW OF FUNDS AND ON BALANCE OF PAYMENTS

CATEGORY OF EFFECT	POSITIVE	NEGATIVE
FINANCIAL FLOWS	Inflow of foreign capital	Outflow of profit, royalties and revenues/incomes
TRADE FLOWS	Increased Export earnings	Increased import of capital goods
	Savings from reduced imports	Increased import of intermediate goods
		Increase in imports of consumer goods

NOTE: The balance on financial flows will tend to be strongly negative over time as the one-time inflow of capital would give rise to a stream of outflows of investment income. The larger the stock of foreign investment, the greater will be the outflows.

To avoid BOP difficulties, the balance on trade flows should be strongly positive to offset the deficit on financial flows. However this is not necessarily so. In some cases the trade balance from FDI may be positive but weakly so; in other cases it may even be negative as the high imports of foreign companies exceed their export earnings. In the latter case, a trade deficit is added to the finance deficit, which may cause BOP problems.

** Given the various ways in which FDI affects the host economy, Ghazali (1996: p8-9).proposes that for FDI to be used successfully (with net overall benefit), the following conditions should be met:

(a) Availability of foreign capital does not detract from own savings effort.

(b) The factor payment cost must be minimised and prudently managed.

(c) Encourage or require joint ventures so that part of the returns accrue to locals and is retained by the local economy.

(d) Get foreign firms to list themselves on local bourses.

(e) To enhance positive trade effects, DFI must be concentrated in the tradable sector, especially in export-based activities.

(f) Local content of output should be raised over time to improve trade effect.

(g) Moffat's rule should be adhered to (growth of domestic investment should exceed FDI growth).

(h) To avoid reliance on foreign capital, developing countries should increase their savings rate and maintain sound economic and political conditions.

Ghazali's conclusions are that: "The above are among preconditions for ensuring successful use of FDI. Countries using DFI without regard to the above conditions would do so at their own peril. Any moves designed to prevent host countries from instituting such policies, however they are couched, are moves designed to keep developing countries at the bottom of the global economic ladder...With the correct policies, DFI can be of great help to host countries. Without the correct policies, however, the use of DFI can lead to severe problems especially with regard to the longterm viability of the recipient's balance of payments." (Ghazali 1996: p9-10).

(b) Benefits, Costs and Risks of Foreign Investment (study by South Centre)

The South Centre has published an interesting study on "Foreign Direct Investment, Development and the New Global Economic Order" (1997) that deals with the benefits, costs and risks of FDI, as well as the issue of an appropriate policy towards foreign investment. According to the report, the academic literature on FDI fully recognises that from the viewpoint of host developing countries, there are both important benefits and potentially significant costs associated with FDI. The possible benefits include technology transfer; increased production efficiency due to competition from multinationals; improvement in quality of production factors such as management (including in other firms); benefits to the balance of payments through inflow of investment funds; increases in

exports; increases in savings and investments and hence faster growth of output and employment.

The acknowledged costs include the possible negative effects on the balance of payments due to increased imported inputs and profits to abroad; the high market power of multinationals can lead to non-competitive pricing and its resulting overall inefficiency in resource allocation; adverse impact on competitive environment; discouragement of development of technical know-how by local firms. If it fails to generate adequate linkages with the local economy, FDI will have fewer spillover beneficial effects and may on balance be harmful if the other negative features above exist. Other costs are transfer pricing (which diminishes host government taxes); distortion of consumption patterns due to brand names of multinationals (with costly effects when costly foreign foods from FDI supplant local and more nutritious foods in the diet of the urban poor); the net loss of jobs when capital-intensive FDI displaces labour-intensive local firms.

There are also environmental and natural resource costs associated with FDI, and the risk of FDI in the media facilitating western cultural hegemony. Also, politico-strategic interests are at stake if FDI comprises a large component of total investment and involves loss of local control over strategic sectors, infrastructure and natural resources; whilst decisions made abroad can impact on the local economy and society, and sometimes even the country's sovereignty may be at stake.

These factors have to be taken into account in an overall net evaluation of the costs and benefits of FDI.

Although there are arguments encouraging any kind or volume of FDI, the study concludes that an undiscerning policy towards FDI may cause serious long-run economic difficulties, harming a country's development prospects. In particular, the growing liberalisation of FDI and of financial markets pose significant new hazards to developing countries that can threaten their financial viability.
Among these risks are:

** Balance of payments: The current account position of developing countries is a critical variable deserving the utmost attention in a world of free capital movements, as shown in the Mexican and Asian financial crises. FDI gives rise to foreign exchange outflows due to profit payments and import costs; whether FDI generates sufficient foreign exchange earnings to cover these foreign exchange costs is of great relevance. For example, if FDI takes place in a non-tradable service industry (eg a supermarket, especially if it sells imported goods) and if profits are repatriated, the balance of payments implications are inimical to a country's future development.

** FDI volatility: The level of stocks and flows of FDI can be volatile especially financial liberalisation and since new financial instruments such as derivatives have blurred the distinction between FDI and portfolio investment, so that the value of FDI stock can easily be exported as capital. Also, the level and degree of profits that are retained (which is a key

component of FDI flow) can be highly volatile especially in a crisis. The old presumption that FDI flows are less volatile than portfolio investment may no longer hold.

** Cyclical behaviours and surges in FDI: Firstly, FDI surges pose equally acute macroeconomic problems as do surges in portfolio investment as they lead to currency over-valuation and financial instability. Secondly, pro-cyclical FDI flows may exacerbate economic fluctuations. If retained foreign profits are a large part of FDI inflows, these are likely to be pro-cyclical.

** Financial fragility: The impact of FDI depends on factors such as the steadiness or volatility of FDI inflows, the proportion of FDI accounted for by retained profits; the level of imports related to the FDI; the percentage of output exported. A situation can develop where a decision to increase just the rate of profit repatriation can lead to a foreign exchange crisis. A similar crisis can also occur if there is a reduction or interruption of FDI inflows, in a country which is too used to FDI inflows to finance current account deficits.

The South Centre study concludes that not all FDI is conducive to development, some kinds may do more harm than good, and a country that has a policy to accept any and all FDI may harbour trouble for future development prospects. To limit the risks and avoid undesirable effects, the study recommends governments to take a selective policy to FDI by determining the composition of capital inflows and intervening to manage inflows of capital including FDI; a selective policy with respect to specific projects, eg confining FDI to priority sectors; and prudence with respect to total FDI flows and stock to avoid more financial fragility. It concludes: "A global investment regime that took away a developing country's ability to select among FDI projects would hinder development and prejudice economic stability."

2. THE NEED FOR NATIONAL REGULATION AND POLICY INSTRUMENTS/OPTIONS ON FOREIGN INVESTMENTS

The major issue of the desirability of a global investment regime is not whether or not foreign investment is good or bad or should be welcomed. It is whether or not national governments should retain the right and powers to regulate FDI and to have the adequate authority and means to have policy instruments and options over investment, including foreign investment.

Most countries presently accept the importance of foreign investment and are trying their best to attract foreign investments. However, as the previous sub-section showed, there is evidence that foreign investment can have both positive and negative effects, and a major objective of development policy is to maximise the positive aspects whilst minimising the negative aspects, so that on balance there is a significant benefit.

Experience shows that for foreign investment to play a positive role, government must have the right and powers to regulate their entry, terms of conditions and operations.

(a) Regulations on entry and establishment

Most developing countries now have policies that regulate the entry of foreign firms, and include various conditions and restrictions for foreign investors overall and on a sector-by-sector basis.

There are few developing countries (if any) that has now adopted a total right of entry policy. In some countries, foreign companies are not allowed to operate in certain sectors, for instance banking, insurance or telecommunications. In sectors where they are allowed, foreign companies have to apply for permission to establish themselves, and if approval is given it often comes with conditions.

Of course the mix of conditions varies from country to country. They may include equity restrictions (for example, a foreign company cannot own more than a certain percentage of the equity of the company it would like to set up); and ownership restrictions (for instance, foreigners are not allowed to own land or to buy houses below a certain price).

