Foreign Direct Investment: Trends, TRIMs, and WTO Negotiations

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Foreign direct investment (FDI) flows have increased dramatically in recent decades. As developing countries, particularly in Asia, remove restrictions and implement policies to attract FDI inflows, trade and investment have become increasingly intertwined. As such, there have been growing calls for a multilateral framework of foreign investment rules to be negotiated under the auspices of the World Trade Organization (WTO). This paper reviews recent developments in FDI flows and their impacts in developing Asia, and the importance of the policy context in which those flows occur. It discusses advantages and disadvantages of including FDI in WTO negotiations, and related policy options for developing Asian economies.

I. INTRODUCTION

Until the 1980s, most developing countries viewed foreign direct investment (FDI) with great wariness. The sheer size and magnitude of FDI by multinational corporations (MNCs) was viewed as a threat to host countries, raising concerns about MNCs' capacity to influence economic and political affairs. These fears were driven by the colonial experience of many developing countries and by the view that FDI was the modern form of economic colonialism and exploitation. In addition, MNCs were frequently suspected of engaging in unfair business practices, such as rigged transfer pricing and price fixing through their links with their parent companies.

In recent years, however, FDI restrictions have been dramatically reduced as a result of a host of factors—accelerating technological change, emergence of globally integrated production and marketing networks, existence of bilateral investment treaties, prescriptions from multilateral development banks, and positive evidence from developing countries that have opened their doors to FDI. In addition, the drying up of commercial bank lending due to debt crises brought many developing countries to reform their investment policies to attract more stable forms of foreign capital, as FDI appeared to be an attractive alternative to bank loans as a source of capital inflows. In the process, incentives and subsidies were

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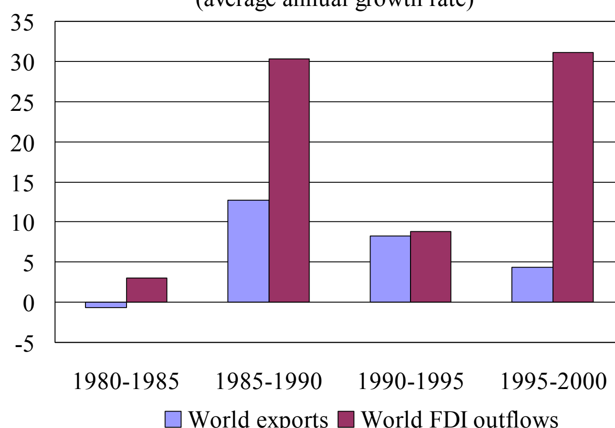
aggressively offered, particularly to MNCs that supported developing countries' industrial policies.

Flows of FDI have seen a dramatic rise in the last 20 years due to increasing openness of host economies. The growing internationalization of trade and investment has prompted some countries to call for increased cooperation through the establishment of international rules and commitments under the World Trade Organization (WTO). This paper reviews recent developments in FDI flows and their impacts in developing Asia (Section II), and the importance of the policy context in which those flows occur (Section III). It discusses advantages and disadvantages of including FDI in WTO negotiations (Section IV), and related policy options for developing Asian economies (Section V). Section VI draws some conclusions.

II. TRENDS AND EFFECTS

From only $53.7 billion in 1980, FDI outflows reached $1.4 trillion in 2000. Since then, however, the weak global economy has considerably reduced outflows, which dropped by 55 percent in 2001 and an estimated further 25 percent in 2002. The upsurge in FDI has substantially changed the international economic landscape. From 1980 to 2000, the growth rate of world FDI outflows surpassed that of world exports (Figure 1). This swift expansion in FDI was more pronounced during 1985-1990, when many host countries began to relax regulations to attract FDI, and 1995-2000, when companies undertook scores of mergers and acquisitions in the wake of the Asian financial crisis and privatization programs in Latin America.

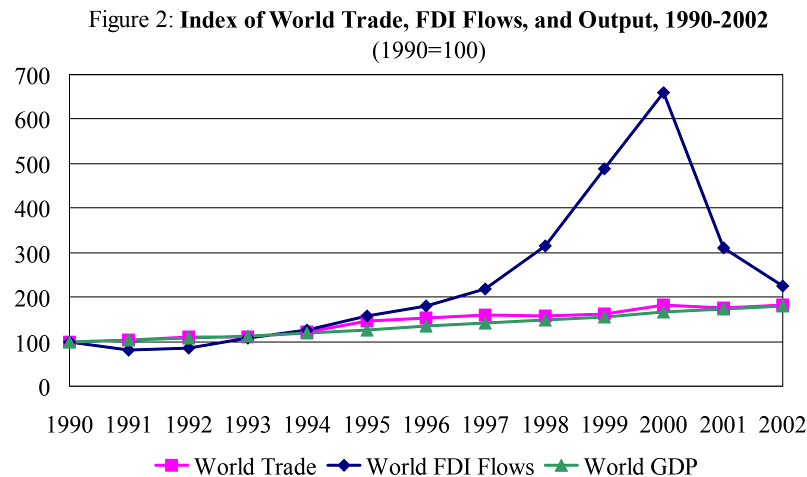
Figure 1: **Growth of World Exports and FDI Outflows**
(average annual growth rate)



Sources: Exports: IMF (2003a), FDI outflows: UNCTAD (2002).