In a recent study on how the MAI would affect the South, the Friends of the Earth-US (1997) compiled a list of existing regulations in developing countries that make foreign investment subject to conditions or restrictions. The following are examples of policies and regulations restricting entry and establishment:

* In China, investment guidelines were issued in June 1995 detailing sectors in which investment is encouraged, restricted or prohibited. China prohibits foreign investment for projects with objectives not in line with national economic development. Also, where foreign investment is allowed, there are areas where restrictions apply. Restricted categories generally reflect the protection of domestic industries such as the services sector in which China fears its domestic market and companies would be quickly dominated by foreign firms; the aim of limiting imports of luxuries or requiring large imports of components and raw materials; and the avoidance of redundancy or excess capacity.

* In Taiwan foreign investment is not allowed in agricultural production (including agricultural chemicals production), in Pakistan foreign investors are not allowed to own land for agriculture or irrigation, and in Brazil foreign ownership of land in rural areas and adjacent to international borders is prohibited.

* In the forestry sector, Bangladesh bars foreign investment in forest plantations and mechanical extraction in reserved forest areas; Taiwan forbids foreign investment in forestry; and China does not allow wholly foreign-owned investment in processing and export of raw wood.

* Malaysia has regulations limiting the degree of foreign equity ownership in some sectors; and in manufacturing, there the equity limit varies with the degree of exports in a firm's output.

* In India, proposals for foreign equity participation exceeding 51 percent and projects considered to be politically sensitive are screened by the Foreign Investment Promotion Board.

An international investment regime that grants the right to establishment and national treatment to foreign investors would
put pressure on developing countries to give up or phase out present policies regulating the entry and the degree and conditions of participation of foreign investors.

(b) Policies favouring local firms and domestic economy

Many developing countries also have policies that favour the growth of local companies. For instance, there may be tax breaks for a local company not available to foreign companies; local banks may be given greater scope of business than foreign banks; only local institutions are eligible for research and development grants; local firms may be given preference in government business or contracts.

Governments justify such policies and conditions on the grounds of sovereignty (that a country's population has to have control over at least a minimal but significant part of its own economy) or national development (that local firms need to be given a "handicap" or special treatment at least for some time so that they can be in a position to compete with more powerful and better endowed foreign companies).

Most developing countries would argue that during the colonial era, their economies were shaped to the advantage of foreign companies and financial institutions (belonging usually to the particular colonising country).

Local people and enterprises were therefore at a disadvantage, and require a considerable time where special treatment is accorded to them, before they can compete on more balanced terms with the bigger foreign companies.

This has been the central rationale for developing countries' policies in applying restrictions or imposing conditions on foreign investments.

A global investment regime that prohibits or severely restricts affirmative action by developing countries for local firms and the domestic economy would therefore have serious consequences. No longer will each government have the freedom to choose its own particular mixture of policies and conditions on foreign investments. The major policies would be already determined by the multilateral set of investment rules, and the choice available would be very much constrained to more minor aspects.

Under the Services Agreement (GATS) in the WTO, establishment rights and national treatment are to be given to those services sectors which are put on offer by a country. The Services Agreement is not a catch-all agreement and applies only to those sectors or activities that the country has put "on offer." The proposed MAI would in contrast be a catch-all agreement, in which all sectors and activities are included, unless specifically excluded. Thus, any "affirmative action" measures that promotes local industries or services (through subsidies, preferential tax treatment, specified condition for investment, even R&D subsidy) could be seen as "discriminatory" against foreigners and thus prohibited.

(c) Measures to manage the balance of payments

As earlier shown, there is a general tendency for FDI to generate a net outflow of foreign exchange. Many developing countries have taken measures to try to ensure a more positive result from FDI on the balance of payments and on the domestic economy. These measures may aim at: (a) increasing the share of export earnings (and thus foreign exchange) in the output of FDI (for example, incentives or permission for higher equity ownership are given to firms that are more export-oriented in order to encourage export earnings.; (b) reducing the imports of capital and intermediate goods by foreign firms through encouraging the use of local products; (c) reducing the amount of foreign profits through requirements that the foreign firm forms a joint venture with local partners, or allocates a part of the company's shares to locals, so that a portion of FDI profits accrue to locals; (d) requiring or encouraging a foreign firm to retain a significant part of their profits for reinvestment. The objectives are to generate spin-offs for and linkages to the domestic economy and thus boost growth, whilst also to attempt to get FDI to have a more positive impact on the balance of payments by increasing the share of revenue and value-added that is retained in the economy.

Some of the traditional measures have already come under pressure from the WTO's TRIMS Agreement. For instance, governments have placed conditions that firms must use specified local inputs, or a percentage of the output value must be locally sourced (local content policy). Another condition is that imported inputs of a firm must be restricted to only a certain percentage of that firm's export earnings (balancing of foreign exchange policy). Another policy may be to restrict a commodity or product from being exported (by imposing a ban or limiting export to a percentage).

All these three policy measures have been explicitly mentioned in an illustrative list and made illegal by the TRIMS Agreement on the ground it discriminates against foreign products or foreign trade. The removal of these policy measures would make it more difficult to resolve balance of payments deficits. Developing countries have 5 years (from Jan 1995) to implement this.

The MAI's proposals to prohibit a wide range of "performance requirements" (including the above but expanding the list to many new items) would make the situation even more difficult.

Governments now are able to control the quantity and quality of foreign investment. As shown above, some countries limit the percentage of foreign equity, in some cases requiring the foreign firm to form joint ventures so that a share of the profits is retained by locals. Some countries limit the outflow of profits. If a global investment regime like the MAI were to prohibit these measures, then governments would lose these as instruments to protect the balance of payments. Inability to regulate entry will increase the foreign share of equity. Removal of joint-venture arrangements would further raise foreign equity. Together these would raise the foreign share of profits in the economy. Given international trends, corporate tax is also increasingly reduced in many countries, thus adding to the trend of higher net foreign profit. If foreign profit outflow is too high and can threaten the BOP or reserves and financial stability, the option of limiting profit repatriation would not be available.

(d) Conclusions

At present most governments in developing countries have maintained systems of regulation of foreign investment, that include policies and rules on entry, establishment, operations and requirements to fulfil certain obligations in line with national, development, social and environmental objectives. These policies and regulations reflect the recognition that the role of foreign investment should be placed in an appropriate context, and that it is the responsibility of government to ensure that the benefits of FDI accrue to the country whilst the risks and costs are reduced or minimised, so that there will be net positive results. Thus many of the existing policies and regulations have a logic and rationale within this overall context and framework. An appropriate international approach to investment should recognise and endorse this developmental framework. To do away with this carefully constructed policy framework and with the many kinds of regulations may well damage or destroy the opportunities and conditions for sustainable and human-oriented development.

ANNEX 3: IMPLICATIONS AND POSSIBLE IMPACTS OF A WTO INVESTMENT AGREEMENT ON DEVELOPING COUNTRIES

Note: The analysis below is based on an investment agreement, taking the OECD-MAI draft agreement as the basis. The proposed WTO agreement is likely to be similar in many respects to this MAI model.

1. Likelihood of Deriving Claimed Benefits

The MAI's preamble lists some of its key assumptions and goals: that international investment has assumed great importance to the world economy and considerably contributed to development; that a fair and predictable investment regime benefits the trading system, that a investment framework with "high standards" for investment liberalisation, investor protection and strong dispute settlement would contribute to efficient use of resources, create job opportunities and improve living standards.

Besides these assumptions in the preamble, the proponents of the MAI have also claimed that such an agreement would lead to a greater flow of foreign investments to developing countries that join it, and that this is an indispensable condition for their development as it would spur economic growth. It is this claim that has attracted the positive attention of some developing countries to the MAI model.

The MAI's main assumption is that foreign investment and its free movement only generates benefits for the host country, and does not result in costs, and that thus any increase will necessarily contribute to development. This assumption cannot stand the test of reality.

Firstly, since investment is defined in such a broad way, and no distinction is made for the possible differential effects of different kinds of "investment", there is the unsustainable case made out that all kinds of foreign investment, especially when controls and regulations are lifted, necessarily lead to benefits.
It is true that if the inflow of funds is well managed and the investment is used and implemented in the proper way, the benefits of increased capital, technology and marketing networking could more than offset the costs (which include the servicing of the investment and its possible eventual repatriation). However, the record shows that in the case of foreign loans (included as investment under the MAI), the lack of control over their inflow and the absence of a framework for ensuring their proper use often (or usually) lead to an external debt crisis that causes recession for many years. In the case of foreign portfolio investment, its free movement in and out of developing countries can cause great volatility and instability in the flow of funds, in the exchange rate, and in the real economy financial instability, as the current financial crisis in many Asian countries, Russia and Brazil has shown. Even in the case of FDI, as we have earlier seen, there are costs as well as benefits (in terms of savings, growth and balance of payments, and also

in social and cultural terms) and only under certain conditions will the balance be positive.

Given these complex realities, it is obvious that foreign investment has to be prudently and well managed, so that the benefits are well brought out and the costs reduced, and that the former exceeds the latter. As this will happen only under certain conditions, the policy makers in the host developing countries need an array of policy instruments in an attempt to achieve net positive results. In the past and presently these instruments have included careful screening of investments and various conditions imposed on approved investments, a wide range of performance requirements (including technology transfer, establishment of joint ventures, local content), and controls on capital inflows and outflows (especially on loans and short-term capital). It is precisely these policy instruments that the MAI is aiming to dismantle and make illegal. By so doing, the MAI would deprive developing countries of the opportunity or even the possibility of ensuring net benefits from foreign investment, and ironically (despite its preamble) it would more than tilt the balance so that foreign investment would probably result in costs outweighing the benefits in many cases.

As for the argument that an MAI-like agreement, by ensuring greater rights and protection to investors, would lead to a greater increase of investments in developing countries and thus to higher growth and development, once again this makes assumptions that do not stand the test of reality.

Even if an MAI-like agreement leads to increased investment for a country, this is not necessarily good as the effects depend on the quality and type of investments and their management. Thus, especially under conditions of capital deregulation and liberalisation (which are the conditions championed by the MAI), it is possible (and even more likely) that the increased inflow will cause problems, even massive problems, as the current Asian crisis has demonstrated.

But even if a country is willing to take the risks of increased and unregulated inflows, there is no guarantee (and in many cases no likelihood) that there will be an increase in foreign investment. The flow of foreign investment is determined by many factors, of which the treatment and protection of investment is only one factor, and usually not the most significant. Other factors are the opportunities for sales and profits, the size of the market, the general level of development of a country, the state of the infrastructure and quality of labour skills, political and social stability, the availability of natural resources to exploit, the location of the country. A developing country that joins the MAI but does not possess some or most of the above qualities is likely not to experience an increase in foreign investment. Many countries that liberalised their foreign investment regimes under structural adjustment programmes have not seen a rise in foreign investment inflow.

A case may be made that all other things being equal between two developing countries, the one that joins the MAI will have an additional factor to attract foreign investments. However, presumably the proponents of the MAI (or a similar agreement) would like as

many countries as possible to join. Thus, should most developing countries be persuaded to be members, then there would be no advantage for any of them. The advantage would be to the foreign investor, whose treatment and protection is tremendously enhanced but whose obligations to the host country would be minimised. The developing countries as a whole would be at a disadvantage and lose both their policy options and their opportunity to maximise or increase their benefits from foreign investment.

Indeed, it is likely that the least developed countries would be at most disadvantage. More advanced developing countries have more of the attractive qualities (profitable market, infrastructure, skilled labour). An LDC can offset its lack of attractiveness by offering better treatment, protection or incentives. But if most or all developing countries were to join the MAI, then the LDCs would lose this advantage.

(2) LOSS OF POLICY AUTONOMY

Most countries of the South welcome foreign investments for their role in fostering economic growth. However, many countries also have sophisticated regulatory frameworks that govern the entry and conditions of establishment and operations of foreign firms.

Restrictions are placed on foreign investments in certain sectors or in some ways (for example, requiring that a percentage of equity be reserved for locals). These are aimed at attaining a minimum level of participation of local people in the economy; at protecting and strengthening local firms and small farmers which would otherwise not be able to face the onslaught of giant multinationals; and at protecting the balance of payments from too much financial outflows due to profit repatriation and high import bills of foreign companies.

Under the liberalisation sections, the MAI aims at ultimately giving foreign investors the right to enter and establish enterprises with full equity ownership in all member countries.

This is particularly significant since, as we have seen, a very broad definition is given to the terms "investors" and "investments". Thus, governments would no longer have the authority to screen the entry of foreign investors (or even of non-commercial societies), nor to place limits on the degree of their participation in the national economy and society. (The MAI would however allow some general exceptions as well as country-specific reservations, including on a sectoral basis. However any "rolling back" of investment rules would be prohibited).

The proposed MAI would prevent developing countries from the policy instruments and options they require to attain economic and social development. A very major component of economic policy making (that relating to investment mobilisation, strategy and use, and capital flows) would be removed from the jurisdiction of national

authorities, affecting industrialisation, finance and development as a whole. The loss of policy autonomy in this crucial area is will seriously adversely affect the development prospects of developing countries.

By removing much of the regulatory authority of governments, and by allowing investors to sue governments in international courts, the MAI would also create the conditions where it would be difficult for member states to strengthen or even maintain environmental, safety, health and social standards.

(3) Erosion of sovereignty and local participation in the national economy

The MAI or a similar agreement would seriously erode national sovereignty as well as local participation in the national economy.

States at present have national sovereignty over their natural resources. This was more recently reaffirmed in the Convention on Biological Diversity, where national sovereignty over biological and genetic resources was recognised as a primary principle. However, the extreme liberalisation model of the MAI would severely reduce and limit this sovereignty, as foreign investors would have the right of establishment and national treatment in all sectors, including land, forestry, mining and other natural resources, unless these sectors are specifically excluded in a country's exclusion schedule. Even if such resources are listed, there would be a "standstill" in that the existing policies cannot be altered in the direction of more regulation, and there will be continuous pressures for further liberalisation. In practice as well as in the rules, developing countries would find their sovereignty over resources eroded.

Several features of the MAI would result in erosion of sovereignty and of local participation in the economy. They include the following.

(a) The broad definition of "investor" and "investment" to also include non-commercial organisations and activities would make it difficult for states to disallow or regulate the entry and operations of foreign political, social, cultural or even religious organisations.

(b) The right to establishment (especially in the pre-establishment phase) would remove (or at least seriously erode) the state's crucial authority in approving, approving with conditions, or rejecting foreign direct investment applications as well as proposals for foreign operations in finance.

(c) The national treatment principle implies that policies that favour local businesses, farmers or even consumers (for example in house and land purchases and ownership) would be prohibited. Small and medium-sized local firms and farms would not be able to enjoy " affirmative action" policies as these would be considered illegitimate acts of discrimination against foreign companies.

(d) The prohibition of a long list of performance requirements would remove the state's right to impose obligations on foreign (and even local) investors to meet social and development objectives. Moreover, this would prevent several measures presently taken by many governments to increase local participation in the domestic economy. Besides the local content requirement (which is already prohibited in the WTO), the prohibition of the requirements on technology transfer, establishing joint ventures with local partners, on minimum level of equity participation, hiring nationals and preference to purchase local products, will affect the ability of governments to boost local enterprises, the level of local skills and technology and the domestic economy in general.

(e) The application of national treatment to privatisation exercises means that in many developing countries local investors would lose their present advantage since privatisation policies often give preference to nationals or may require foreign investors to form partnerships with local investors (or to allow a certain level of local equity ownership). The erosion of local control is made worse by restrictions on "golden shares" which make it difficult for governments to retain some control over privatised concerns. As a result, a substantial part of privatised national assets is likely to come under foreign investor control.

(f) The definition of "expropriation" and the dispute settlement system will be powerful devices that severely constrain a developing country from formulating economic, social and environmental policies, as revealed in the Ethyl Corporation case. The wide latitude given to states and investors to sue other states, and the high costs of defence and of compensation (in the event the case is lost) would act to exert great pressure on developing countries not to have any policies that could offend foreign investors as the mere threat of action by them may cause the government to reverse its intended policies. (In a WTO agreement it is not envisaged that companies can sue states, but they can request their home state to sue another state on their behalf).

(4) Possible Effects on the National Financial Position

The deregulation and liberalisation of such a wide variety of foreign investments, credit and financial operations (through the MAI provisions on the right of establishment and on transfers of funds) is likely to result in conditions where a host developing country face deterioration in its financial position, or even a financial crisis.

Decontrol and deregulation of foreign loans and portfolio investment can lead to greatly increased volatility in inflows and outflows. As most developing countries (and even some developed countries) do not have the capacity to withstand the potential shocks caused by such volatility, the financial liberalisation process will create greater potential for financial crises of the type seen in recent years in Mexico, East Asia and Brazil. Needless to say, susceptibility to these crises would greatly affect the potential for development.