Relative to world output and total trade, FDI flows have risen tremendously since the early 1990s (Figure 2). World FDI flows increased more than six times from 1993 to 2000 before falling beginning in 2001, while world trade and output grew at a more modest pace, not even doubling in value between 1990 and 2002.

Figure 2: **Index of World Trade, FDI Flows, and Output, 1990-2002**
(1990=100)



Notes: World trade is defined as the sum of exports and imports; FDI flows as the sum of inflows and outflows. Data for 2002 are preliminary estimates.
Sources: Trade and GDP: IMF (2003b), FDI flows: UNCTAD (2002).

The geographic pattern of FDI outflows changed slightly during the last decade. Europe and North America continued to be the largest sources of FDI flows in the world, supplying at least 75 percent since 1991. In contrast, the share of the Asian and Pacific region in total FDI outflows fell significantly beginning in 1998 due to the declining importance of Japan as an FDI supplier.

At the same time, Europe and North America continued to be the biggest recipients of FDI. While economies in the Asian and Pacific region received increasingly larger shares of world FDI inflows beginning in the 1990s, the 1997 financial crisis temporarily reversed this trend. But FDI flows soon recovered, particularly in the wake of mergers and acquisitions after the crisis.

In terms of individual country destinations, there have been shifts in the preferences of foreign investors over the last decade. Malaysia, Singapore, and Thailand, which used to be included in the 20 largest FDI recipients during 1991-1993, were replaced by Brazil, Finland, and Ireland during 1998-2000. In addition, Japan and the Republic of Korea became preferred locations for FDI in the post-Asian crisis era (JBICI 2002).

Among the preferred Asian destinations for FDI, there has not been as much change. Indonesia and the Philippines, two of the top 10 FDI destinations in the early 1990s, dropped from the list primarily due to uncertainties in their domestic economies and were replaced by India and Viet Nam in the late 1990s. Meanwhile, Hong Kong, China overtook Malaysia as a preferred FDI destination. While the total value of FDI inflows to the top 10 Asian destinations substantially increased during the last decade, the region's share in the world total dropped significantly. Average FDI inflows per capita showed remarkable increases in some Asian economies. In Hong Kong, China, for instance, per capita inflows increased 7.5 times to $4,970 between the early and late 1990s. In other Asian economies, FDI accounts for as much as 30-40 percent of total investment (Table 1).

Table 1. **FDI Top 10 in Developing Asia**

Rank	Host Economy	1991-1993	Rank	Host Economy	1998-2000
Average Annual Total Inflows, $ billion					
1	China, People's Rep. of	14.3	1	China, People's Rep. of	41.6
2	Malaysia	5.0	2	Hong Kong, China	33.8
3	Hong Kong, China	3.9	3	Korea, Rep. of	8.0
4	Singapore	3.9	4	Singapore	7.9
5	Thailand	2.0	5	Thailand	3.8
6	Indonesia	1.8	6	Malaysia	3.5
7	Taipei,China	1.0	7	Taipei,China	2.7
8	Philippines	0.9	8	India	2.4
9	Korea, Rep. of	0.8	9	Viet Nam	1.5
10	Kazakhstan	0.7	10	Kazakhstan	1.3
Total Asia-Pacific		36.0	Total Asia-Pacific		108.5
(Percent of World Total)		19.3	(Percent of World Total)		9.9
Average Inflows per Capita, $					
1	Singapore	1,234	1	Hong Kong, China	4,970
2	Hong Kong, China	666	2	Singapore	2,012
3	Malaysia	265	3	Brunei Darussalam	1,833
4	Vanuatu	164	4	Korea, Rep. of	172
5	Fiji Islands	102	5	Malaysia	159
6	Solomon Islands	51	6	Taipei,China	121
7	Taipei,China	50	7	Vanuatu	106
8	Kazakhstan	41	8	Kazakhstan	82
9	Thailand	35	9	Azerbaijan	72
10	Maldives	29	10	Thailand	62

continued.

Table 1. continued.