Even in the case of FDI, there is a tendency for its liberalisation to generate net outflows of foreign exchange and a deterioration in the balance of payments, which in the worse cases could also generate sharp currency depreciation and financial crisis. The MAI, by preventing host countries from taking measures to compensate for the negative balance-of-payments effects of FDI, could well contribute to this process. Given the increasingly financially integrated world, the risks of balance of payments deficits becoming financial crises that then develop into recession in the real economy have become much greater. It is really a case of bad timing that the MAI would prevent or seriously constrain governments from avoiding or reducing those risks.

Finally, developing countries could also find themselves facing a series of expensive legal suits from either other states or foreign investors. Bearing the costs of defence and of the tribunal proceedings can already be a heavy burden, whilst in the event of losing the cases the country may find itself with enormous compensation claims that have to be met in international foreign exchange. The potentially very high financial losses on this account should not be underestimated, given the Ethyl case.

(5) Effects on Social Development

A key point in the MAI preamble is that the treatment given to investors will contribute to efficiency, employment and living standards. However this assumption should be tested against the possible effects of the MAI on aspects of social development.

The inclusion of short-term capital flows in the MAI, and its tendency to get member states to liberalise these flows, would in the light of present knowledge and experience more likely lead to financial instability and multi-year recession. The MAI would make developing countries more susceptible to the kind of crisis that befell East Asian countries in 1997-99. The crisis has caused not only unprecedented rates of declines in the GDP, but also sharp deterioration in social conditions, with dramatic increases in the rates of poverty, unemployment and living standards and deterioration in education and health standards.

Even without considering these negative effects of liberalising short-term capital flows, the liberalisation and national treatment of FDI through the MAI can also lead to negative effects on social development.

The treatment provided to FDI in the MAI could cause the displacement of local enterprises and also local farms, since the protection or favourable treatment accorded to them would be removed. This is especially so in the case of FDI that targets the home market, rather than the export market. In such cases, this will result in retrenchments as the local sector loses its share of business. It is true that FDI would also generate local employment and thus could offset some of these job losses. However it is well known that per unit of capital employed, FDI generates far fewer jobs than local firms (which are more labour-intensive). Since the flow of FDI, including to developing countries, is limited, it would not be possible for FDI to generally be in such great quantities as to

absorb the loss of jobs caused by displacement of local firms. There can of course be exceptions, in those few developing countries where much of the flow of FDI is concentrated and where FDI is predominantly export-oriented. However, for countries where there is a large population and high unemployment, it is unlikely that FDI can make a significant dent in reducing unemployment and the overwhelming task of generating jobs will fall on local enterprises. The constraints placed on governments will make it much more difficult to assist in the capacity building and operations of this local sector.

The MAI provisions on foreign key personal, on management and choice of employees could also affect the employment opportunities of local professionals in many developing countries, since the governments would have to phase out or remove policies that reserve executive, managerial or professional positions for local people through restrictions on the entry of foreign personnel. Most developing countries now have regulations restricting the number (and functions) of foreign staff a foreign investor can bring in.

(6) Implications for Human Rights

The NGO human rights community has also expressed concern over the implications of the MAI on the enjoyment of human rights. Partly through the efforts of human rights activists, the MAI was recently brought to the attention of the Human Rights Commission (Kothari and Prove, 1999). In August 1998, the UN Sub-Commission on Prevention of Discrimination and Protection of Minorities adopted a resolution on "Human rights as the primary objective of trade, investment and financial policy." The resolution emphasised that the realisation of human rights and fundamental freedoms described in the international human rights instruments is the "first and most fundamental responsibility and objective of States in all areas of governance and development."

In this context, the Sub-Commission expressed concern about the human rights implications of the MAI and "particularly about the extent to which the Agreement might limit the capacity of States to take proactive steps to ensure the enjoyment of economic, social and cultural rights by all people, creating benefits for a small privileged minority at the expense of an increasingly disenfranchised majority." The resolution called on the OECD to "review the draft text of the Multilateral Agreement on Investment to ensure that all its provisions are fully consistent with their human rights obligations, and to keep these obligations in mind during any future negotiations on the Agreement." (Kothari and Prove 1999). The Sub-Commission also mandated the preparation of a working paper on ways by which the primacy of human rights norms could be better reflected in trade, investment and financial agreements and practices, and how the UN human rights system could play a central role in this regard. The paper is also to include "an analysis of the text of the MAI from a human rights perspective, and to consider ways to ensure that future negotiations on the MAI or analogous agreements or measures take place within a human rights framework."

In 1998, an International NGO Committee on Human Rights was established by many human rights groups. The impetus to form the Committee came from the perceived threat to economic, social and cultural rights posed by the MAI (Kothari and Prove, 1999). A policy statement by the NGO Committee revealed the following four human rights principles as being under threat:

(a) The primacy of human rights: The promotion and protection of human rights must be accepted as the fundamental framework for and goal of all multilateral and bilateral investment, trade and financial agreements. Such agreements cannot exclude or ignore human rights principles and aims without losing their most fundamental claim to legitimacy.

(b) Non-retrogression: All States have a duty to respect, protect, ensure and fulfil international human rights obligations and cannot derogate or limit them except as provided for in human rights treaties. "Rollback" and "standstill" requirements in the MAI are incompatible with the requirement that economic, social and cultural rights be realised progressively as stated in the International Covenant on Economic, Social and Cultural Rights. There is a specific duty on States to not take retrogressive measures that would jeopardise these rights.

(c) The right to an effective remedy in the appropriate forum: The right to an effective remedy for anyone whose rights have been violated cannot be contracted away by the State nor denied by the operations of inter-governmental institutions. Investment or trade bodies should not adjudicate concerns that fall firmly into the human rights domain, as disputes between corporations and State actors, but these should be dealt with by appropriate domestic, regional and international human rights fora and enforcement mechanisms.

(d) Rights of participation and recourse of affected individuals and groups: Human rights cannot be effectively realised unless the right of participation of the affected populations in planning, implementation and seeking redress for violations is respected. The participation of women in all these processes is particularly important.

(7) Effects on the Environment and Community Rights

Investment liberalisation and increased rights to foreign investors could also result in adverse environmental effects. Firstly, it would be more difficult for developing countries to restrict the participation or regulate the operations of TNCs and other foreign firms in the natural resources sector. As the large multinationals generally have greater technical capacity, their ability to exploit, damage, destroy or pollute the physical environment at a faster rate can be greater than smaller local firms. It is true that local firms are usually also do not have ecological practices, and that some TNCs could have more environmentally friendly technology. But by and large the large firms can do more damage due to their greater scale and speed of operations. TNCs are the most important players and factors involved in many environmentally damaging activities. Their

activities generate more than half of the greenhouse gases emitted by industrial sectors with the greatest impact on global warming; in mining, TNCs still dominate key industries and are intensifying their activities; in agriculture, TNCs control 80% of land worldwide cultivated for export crops; and 20 firms account for 90% of pesticide sales; TNCs manufacture most of the world's chlorine, the basis for some of the most toxic chemicals including PCBs, DDT and dioxins; TNCs are the main transmitters of environmentally unsound production systems, hazardous materials and products to the Third World (Khor, 1997). Case studies of the recent performance of twenty TNCs by Greer and Bruno (1996) show that despite the improved public relations exercise claiming greater environmental responsibility and despite more and more voluntary codes of conduct by industry, there has been little change and much "business as usual", with the corporations continuing with activities that are environmentally harmful.

Investment liberalisation and deregulation under the MAI will greatly facilitate the further spread of TNCs in the developing world. With their continuing use of unsustainable production systems (and promotion of wasteful lifestyles), and in many cases displacing more sustainable systems or lifestyles, more environmental degradation worldwide must be expected.

The case of investment liberalisation in the mining sector is illustrative. In recent years, there has been a worldwide escalation of mining projects by foreign companies, accompanied by social protests by affected communities, including in Venezuela, Ecuador, Ghana, Nigeria, Papua New Guinea, Burma, Borneo, the Philippines. Pressure on developing countries to open up to foreign investors have led to new or amended mining laws that threatens the environment and is resulting in widespread dislocation of communities and social chaos. In a study of recent trends in the global mining industry, Corpuz (1997) shows that in recent years many developing countries liberalised and deregulated their mining laws. Around seventy countries in Latin America, Africa, Asia-Pacific are now fully liberalizing their mining laws and implementing deregulation in a wide range of areas, including land rights and mineral rights, taxation, environment protection, in order to attract foreign mining investors.