Rank	Host Economy	1991-1993	Rank	Host Economy	1998-2000
FDI as Percent of Total Investment[a]					
1	Vanuatu	34.7	1	Hong Kong, China	39.9
2	Fiji Islands	24.6	2	Cambodia	31.0
3	Viet Nam	24.2	3	Kazakhstan	30.1
4	Solomon Islands	20.7	4	Papua New Guinea	25.9
5	Malaysia	18.6	5	Azerbaijan	24.2
6	Singapore	18.3	6	Vanuatu	24.1
7	Cambodia	15.2	7	Singapore	21.2
8	Hong Kong, China	11.5	8	Kyrgyz Republic	16.9
9	Papua New Guinea	10.6	9	Viet Nam	16.3
10	Maldives	8.2	10	Malaysia	14.9

[a]Total investment here refers to the sum of gross fixed capital formation and FDI.
Source: UNCTAD (2002).

Distinguishing characteristics of FDI are its stability and ease of service relative to commercial debt or portfolio investment, as well as its inclusion of non-financial assets to production and sales processes. Aside from increasing output and income, potential benefits to host countries from encouraging FDI inflows include the following:

(i) *Foreign firms bring superior technology.* The extent of benefits to host countries depends on whether the technology spills over to domestic and other foreign-invested firms.

(ii) *Foreign investment increases competition in the host economy.* The entry of a new firm in a nontradable sector increases industry output and reduces the domestic price, leading to a net improvement in welfare.

(iii) *Foreign investment typically results in increased domestic investment.* In an analysis of panel data for 58 developing countries, Bosworth and Collins (1999) found that about half of each dollar of capital inflow translates into an increase in domestic investment. However, when the capital inflows take the form of FDI, there is a near one-for-one relationship between the FDI and domestic investment.

(iv) *Foreign investment gives advantages in terms of export market access arising from economies of scale in marketing of foreign firms or from their ability to gain market access abroad.* Besides their contributions through joint ventures, foreign firms can serve as catalysts for other domestic exporters. In an empirical analysis, the probability a

domestic plant will export was found to be positively correlated with proximity to multinational firms (Aitken et al. 1997).

(v) *Foreign investment can aid in bridging a host country's foreign exchange gap.* Two gaps may exist in the economy: insufficient saving to support capital accumulation to achieve a given growth target, and insufficient foreign exchange to purchase imports. Often investment requires imported inputs. If domestic savings are not sufficient, or face barriers in being converted to foreign exchange to acquire imports, domestic saving may not guarantee growth. Capital inflows help ensure that foreign exchange will be available to purchase imports for investment.

However, capital inflows do not always increase welfare in the host country. For example, when capital flows to an industry in which an existing firm has monopoly power in the world market, an increase in output from the new competition lowers the price of the exportable, thus reducing the terms of trade and lowering welfare in the host country. Also, the benefits from foreign investment are usually evaluated under the assumption that host countries can absorb a large inflow of capital without large declines in its rate of return. But if capital grows much faster than the productivity of labor, its productivity will fall, which might reduce its rate of return significantly.

Under full employment, a capital inflow that reduces the relative scarcity of capital and raises the productivity of labor in the host country can raise real wages across the board and reduce income disparity within the host country. However, the question of distribution also arises with respect to the sharing of gains between foreign capital and host countries' factors. Traditionally, foreign investment was geared toward primary commodity exports. During the colonial period, for instance, foreign investment in Java was concentrated in tea and sugar export sectors and in Sumatra in rubber and palm oil exports. In some cases, this led to capacity expansion, productivity growth, declining prices of exportable commodities, and deterioration in the host country's terms of trade, possibly leading to welfare losses. In addition, there are generally little spillovers to the rest of the host economy from primary commodity production. The resulting view was that the gains from capital inflows favor the source economy more than the host economy.

Many new foreign investments in developing countries are in process manufacturing because of lower labor costs, such as Nike's shoe factories across developing Asia. The host countries often import unfinished components and export finished goods or refined components for further processing elsewhere. While wages may rise across the board in host countries and reduce income disparity, in practice wages are likely to rise only for a small fraction of the labor force employed by the foreign investor. By creating a favored local group, this can lead to greater income disparity within the host country. Generally, this favored group be-

longs neither to the lowest nor highest income group. The result can be to improve the absolute and relative condition of workers within this favored group, in the process aggravating income inequality. Over time, however, and given a conducive policy environment, linkages and leakages emerge, creating a country reputation that influences other potential investors. The Singapore story is a case in point.

A capital inflow can lead to a rise in the prices of nontradable goods and services relative to those of imported goods and services. If world demand for the country's exports is perfectly price-elastic, the price of nontradables will rise relative to the price of exports as well. Consequently, the change will affect the returns to factors that are used intensively in either tradable or nontradable sectors. Thus, a capital inflow-induced terms of trade effect may affect real income for any given level of real output, which may or may not be affected.

When the price of nontradables rises relative to the prices of imports and exports, the "Dutch disease" may result, in which resources are drawn from production of tradables to nontradables, and exports fall as the macroeconomy adjusts to a new equilibrium with corresponding changes in factor demand and prices. Distributional effects will result (Cooper 2002).

When there are "lumpy" adjustment costs for new investment and there are economies of scale in the investment technology, trade openness can trigger discrete changes in the terms of trade and thereby lead to a discrete jump in the level of investment. However, it can also lead to boom-bust cycles of investment where multiple equilibria are supported by self-fulfilling expectations (Razin et al. 2002).

As foreign investors search for the location that will provide the highest returns on their investment, they are often drawn to countries with abundant natural resources but low-quality institutions. Weak and inefficient institutions allow the extraction of natural resources at a pace faster than that required for sustainable development. As a result, ethnic communities are sometimes harmed as the environment, their main source of livelihood, is damaged or destroyed. Foreign investment-led growth also promotes western-style consumerism, which could have serious potential consequences on the health and food security of the host population (French 1998).

Not all investments by MNCs lead to technology transfer and positive spillovers. In their desire to protect the technology of the parent company, MNCs may limit the production of affiliates in host countries to low value-added activities, thereby reducing the scope for technical change and technological learning. MNCs may also restrict vertical integration by relying completely on foreign suppliers for their inputs. In some cases, MNCs, by their sheer size, can even eliminate competition by crowding out domestic producers. As integral parts of global value chains, MNCs have a built-in advantage (e.g., economies of scale and scope) over their local competitors.

No absolute consensus on the positive effects of FDI have been reached by all governments or the general public, reflecting differences in economic conditions, specific histories of utilizing FDI, cultural variation, and ideological differences. In particular, the policy framework plays an important role in determining the effects of FDI on a recipient country. Increasing FDI across borders has increased the impact of FDI on national economies and the international economy as a whole, with the widely held perception in Asia that the net effect was positive. This trend may therefore warrant increased attention toward the possible formation of international rules and regulations governing FDI, either in the WTO framework or other forums.

III. IMPORTANCE OF THE POLICY CONTEXT

Whether, and the ways in which, FDI is beneficial or harmful to the host country depends on the context in which the investment takes place and in which the resulting economic activity operates. This is particularly true of the policy environment in the recipient country and especially in that local area of the recipient country where the investment is located. It is also true of policies that may be internal to the investing firm, such as transfer pricing.

Most countries offer incentives to attract FDI. These often include tax concessions, tax holidays, tax credits, accelerated depreciation on plants and machinery, and export subsidies and import entitlements. Such incentives aim to attract FDI and channel foreign firms to desired locations, sectors, and activities. At the same time, most countries also regulate and limit the economic activities of foreign firms operating within their borders. Such regulations often include limitations on foreign equity ownership, local content requirements, local employment requirements, and minimum export requirements. These measures are designed to transfer benefits arising from the presence of foreign firms to the local economy. This "carrot and stick" approach has long been a feature of the regulatory framework governing FDI in host countries (McCulloch 1991).

The growing evidence that investment can make significant contributions to domestic development has increased the proliferation of incentives to attract such FDI. Government action at the national level can enhance FDI prospects by significantly reducing the uncertainty, asymmetric information and related search costs, and other transactions costs (especially the amount of time and number of steps involved in acquiring approval) faced by foreign investors.

Tax breaks and subsidies are also common, but generally influence investment location decisions only at the margin. More important to most potential investors are the size and expected growth rate of the market that could be served, the long-term macroeconomic and political stability, supply of skilled or trainable workers, and modern transportation and communications infrastructure. Once these criteria are satisfied, then financial incentives may influence the investor's

choice of suitable sites. More importantly, such incentives often create distortions and inefficiencies. Table 2 indicates the wide variety of both incentive-based measures and rules-based measures commonly used to attract FDI. By distorting the relative costs for other sectors and investment projects that are not targeted for incentives, such schemes typically discriminate against smaller and domestic investors, as well as areas of actual or potential comparative advantage that are not recognized as such by policymakers. Perhaps of greatest concern, over time these actions contribute to the development of a governance system that lacks transparency and accountability (JBICI 2002). Imperfect competition, which leads to FDI as opposed to exports, raises issues of national sovereignty and needs for competition policy, as well as rent-seeking behavior among countries.

Table 2. **Foreign Investment Regime in the Host Economy: Main Types of Regulatory and Incentive Measures**

Types of Measures	Examples
Screening, admission, establishment	Closure of certain sectors, industries or activities to FDI Minimum capital requirements Restrictions on modes of entry Admission to privatization bidding procedures Establishment of special zones (e.g., export processing zones) for FDI with legislation distinct from that governing the rest of the country
Fiscal incentives	Reduction in standard corporate income tax rate Tax holidays Reduction in social security contributions Accelerated depreciation allowances Duty exemptions and drawbacks Export tax exemptions
Financial incentives	Investment grants Subsidized credits Credit guarantee
Other incentives	Subsidized service fees (electricity, water, telecommunications, transportation, etc.) Subsidized designated infrastructure (e.g., commercial buildings) Preferential access to government contracts Closure of the market to further entry or granting of monopoly rights
Performance requirements	Protection from import competition Local content (value added) Minimum export shares Trade balancing Technology transfer Local equity participation Employment targets R&D requirements

Source: JBICI (2002, 84).