This liberalisation policy at national level is accompanied by the globalisation of mining operations. Mergers concentrate the power of mining TNCs even further, putting them in a better position to further expand their control over mineral lands. Mining TNCs are motivated to open up in the Third World because of the tightening environmental standards and increasing resistance from the indigenous peoples and environmentalists in their own countries and depletion of their mineral resources. To escape from the high environmental regulations which require them to install expensive anti-pollution technologies and devices and other environmentally sound technologies, many companies transfer their operations to countries which no or low regulations.

A good illustration of the effects of the recent liberalisation of mining laws on sustainable development and people's livelihoods is provided in Corpuz (1996). In recent years in the Philippines there has been a major policy shift, where land previously restricted to foreigners has now been opened up to foreign mining companies. Much of the untapped

mineral lands are in regions populated by indigenous peoples, and also where small-scale local miners operate. The new Mining Act of 1995 allows foreign mining companies 100% control of their local subsidiaries (in contrast to previous requirement of 60% Filipino ownership). The law also provides for tax holidays and other exemptions, and gives other rights such as Water Right and Timber Right (or prior rights to the company in the use of water and forest resources) and "Easement Right" (the right to evict people from the mineral areas). Mineral lands are also exempted from the issuance of ancestral land claims and ancestral domain claims.

According to Corpuz (1996), there are already hundreds of mining applications pending approval. Taking the lands applied for and including existing and already approved mining operation areas, 45% of the entire 30 million-hectare land area of the country is affected by mining applications and operations. The indigenous people in particular have protested against the violation of their land rights and the dislocation the proposed mining activities would bring to large numbers of them.

The liberalisation of investment regimes will also likely have adverse ecological effects on forests and agriculture. Despite great public concern over the fate of the world's forests, logging activities are still undertaken, often by foreign companies. The increasing use of genetic engineering technology in agricultural crops has raised grave concerns by scientists and environmentalists that it will adversely affect biodiversity and also destabilise agricultural production. Some European countries have imposed a moratorium on the commercial use of genetically-engineered crops. However, with the present investment liberalisation (even before the MAI) spreading to agricultural sector, some developing countries are already introducing such crops, even though they do not yet have the biosafety knowledge or capacity in place.

The MAI is likely to make it more easy for foreign companies to operate with less regulations in many sectors in developing countries. This will correspondingly make it more difficult to implement environmentally sustainable development practices and policies.

ANNEX 4: OTHER ATTEMPTS AT INTERNATIONAL FRAMEWORKS ON INVESTMENT

The initiatives on the MAI are of course not the first attempts at establishing an international framework on foreign investment. However, the approach taken by the MAI proponents is new in that it is an extreme and one-sided approach as it covers and greatly expands the rights of international investors, whilst not recognising and thus greatly reducing the authority and rights of host governments and countries. It also promotes investment liberalisation (through legally-binding rules) that would facilitate the international movement of capital and foreign corporations, with their great capacity to change the physical, economic and social environment of the host countries, whilst it contains little or no safeguards to oblige or ensure that the powerful international firms respect or promote sound environmental, social and development practices and principles. Moreover the proposal to have a very strong international enforcement mechanism either in the OECD's MAI framework, or in the WTO's dispute settlement system means that the foreign investors' rights can be effectively enforced, and the host countries would be effectively disciplined to fulfil their obligations.

This one-sided approach on behalf of foreign investors' interests is in contrast to some earlier attempts within the UN system to set up an international framework on foreign investments that attempted to balance the rights and obligations of foreign investors and host countries, as well as to balance the foreign investors' production activities with development, social, environmental goals.

On a general level, the most well known has been the Draft UN Code of Conduct on Transnational Corporations, which underwent a decade of negotiations from 1982 to the early 1990s under the UN Commission on Transnational Corporations, and serviced by the UN Centre on Transnational Corporations (UNCTC). The draft text of the Code of Conduct on TNCs had two core content sections, one that dealt with the obligations of TNCs to host countries (Section on "Activities of TNCs"), and one with the obligations of host countries to TNCs (Section on "Treatment of TNCs"). A review of the February 1988 version of the text of the Code shows that the Code was an attempt at balancing the rights of host countries with the rights of foreign investors, and the obligations of TNCs with the obligations of host countries. The Code was also inclusive of many issues, including political dimensions (respect for national sovereignty, non-interference and human rights), development dimensions (transfer pricing, balance of payments, technology transfer) and social dimensions (socio-cultural values, consumer and environmental protection).

The section on **"Activities of TNCs"** includes the following areas:

(A) General aspects, including:

- Respect for national sovereignty and observance of national laws, regulations and administrative practices;
- Adherence to economic goals and development objectives, policies and priorities of host countries

- Review and renegotiation of contracts and agreements
- Adherence to socio-cultural objectives and values
- Respect for human rights and fundamental freedoms
- Non-collaboration by transnational corporations with racist minority regimes in southern Africa
- Non-interference in internal affairs of host countries
- Non-interference in intergovernmental relations
- Abstention from corrupt practices

(B) Economic, Financial and Social Aspects, including:
- Ownership and control
- Balance of payments and financing
- Transfer Pricing
- Taxation
- Competition and restrictive business practices
- Transfer of technology
- Consumer protection
- Environmental protection

(C) Disclosure of information

The section on **"Treatment of Transnational Corporations"** includes the following areas:
(A) General provisions relating to the treatment of TNCs
(B) Nationalisation and compensation
(C) Jurisdiction
(D) Dispute settlement

A preamble setting out the overall aim states that a universally accepted Code of Conduct on Transnational Corporations is an essential element in strengthening international cooperation, in particular to "maximise the contributions of transnational corporations to economic development and growth and to minimise the negative effects of the activities of these corporations."

The Code was therefore placed in the context of international cooperation, recognised both the contributions and negative effects of TNCs, and sought to maximise the former and minimise the latter, towards the goal of development and growth. This is a more balanced approach than the MAI which implicitly only makes claims for the benefits of liberalising and protecting foreign investments, and does not recognise or attempt to deal with the negative aspects.

The draft Code recognised both the rights of the host countries and the right of TNCs to fair and equitable treatment. In the section on "Activities of TNCS," the Code contains many essential points obliging TNCs to recognise and respect the host government and country. The following are among the key elements.

ACTIVITIES OF TNCS

A. General

** TNCs shall respect the national sovereignty of host countries and the right of each States to exercise its permanent sovereignty over its natural wealth and resources.

** TNCs are subject to the laws and regulations of a country in which they operate, and shall also respect the right of each State to regulate and monitor the activities of their entities operating within its territory.

** Activities of TNCs should conform with the development policies, objectives and priorities of host governments and seriously work to contribute to achieve such goals. They should cooperate with host governments to contribute to the development process and respond to requests for consultation in this respect.

** TNCs should respect the social and cultural objectives, values and traditions of the countries in which they operate, and avoid practices, products or services which cause detrimental effects on cultural patterns and socio-cultural objectives as determined by governments.

** TNCs shall respect human rights and fundamental freedoms in countries in which they operate. In their social and industrial relations, TNCs shall not discriminate on the basis of race, colour, sex, religion, language, ethnic origin or political or other opinion; and shall conform to government policies to extend equality of opportunity and treatment.

** TNCs shall not interfere in the internal affairs of host countries; shall not engage in activities of a political nature that are not permitted; and not interfere in intergovernmental relations.

** TNCS shall refrain from offering or giving payment to a public official as consideration to perform or not perform his duties; and shall maintain accurate records of any payment to any official.

B. Economic, financial and social

** TNCs should make every effort to allocate their decision-making powers among their entities to enable them to contribute to the development of host countries.

** TNCs should cooperate with governments and nationals of host countries to implement national objectives for local equity participation and for the effective exercise of control by local partners

** TNCs should carry out personnel policies in line with national policies of host countries which give priority to the employment and promotion of nationals in management to enhance effective participation of nationals in decision-making.

** TNCs should contribute to the managerial and technical training of nationals in host countries.

** Balance of payments: TNCs shall conform with host country policies on balance of payments (BOP) and financial transactions, and contribute to alleviating pressing problems of BOP and finance of host countries.