Incentives and regulations are often closely linked, such as when the former are granted subject to conditions. For example, many countries allow foreign firms majority ownership on the condition that they export all or a significant proportion of their input. The length of tax holidays and the amount of tax credit granted often depend on, among other things, the market orientation of the venture and the local content of the output (Ariff 1989).

Arrangements that commit host country entities to purchase fixed quantities of output on a take-or-pay basis, and especially to pay in foreign currency, are common means of shifting risk from investors to the host government but can be detrimental to the host government. This was evident in Southeast Asia during the financial crisis when regional currencies depreciated sharply and swiftly but foreign investments in infrastructure such as power plant investments in Indonesia and the Philippines were based on continuing repayments in United States (US) dollars at rates that did not take the depreciation into account.

Too often, policies ostensibly designed to maximize net benefits of FDI for recipient economies have resulted in subscale manufacturing plants, frequently through mandated joint ventures, which are not allowed to source inputs freely and contribute little to the technological, social, or economic development of the country. Arrangements between foreign investors and host country authorities that block other new entrants to the industry or that inhibit alternative cheap sources of supply are also common but are generally not in the best interests of the host country. However, the host country can capture part of the rents from the scale economies through a licensing fee or an increase in factor prices in the export sector as foreign firms bid up factor costs above the level sustained by the small domestic export industry.

Incentives for the foreign investor and benefits for the host economy will be less when the investment is directed toward serving small and protected domestic markets.[1] The benefits to the host economy are greatest when international companies can exploit economies of scale both locally and globally, and are continually driven to update their technologies and managerial practices in order to remain competitive.

An investor will invest more of the latest proprietary technology and procedures when the investor feels it has the greatest control over protection of the proprietary content transferred through the investment and greatest freedom in its use. Restrictions such as forced sharing of technology through mandatory joint ventures, local content, or performance criteria reduce the incentives for the investor to apply the most modern techniques and technologies, hindering integration

[1]Efforts to protect domestic markets offer an incentive to foreign investors to reap a secondary round of oligopoly rents from older technology.

into the global sourcing network of the parent company.[2] Subsidiaries have been found to receive greater resources than partially licensed or owned or independent firms with lower transaction costs involved in technology transfer. Thus, multinational investment is found to be superior to direct licensing of technology to independent firms. Technology transfer and interchange of managers and technicians between parent and subsidiary firms have been found to be significantly higher for wholly owned subsidiaries than for joint venture partnerships or licensees (Ramachandran 1993).

Hopes have faded that import-substituting industries benefiting from infant industry protection would grow to become globally competitive. So have hopes that domestic content and joint venture requirements for foreign investors would stimulate domestic supply chains. In fact, empirical evidence has accumulated in the 1990s that the reverse is actually more likely. Foreign direct investment facilitates integration into international supply chains, allowing host economies to both increase efficiency of existing activities and to enter into new economic activities. Allowing wholly owned affiliates of foreign firms the freedom to source from wherever they consider most advantageous is *more* likely to lead to domestic suppliers achieving economies of scale and becoming integrated into global supply chains, often under the direct supervision of the foreign buyers. Foreign buyers have increasingly helped local suppliers to export first to sister plants and later to independent purchasers in order to lower the suppliers' costs of production through economies of scale, thereby promoting contract manufacturing as a new infant industry development strategy. Externalities in adoption of production, quality control, and managerial processes (including export coaching) frequently spread vertically within the invested sector and eventually to other sectors in the host economy (Moran 2002).[3]

National level programs to promote the development of linkages between foreign-invested firms and domestic firms commonly include:

(i) provision of market and business information;
(ii) matchmaking by such means as trade fairs or data bases; and
(iii) support to local enterprises through provision of managerial and technical assistance, training, audits and, occasionally, by financial assistance or incentives (UNCTAD 2001, 183).

The Economic Development Board of Singapore has successfully encouraged foreign investors to voluntarily serve as scouts to identify promising local

[2]On the other hand, voluntary joint ventures, to spread risk and increase market access, offer less disincentives for technology transfer, at least for more established technologies.

[3]However, the affiliates of foreign investors generally try to avoid horizontal technology transfers that may create greater competition for themselves.

suppliers and then contribute to vendor development. This sort of build-up strategy is most effective in a conducive economic environment, i.e., one that provides low inflation, a realistic exchange rate, rewards saving and investment, and encourages legal and regulatory consistency (Moran 2002). Not only does the high return to capacity building pay off in terms of income, it attracts additional FDI in higher-skill areas, encouraging progression from lower to higher-skilled activities with consequent social improvements in worker treatment.

With strengthened interest in human resource development and skill formation in the context of FDI policy, many countries regulate the hiring of foreign workers and impose training requirements on foreign investors**.** Malaysia is one example that has provided incentive schemes to promote technical and vocational training (JBICI 2002). In general, attracting internationally mobile factors of production will increasingly require host countries to improve the quality of their immobile assets.

Protection of intellectual property rights (IPR) also plays an important role in attracting advanced technology production processes. Weak intellectual property protection deters foreign investors in technology-intensive sectors that rely heavily on IPR, and encourages investors to undertake projects focusing on distribution rather than local production (Smarzynska 2002).

In the context of bilateral and multilateral trade and investment negotiations, most favored nation (MFN) treatment obliges the host country to offer equally advantageous investment conditions to potential investors from all treaty signatories. National treatment (nondiscrimination) requires the same treatment of both foreign and domestic investors. In terms of creating a level playing field as regards screening procedures for entry and the right of establishment as well as granting national treatment, Latin American countries appear to have implemented a more liberal legal framework than the larger developing Asian markets (JBICI 2002).

In addition to national policies, bilateral agreements also shape FDI policy frameworks. Over 1,900 bilateral investment treaties (BITs) and 2,100 double taxation treaties were in effect by the end of 2000 (UNCTAD 2001). These BITs generally contain binding commitments on expropriation, transfer of funds, and compensation due to armed conflict or political instability. These commitments are provided on a national treatment or MFN basis. Disagreements between foreign investors and the host government are usually referred to private arbitration centers of the International Chamber of Commerce or the World Bank's International Centre for Settlement of Investment Disputes.[4]

[4]While private sector arbitration mechanisms have generally worked satisfactorily so far, it raises the potential for political disagreements in that a sovereign judicial system can be overruled by an arbitration panel that is unelected and usually operates with little transparency.

In the multilateral context, the General Agreement on Tariffs and Trade (GATT)/WTO has stipulated certain rules related to trade-related investment measures (TRIMs). TRIMs are a subset of the incentives and regulations designed to influence FDI. Broadly speaking, they consist of incentives and regulations deemed to have a direct impact on international trade. The most common TRIMs are local content requirements and export performance requirements. Local content provisions require foreign firms to purchase a specific proportion of their inputs from local rather than foreign sources. Failure to comply with this regulation may result in increased tariffs on imported inputs. Trade balancing measures are also considered to be TRIMs. In this case, governments impose restrictions on the import of inputs by a corporation, or limit the import of inputs in relation to the level of exports of the firm. Some foreign exchange balancing requirements impose a similar scheme whereby a corporation's permitted imports are tied to the value of its exports so that there is net foreign exchange earning. Another measure used is denying foreign corporations access to the host country markets.

There appears to be increasing acceptance that liberal policy regimes in most industries bring the highest benefits to host countries. FDI policies can be put in place at both national and international levels. However, FDI policies are predominantly national rather than international at present. There is still much disagreement on forming and implementing an international agreement in the WTO, as shown by the discussion in the following section.

IV. THE TRIMs AGREEMENT[5], WTO NEGOTIATIONS, AND FOREIGN INVESTMENT

A. The Agreement on Trade-Related Investment Measures (TRIMs Agreement)

The principal multilateral agreement on FDI, the TRIMs Agreement, was formulated in the Uruguay Round of the GATT, the forerunner of the WTO. This agreement was designed to address certain issues relating to investment policies in the multilateral framework. Formal consideration of TRIMs in a GATT forum was a long time in coming. The Uruguay Round of GATT was the first attempt to formulate an agreement covering trade and investment (Table 3).

[5]It is important to distinguish between TRIMs and the Agreement on TRIMs. TRIMs refer to certain measures taken by host countries to regulate/encourage FDI that have a direct impact on trade. The TRIMs agreement refers to the GATT/WTO agreement that deals with TRIMs.

Table 3. **Multilateral Trade Negotiation Rounds**

Kennedy Round	1964-1967
Tokyo Round	1973-1979
Uruguay Round	1986-1994
Doha Round	2001-

A combination of factors led to the inclusion of foreign investment in the work program of the Uruguay Round negotiations. There was a changing perception of the role of FDI in development. Foreign investment had become increasingly important. Perceptions had also moved from initial anxiety to a more welcoming stance. The US-Canada dispute over Canada's application of performance measures on foreign firms around this time also facilitated debate on the linkages between GATT rules and foreign investment policy (Bora 2001).