** TNCs should contribute to promotion and diversification of exports and to increased utilisation of goods, services and other resources locally available.

** TNCs should be responsive to requests by host governments to phase over a limited period the repatriation of capital in case of disinvestment or remittances of accumulated profits when the size and timing of such transfers would cause serious BOP difficulties.

** TNCs should not engage in short-term financial operations or transfers or defer or advance foreign exchange payments (including intra-corporate payments) in a manner which would increase currency instability and thereby cause serious BOP difficulties.

** TNCs should not impose restrictions on their entities on transfer of goods, services and funds which would cause serious BOP difficulties.

** Financing: When having recourse to money and capital markets of host countries, TNCs should not engage in activities which have adverse impact on the working of local markets, particularly by restricting availability of funds to other enterprises. When issuing shares or borrowing in the local market, they should consult with the government on the effects of such transactions on local markets.

** Transfer pricing: In intra-corporate transactions, TNCs should not use pricing policies that are not based on relevant market prices or the arm's length principle which adversely affect tax revenues and foreign exchange resources of countries in which they operate.

** Taxation: TNCs should not use their corporate structure and modes of operation, such as intra-corporate pricing, to modify the tax base on which their entities are assessed.

** Competition and RBPs: The provisions of the Set of Principles and Rules for Control of Restrictive Business Practices of December 1980 shall apply to this Code.

** Technology transfer: TNCs shall conform to technology transfer laws and regulations in host countries and cooperate to assess the impact of international technology transfers and consult with them on various technological options.

** TNCs should avoid practices which adversely affect the international flow of technology or otherwise hinder economic and technological development of countries.

** TNCs should help strengthen the scientific and technological capacities of developing countries and undertake substantial research and development activities in developing countries and make use of local resources and personnel in this process.

** Consumer protection: The operations of TNCs shall be carried out in accordance with laws and policies on consumer protection in host countries and shall follow international standards so they do not injure the health or threaten the safety of consumers or vary the quality of products in each market with detrimental effects on consumers.

** TNCs shall supply to any country they produce or market in information on their products and services concerning: characteristics that may injure health and safety of consumers; and prohibitions, restrictions, warnings and regulations imposed in other countries on health and safety grounds.

** TNCs shall disclose to the public information on contents and possible hazardous effects of their products through labelling and accurate advertising.

** Environmental protection: TNCs should operate in accordance with national laws and international standards on the environment. In their activities, they should protect the environment and if damaged rehabilitate it and apply adequate technologies for this purpose.

** TNCs should supply to the authorities information on: characteristics of these products, processes (including experimental uses) which may harm the environment and the measures and costs needed to avoid or mitigate the harmful effects; prohibitions, restrictions and regulations imposed in other countries on environmental grounds.

C. Disclosure of information

** TNCs should disclose to the public in countries they operate in comprehensive information on structure, policies and activities of the TNC as a whole. The Code lists the kinds of financial and non-financial information needed.

** TNCs shall provide to trade unions in countries they operate in information in accordance with the ILO Tripartite Declaration of Principles concerning Multinational Enterprises, including future prospects or plans having major economic and social effects on employees.

TREATMENT OF TNCS

General provisions on treatment

** In matters relating to the Code, States shall fulfil their international obligations including international legal rules and principles.

** States have the right to regulate the entry and establishment of transnational corporations including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors.

** Subject to national requirements for public order and national security and consistent with national laws, and without prejudice to development objectives of developing countries, TNCs should be given treatment accorded to domestic enterprises in similar circumstances.

** Confidential business information furnished by TNCs to the authorities shall be accorded safeguards to protect its confidentiality.

** TNCs are entitled to transfer all payments legally due, subject to the host country's legislation, such as foreign exchange laws and restrictions emanating from exceptional BOP difficulties.

NATIONALISATION, DISPUTE SETTLEMENT

** It is acknowledged that States have the right to nationalise or expropriate the assets of a TNC operating in their territory, and that appropriate compensation is to be paid by the State in accordance with applicable legal rules and principles.

** An entity of a TNC is subject to the jurisdiction of the country in which it operates.

** Disputes between States and TNC entities shall be submitted to competent national courts or authorities. If they agree, such disputes may be referred to other mutually acceptable dispute settlement procedures.

INTERGOVERNMENTAL COOPERATION

** States agree intergovernmental coop[eration is essential to accomplish the Code's objectives and should be established and strengthened at bilateral, regional and interregional levels.

** States agree to consult on matters and application of the Code and with respect to developing international agreements and arrangements on issues related to the Code.

** States agree not to use TNCs as instruments to intervene in the internal or external affairs of other states and agree to take action to prevent TNCs from engaging in activities that interfere in internal affairs of or engage in political activities in host countries.

** Government action on behalf of a TNC operating in another country shall be subject to the principle of exhaustion of local remedies and procedures for dealing with international legal claims. Such action should not amount to the use of any type of coercive measures not consistent with the UN Charter.

IMPLEMENTATION

** At national level, States should implement the Code and report to the UNCTC on action to promote the Code.

** At international level, the UN Commission on TNCs shall be the institutional machinery to implement the Code, with the UNCTC as secretariat. The Commission's functions shall include: discussion at annual sessions matters related to the Code; periodically assess the Code's implementation; clarify the Code's provisions in the light of actual situations where the Code has been the subject of intergovernmental consultations; facilitate intergovernmental arrangements or agreements on specific aspects relating to TNCs upon request of governments.

** The UNCTC shall assist in the Code's implementation by collecting, analysing and disseminating information and conducting research and surveys.

** The Commission shall make recommendations to the General Assembly to review the Code, with the first review not later than six months after the Code's adoption.

It is worthwhile to have another look at the provisions of this draft Code as many of them deal with the same issues as the MAI but remarkably take a different or opposite position on many of them. The Code's main difference with the MAI is that the majority of its articles deal with the obligations of TNCs towards the host country, whilst the MAI is silent on this. In fact, the MAI has taken an opposite position, converting what were TNC obligations to observe the host country's rights, into the host State's obligations to observe the foreign investors' rights not to be hampered by obligations or requirements by the host State.

For example, the Code requires (or encourages) TNCs to conform to the host country's policies on equity participation by nationals, on technology transfer, employment and training of nationals, use of local products and resources, and protection of balance of payments whereas the MAI on these very same matters prohibits the governments of host countries from imposing these policies on foreign investors (and even on local investors). One of the most glaring of conflicting positions is in the treatment of the right of entry

and establishment. Whereas the Code affirms the State's right to regulate the entry and establishment of transnational corporations including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors, the MAI specifically confers rights of establishment to foreign investors and denies States the right to regulate (except through country-specific exceptions).

The Code and the MAI are obviously the products of contrasting paradigms. The Code arose from the perception that the host developing countries, whilst having to accord some rights to TNCs, required an international understanding that TNCs have to comply with international guidelines that recognise the countries' development needs and national objectives, and that the hosts could by right allow the guest foreign investors to enter and operate on terms generally chosen by the hosts. The affirmation of the host countries' rights was seen to be important in light of the perceived growing economic power of TNCs and their potentially great economic, social, cultural and even political impacts on host developing countries. The Code also recognised the positive and negative effects of TNCs. As the UNCTC pointed out, the Code was meant to provide a stable, predictable framework to enhance the role of foreign investments in growth and at the same time minimise any negative effects associated with the activities of TNCs. (UNCTC 1990: p20).

The MAI on the other hand has arisen from the perceived need by foreign investors to expand and protect their interests from the perceived interference by states that impose conditions on their operations. In this paradigm, the "borderless world" is the ideal construct, and any barriers to the free flow of investments and to the right to investment, property ownership and unhindered operations must be considered "distortions" and the denial of the investors' rights. The affirmation of these alleged investors' rights are seen as important to prevent states from constraining the expansionary reach and operations of foreign investors. Whilst the Code envisaged only a weak enforcement system, based on voluntary compliance and international cooperation, the MAI proponents suggested an extremely effective dispute settlement system to enforce the legally-binding rules. The MAI assumes that foreign investment brings only benefits to all countries, and does not recognise or attempt to deal with any negative effects.

A reading of the two texts gives the impression that the MAI was in some way a response to the Code, a substitution of one paradigm for another.