The TRIMs Agreement recognizes that certain investment measures distort trade and that these distortions are not consistent with GATT principles. Export subsidies, import entitlements, minimum export requirements, and local content requirements directly affect volumes and prices of imports and exports, and in some cases the composition of trade. For example, local content requirements mean that imports are treated less favorably than domestic inputs, violating the national treatment principle of the GATT. The trade-balancing requirement that limits the quantity of imported products that can be used if an MNC does not meet its export target also violates national treatment obligations. Incentives geared to attracting FDI, such as tax incentives, may also influence trade flows in that they can persuade firms to favor FDI over exports as a method of foreign market penetration. As such, the inclusion of TRIMs on the agenda of the Uruguay Round of multilateral trade negotiations was favored and considered legitimate by developed countries (Balasubramanyam 1991).

Despite this, only a brief TRIMs Agreement was put into effect on 1 January 1995 after a lengthy debate. The TRIMs Agreement included the following terms:

(i) It would only cover regulations and requirements imposed on foreign investors[6] that directly impinged on international trade flows.

(ii) Its coverage "applies to investment measures related to trade in goods only." This meant that it excludes investment incentives and many performance requirements. Furthermore, services are covered by the WTO General Agreement on Trade in Services (GATS), and export subsidies are covered in the Subsidies Agreement. As such, technol-

[6]As noted below, the TRIMs Agreement does not define "investment" and "investors" and can therefore be considered nationality-neutral. But the general perception is that the agreement mainly governs FDI.

ogy transfer requirements, licensing requirements, and joint venture requirements are not included in the TRIMs Agreement. One aspect of the agreement that has received much attention from academics and policymakers is export performance requirements, which is not actually part of the annexed list of the TRIMs Agreement. There has been ongoing debate about whether or not the list should be extended to prohibit this policy.

(iii) The central provision prohibits trade-distorting investment measures subject to GATT Article III (national treatment) or Article XI (elimination of quantitative restrictions). Measures specifically identified as inconsistent with Articles III and XI include provisions for local content, trade balancing, import substitution, foreign exchange, and export limitation requirements.

(iv) The Agreement sets out deadlines for removing trade-related investment measures. Member states were given 90 days from 1 January 1995 to notify the Council for Trade in Goods of all measures that did not conform with the Agreement. They were then given a "transition period" to eliminate their notified TRIMs. A member's level of development determined the length of time it was given to eliminate TRIMs. Developed members were allowed two years, developing countries were given five years, and least-developed countries were given seven years.

(v) There was provision for developing and least-developed countries to apply for an extension of the transition period. Ten WTO members have so far submitted transitional period extension requests. The requests range from less than a year for Chile to seven years for Pakistan.

(vi) An allowance was made for developing country members to deviate temporarily from the provisions of the obligations as, for example, under the Balance-of-Payments Provisions of GATT 1994. The waiver of an obligation will be granted providing that three fourths of the Members agree.

(vii) Arrangements were made for the Agreement to be overseen by the WTO Council for Trade in Goods, with the WTO dispute settlement mechanism to apply to the TRIMs Agreement. A review of the operation of the Agreement took place in 2000, five years after its entry into force.

(viii) The Agreement did not provide an explicit definition of TRIMs. Nor did it define "investment." Instead, it provides an Illustrative List in the Annex with examples of laws, policies, or regulations that are considered as TRIMs and are deemed to violate GATT Articles III and XI.

All developing countries were to have implemented the TRIMs Agreement and eliminated their relevant regulations by 1 January 2000. Twenty-six developing country members with widely varying economic characteristics gave notice that at that time they still had a variety of policies in existence, however. Most of the policies related to the auto industry or the agro-food industry. The policies overwhelmingly adopted by these countries were local content schemes. The second most frequently notified type of TRIMs was foreign exchange balancing requirements (Bora 2001).

A number of countries requested extensions of the transition period. Argentina, Malaysia, Philippines, and Thailand cited financial crises that added to their structural adjustment problems as a major factor behind their extension requests. Colombia and Pakistan cited specific development reasons for their extension requests. Colombia detailed difficulties in transforming its economic model, especially in terms of developing substitutes for illegal crops. They argued this would require domestic absorption, or local content policy, to ensure that farmers are able to sell their produce. Pakistan's request suggests that opening its economy to import competition would not allow it to exploit domestic resources optimally, to promote the transfer of technology, or to promote employment and domestic linkages. Another reason cited for an extension request was inconsistency between preferential trade agreements and multilateral obligations (Bora 2001).[7]

Since 1995, TRIMs obligations of new members on accession to the WTO depend on the terms of their accession. So far, all acceding countries have agreed to implement the TRIMs Agreement upon accession regardless of whether they are developing countries or not.