Negotiations on the Code started in 1976 and despite disagreements on many points through the years, agreement had been reached on about 80 percent of the text. "A draft text of the Code lies nearly complete, but blocked by continued disagreement over a few key issues," stated a UNCTC document in 1990. (UNCTC 1990: p1). The disagreements were never resolved. The attempt at a balanced approach through the Code failed, due mainly to the reluctance and hostility of some developed countries that did not favour the obligations placed by the Code on TNCs. In 1992, the Code process was abandoned. The UN Commission on Transnational Corporations itself was disbanded, and the UN Centre on TNCs (which was secretariat for the process) was also closed down and some

of its staff were transferred to UNCTAD's Investment Division, whose present functions are very different from those the Centre had performed.

The aborted Code of Conduct on TNCs was the main set of international guidelines that were to have dealt generally with the relations between TNCs or foreign investors with states. However, there are a number of other codes and guidelines that the UN system has established or attempted to establish that cover more specific issues.

These include the UNCTAD-based Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (adopted in 1980 by the UN General Assembly) and the Draft International Code of Conduct on the Transfer of Technology (which has not yet been adopted by the General Assembly); the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy (1977); the WHO-based International Code of Marketing of Breast-Milk Substitutes (1981); and the Guidelines for Consumer Protection (based on a UN General Assembly resolution in 1985). In the environmental field, there are also international legal agreements (such as the Basel Convention banning the export of hazardous wastes to developing countries) that have an influence on the behaviour of international companies.

These instruments have the intention of influencing the behaviour of foreign investors and TNCs so that they conform to development needs, or fulfil social and environmental obligations. Together they would also constitute elements of an alternative approach to an international policy or framework on foreign investment. Such a framework, encompassing the various existing instruments, could be further developed through additional instruments covering other areas by sector and issue.

However, such an approach would have to contend with the, at present, stronger international trend emphasising investors' rights to the exclusion of host country rights. At the same time as the Code of Conduct on TNCs was being downgraded and eliminated, and the UN Commission on Transnational Corporations was being eclipsed, negotiations were taking place on Trade Related Investment Measures (TRIMS) in the Uruguay Round. The Uruguay Round approach to investment was to eventually supplant the more balanced approach of the Code of Conduct process.

The TRIMS proposal initially contained two components. The first involved foreign investment policy and rights per se (including the right of entry and establishment of foreign companies and granting of national treatment to them). The second dealt more narrowly with investment measures (such as local content policy) which have direct effect on trade.

Many developing countries initially objected strongly to TRIMS being brought into the GATT system. They eventually succeeded in removing the first aspect (investment per se), on the grounds that governments had the sovereign right and the necessity on development grounds to regulate the entry and terms of operations of foreign investments, and that the GATT system was not the competent body to deal with the

issue. The second aspect was developed in the Uruguay Round negotiations and established as the present TRIMS agreement in the WTO.

Some developed countries are now seeking to bring back the broader issues of investment policy per se into the WTO via a proposed MAI-type investment agreement.

The recent history of evolving an international framework for foreign investment shows that the proposed MAI (and models based on it) constitutes only one approach. It is an approach based on a paradigm that seeks to protect foreign investors' rights to the exclusion of their obligations and of host countries' rights. A alternative approach would take into account the rights and obligations of host countries and foreign investors, ensure that these are properly balanced, and be based on the primary objective of contributing to economic development and social and environmental objectives. It is however an issue for debate whether such an approach is possible in the present global environment, and also what would constitute an appropriate venue for discussions on the investment issue.

Annex 5: PROPOSALS FOR APPROPRIATE MANAGEMENT OF FOREIGN INVESTMENT

1. INTRODUCTION

Previous sections have emphasised the following points:

(i) There are various categories of foreign investment, and it is important for governments to distinguish between the different types, understand the characteristics and effects of each type, and formulate policies to deal with each.

(ii) Even in the apparently most beneficial type, FDI, where there can be important contributions to development of host countries, it is academically recognised that there are also potential costs and risks, among the most important of which are financial instability and balance of payments difficulties.

(iii) Therefore a policy framework for managing FDI must take into account the need to attempt to maximise the benefits whilst reducing the costs and risks.

(iv) Thus, governments, especially of the developing countries, because of their greater vulnerability, need to be able to formulate policies that: (a) distinguish between the types of FDI that are appropriate; (b) encourage the entry of FDI considered desirable whilst discouraging or disallowing FDI considered not so appropriate to the country; (c) impose certain conditions, if found necessary, on the operations of FDI; (d) subject FDI policy to the wider national objectives and development needs.

(v) The MAI approach is too one-sided in its objectives and functions of protecting and furthering foreign investors' interests whilst denying the interests of host states and countries. Moreover there is the assumption that there is no need to distinguish between different types of foreign investment, that all foreign investments bring only benefits but no costs, and the articles of the MAI are therefore drawn up under assumptions. Social, cultural, development, environmental and human rights concerns are also ignored in this approach.

(vi) There have been other attempts at creating international frameworks dealing with foreign investments or the behaviour of foreign enterprises. Some of these have been more accommodating to the rights and needs of host developing countries and to the imperatives of development. It would be useful to revisit some of these attempts and to examine the usefulness of reviving, improving or extending them, as well as to examine new approaches.

Given the above conclusions, this section attempts to provide suggestions for elements of an appropriate approach or framework for the management of foreign investment. Proposals will be confined mainly to foreign direct investment. The proposals are categorised as national-level and international-level approaches and actions.

(2) NATIONAL-LEVEL POLICIES AND ACTIONS.

(a) Need for a comprehensive policy on foreign investments

Many developing countries may not have an adequate policy framework to deal with foreign investments as a whole. This is partly due to recent rapid global developments where the pace of changes in enterprise behaviour and development has exceeded the capacity of governments to adequately comprehend the trends or to formulate policy responses. Also, many developing countries that have come to depend on foreign loans or debt rescheduling often come under the influence of loan or aid conditionalities, which in recent years have included investment liberalisation. Thus, the ability or degree of freedom of governments to devise a comprehensive foreign investment policy is limited or constrained.

As a first step to remedy this situation, developing countries have to be given more space and freedom to make their own policies on foreign investment. This requires the international financial and aid agencies and the bilateral aid agencies to be more open to dialogue with and give more scope to the developing countries to own the policy process and to search for the best policy options.

Given the nature of international capital flows, national governments need to have a comprehensive policy on the interface between domestic objectives and activities and foreign capital flows. Such a policy firstly requires a distinction to be made between different capital flows, such as FDI and its varieties, portfolio investment, foreign credit and loans, and highly speculative capital that takes advantage of money, currency and capital markets in developing countries. Each kind of capital has to be studied in terms of its behaviour, pattern and effects, and policies should be made to deal with each of these.

The need for countries to distinguish between different types of foreign capital is especially acute because the recent series of financial crises has shown up the dangers posed by some kinds of capital flows, but also because the MAI (which may become the proto-type of investment agreements or frameworks since it is backed by the most powerful countries) has such a wide scope that covers all kinds of foreign investment and property rights. It is beyond the scope of this paper to deal with the various forms of investment, so the suggestions here are confined to FDI.

(b) Selective policy on and strategic approach to FDI

In view of empirical evidence on the benefits and costs of FDI, developing countries should have a selective policy and strategic approach towards FDI. The right of entry and establishment should thus be conferred by a state on to chosen foreign investors, and not be taken as inherent rights of the investors. Historically, many presently developed countries and the more advanced developing countries had such a selective policy. For

example, Japan and South Korea had very little FDI (in 1984-94 FDI inflows to Japan were less than one-tenth of one percent of gross domestic capital formation) and South Korea and Taiwan had important restrictions on FDI entry and degree of foreign ownership. Yet these countries are among the fastest growing in the world. China and Malaysia have allowed much more FDI but they also have a selective approach in terms of opening up of certain sectors where foreign firms can contribute to technological and export development whilst discouraging FDI in other sectors where domestic companies are either weak (and need protection) or already possess technical capability (as in agriculture).

(c) Need to distinguish between the differing capacities and needs of local and foreign investors

An indiscriminate policy of opening up and of treating foreign firms on equal or better terms than local firms could lead to deindustrialisation in a country where the local enterprises are too weak to compete on equal terms with foreign firms. Thus, developing countries should be allowed to continue to protect certain sectors or industries where there is considerable local investment (or where the state is encouraging the attempting to build up local capacity).

In principle, state assistance to local enterprises should not be looked at as a "distortion", or necessarily wasteful or somehow unethical, but possibly as legitimate affirmative action to help the weak companies to eventually stand on their own. There are advantages to national development for local enterprise or farm development to occur, since institutions belonging to nationals are more likely to make use of local materials and talents, generate more domestic linkages, and to retain profits locally for reinvestment, all of which are positive for economic growth and development.

Thus a blanket "national treatment" policy towards foreign investment is inadvisable as a "level playing field" for local and foreign investors is likely to result in more unequal results when the capacities are unequal, as foreign investors are larger and starting from a much stronger position.

(d) Need to ensure acceptable treatment of investors

In order to obtain FDI that is considered beneficial for national development, developing countries have to establish conditions that are attractive to foreign firms. This may include guarantees for their unhindered operations, the exercise of expropriation only in extreme circumstances and even then with adequate compensation at rates that can in principle be worked out before (so that the investor knows what the terms are), and freedom to remit profits generated from FDI. Other, and perhaps more important, conditions include political and social stability, security, good infrastructure, a credible legal system with due process, a trained or trainable labour force, tax and other

incentives, etc. Each country should however be given the space to determine which are the elements it chooses to adopt and act on.

(e) Social and environmental screening and obligations of foreign investors

Whilst developing countries may exert great efforts to attract the investors they desire, their right to request that foreign investors fulfil certain obligations and thus follow some conditions should be recognised. These may include the transfer of technology; the training and employment of local workers, professionals and executives; the development of linkages to the domestic sectors; providing local participation or partnership in equity ownership.

In light of a country's social and environmental goals and the need to maintain or raise standards, governments should carefully screen foreign investment applications and discourage or reject those projects or enterprises that would be socially or culturally detrimental (for example resulting in net loss of jobs, or endangering health and safety of workers or consumers, promoting unsustainable consumption patterns and lifestyles or adversely affect local cultural norms) or that would damage or pollute the environment (for example, through exploitation of natural resources that should be conserved; use of harmful technology or introduction of products that endanger consumer safety).

** As part of the processes of application, selection and approval, foreign investments should undergo an environmental impact assessement and a social impact assessment and only those that are positively assessed should be approved, and with conditions if necessary.

** Moreover, foreign investors may be asked not only to operate with respect for domestic laws, but also to positively contribute to social and environmental development.

(f) Assessing the effects on the local sectors and economy

In their FDI selection system, developing countries should include an assessment of the effects of the proposed investment on the local economy, especially the local enterprises, farms and informal sector. For example, positive criteria for projects under application could include that the projects do not compete with existing local enterprises or farms, that contribute new appropriate technologies and that will have significant linkages with the domestic economy; whilst adverse factors could include significant displacement of existing local firms accompanied by loss of jobs, heavy dependence on imported inputs with little demand for local resources or locally-produced inputs, and substitution of existing appropriate local products with inappropriate new products (eg expensive non-nutritious fast foods potentially replacing more nutritious local foods).

(g) Protecting financial stability and the balance of payments

Most importantly, in formulating their FDI policies, governments of developing countries should take into account the need protect their economies from the risks of financial instability and of getting into balance of payments or foreign exchange difficulties. Thus, foreign investors and their proposed projects should be carefully assessed as to the possible effects their activities would have on the nation's financial stability, foreign exchange position and balance of payments.

** For example, it may be wise policy to discourage the entrance of firms or investors whose main operations are in highly speculative financial activities.

** Conditions should be imposed that investors not indulge in activities such as transfer pricing and restrictive business practices, and efforts should be made by governments to develop more and more effective monitoring and implementation of national regulations prohibiting unethical practices.

** Foreign investment proposals should also be made to undergo a "balance of payments impact (BOP) assessment," with such indicators as impact on import payments and export earnings, profit level and the possible or predicted ratio between profit repatriation and retention for reinvestment. Investments that could lead to serious adverse effects on the BOP and on the state of foreign reserves could be discouraged; or else certain conditions or measures should be encouraged (such as local equity participation, use of more local materials and expertise within legal bounds keeping in view WTO rules, technology transfer) to help mitigate the adverse effects.

(3) INTERNATIONAL-LEVEL POLICIES AND ACTIONS

(a) Need for a fresh look at the nature and effects of foreign investments.

The nature and effects of cross-border foreign investments as a whole should be reviewed from the perspective of human-centred and socially and environmentally sustainable development. The dominant perspective, promoted by the secretariats of international financial and trade institutions amongst others, is that the free movements of capital have positive results for all countries and sections of society. Although there is now an increasing chorus of criticisms about the dangers of short-term speculative capital and calls for some regulatory mechanism, developing countries are likely to continue to face pressures for financial liberalisation. In the case of FDI, there is among the international financial and trade establishment an over-emphasis on the claimed benefits and a lack of appreciation of its potential negative effects on developing countries. Just as the claims about the unalloyed positive effects of short-term capital have been brought down to earth by the Asian financial crisis, it is possible that events will in future also show up that the positive aspects of FDI are also matched by some negative effects.

** It is thus important that a comprehensive review be made of the nature and the positive and negative effects of all kinds of foreign investment, and of the conditions for the successful use and management of each. Such a comprehensive and balanced approach is especially needed now as the global financial crisis has left in its wake a desperate search for causes, solutions, and correct policies.

** The United Nations could set up, or facilitate the establishment, of an independent commission or expert panel comprising academics, development practitioners, and agency experts to deepen and disseminate knowledge on this subject, taking a comprehensive and balanced approach, within the framework of promoting human sustainable development.

(b) Reconsideration of an appropriate international approach to foreign investment and investors' rights.

Given the inadequacies of theory and policies shown up by the financial and economic crises, it is timely for a reconsideration of international approaches to international investment. There should not be a continued "rush forward" with international policies and especially legally-binding agreements that "lock" the vulnerable developing countries into a process of capital and investment liberalisation under a MAI or MAI-type model of international arrangements on investment.

** The on-going global financial and economic crisis which is significantly related to cross-border capital flows signifies a new circumstance that calls for a deep study of and reassessment of recent trends in thinking on the nature of international capital movements. The next few years therefore should be devoted by the international community to an educative process on a wide range of investment issues. Until such a study process yields adequate insights to enable policy conclusions, there should not be initiatives to negotiate or promote a legally-binding international agreement furthering the rights of foreign investors in areas such as their movement and establishment, national treatment and compensation. In particular, there should not be any further initiatives for furthering international arrangements which constrict or deny the host states of their rights or capacity to determine the role of foreign investment in their economy and society, the entry and establishment (and conditions for these) of foreign investments, and to require that foreign investors fulfil obligations towards the national development, social and environmental goals of host countries.

** The proposed study process should be carried out within the UN system, as it is the most representative of international fora, and it is a venue where the multi-disciplinary dimensions of investment, economic and social development and environmental protection can be best integrated, in at atmosphere of objectivity (unlike trade or financial institutions where the atmosphere is less suitable for multi-dimensional, frank and free discussions and study).

(c) Strengthening existing international arrangements and promoting new ones for channelling foreign investments towards development, social and environmental goals.

** International arrangements for facilitating or ensuring the implementation of the positive social, developmental and environmental roles of foreign investments and investors should be strengthened. For example:

* The implementation of the Set of Principles and Rules on Restrictive Business Practices (based in UNCTAD) should be strengthened, and the negotiations on the Draft International Code of Conduct on the Transfer of Technology could be revived.

* The WHO-based Code of Marketing of Breast-milk Substitutes could serve as a model for similar guidelines relating to the marketing of other products.

* The UN General Assembly's Guidelines for Consumer Protection should be strengthened and subject to better monitoring and implementation.

* In the context of the implementation of Agenda 21, the Commission on Sustainable Development could establish a process of obliging enterprises, especially those engaged in cross-border investments, to respect international standards on environmental issues.

* A new international effort can be initiated to facilitate a process or an arrangement whereby foreign investors are required to respect and contribute to the development, social and environmental objectives, policies and practices of host countries; this could incorporate some elements from the draft Code of Conduct on TNCs.

* The process of establishing new protocols and conventions to protect the environment should be accelerated whilst the existing agreements should be strengthened, in view of the increasing global crisis of the environment. These agreements should specifically include provisions on criteria for good practices of and policies on foreign investments and the role and responsibilities of foreign investors.

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