B. Evaluation of the TRIMs Agreement

The current TRIMs Agreement resulted from a compromise. During the Uruguay Round discussion, developed countries, including the European Union (EU), Japan, and US initially proposed to establish a comprehensive agreement on investment. Their proposed framework covered a wide range of areas such as technology transfer requirements, restrictions on the transfer of profits overseas, controls on foreign exchange flows, government reviews of foreign investment performance, and nationalization. This plan faced strong resistance from the governments of developing countries. Brazil and India maintained that investment was outside the GATT's competence, while other developing countries tended to

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[7]Argentina's request stated specifically that negotiations within the context of the MERCOSUR Common Automotive Policy were important. Mexico did not specifically mention the North American Free Trade Agreement (NAFTA) in their request, but it has been noted that there is an inconsistency in the phaseout period for TRIMs between NAFTA and the WTO.

take a defensive position with regard to TRIMs (Ariff 1989). In particular, many developing countries resisted the extent to which market access for foreign firms would be included. The result was that negotiations focused on policies that applied to the operations of foreign firms. Even then, negotiation still proved to be difficult. Since the enactment of the Agreement, the main focus has been on the trade effect of local content and export performance requirements.

The remarkable brevity of the TRIMs Agreement in relation to the complicated issues it covers warrants greater attention. It is indeed extraordinary to have an agreement that is so brief. The brevity of the TRIMs Agreement is a manifestation of the divisions that emerged between developed and developing countries. This lack of consensus also explains the vague nature of elements of the agreement. The current TRIMs Agreement does not contain a basic definition of investment. This requires clarification, as the definition of investment has profound implications for the scope and coverage of the Agreement. The definition of investment in the draft OECD Multilateral Agreement on Investment, for example, goes far beyond the traditional notion of FDI to include portfolio investment, debt capital, intellectual property rights, and various forms of tangible or intangible assets (Ganesan 1998).

Bora (2001) summarizes a few other areas where confusion might arise. Because the TRIMs Agreement did not introduce a new vocabulary in the context of disciplining policies, and instead refers to the GATT articles, there has been some confusion whether or not a policy that violated GATT articles automatically violates the TRIMs Agreement. As the TRIMs Agreement is a stand-alone agreement, it needs to be interpreted independently of the GATT rules. However, since it is independent, many developing countries question whether it goes beyond GATT rules.

The TRIMs Agreement covers measures related to foreign investment according to their impact on trade. However, since nothing in the TRIMs Agreement suggests that the nationality of the ownership of enterprises is an element in deciding whether that measure is covered by the Agreement, the TRIMs Agreement is not confined to policies targeting foreign firms. It is in fact ownership-neutral. However, some argue that the TRIMs Agreement is basically designed to govern and provide a level playing field for foreign investment and that therefore measures relating to internal taxes or subsides cannot be construed to be trade-related investment measures.

There is also no well-defined phase in place to bring laws into conformity for members that notify under the TRIMs Agreement. Members are under no obligation to respond in detail. This has caused some implementation difficulties. None of the notifying countries have developed either an implementation plan or identified alternative policies that could be used to achieve this objective.

TRIMs are typically used in conjunction with a number of other policies. One aspect, which was not taken into account during the Uruguay Round negotia-

tions, was how the removal of certain TRIMs without addressing companion policies would affect trade. For example, local content schemes are usually combined with a subsidy. The TRIMs Agreement disciplines trade policy, but not incentives. Views are still divided on how to deal with both incentives and regulations.

Ambiguity in the wording of the TRIMs Agreement has made the interpretation of obligations difficult. Some developing countries' lack of capacity to fully understand the scope and implications of these obligations has exacerbated this problem. These problems have also created a tension between the generally accepted notion of efficiency and the broader definition of development. Some work to clarify these issues has been done recently by the WTO Council for Trade in Goods, but solving these problems will require much time and effort (Bora 2001).

The current TRIMs Agreement relies on the state-to-state mechanisms of the WTO for dispute settlement and arbitration under which, for example, a dispute settlement panel is established and makes its judgment. Some argue that it is necessary to establish investor-to-state mechanisms to ensure investors receive a hearing (Moran 2002).

Believing the existing TRIMs Agreement to be inadequate, developed country parties such as EU, Japan, and US largely view it as a mechanism for removing performance requirements on foreign investment (Greenfield 2001). Still, the Agreement represents a step forward in ensuring that countries are all subject to the same rules respecting the use of certain investment-related performance requirements. Although most FDI has occurred between developed countries, the Agreement has allowed investment issues to be discussed in the context of multilateral negotiations. These discussions have been continued through the Working Group on Trade and Investment where members have further assessed the linkages between trade, FDI, and development (Bora 2001). It has also allowed disputes between member states to be settled in the WTO context, and has enforced GATT provisions.

C. The Ongoing Divide Regarding Negotiating an Investment Agreement in the WTO

Investment was again put on the agenda for the WTO Doha Round. Investment, competition policy, transparency in government procurement, and trade facilitation have been labeled the "Singapore issues", following the WTO work program in the 1996 Singapore Ministerial Declaration (Table 4). The Doha Declaration continues to attach the usual operational qualifications of "trade-related aspects only" for investment and competition policy.

Table 4. **WTO Ministerial Meetings**

Cancun, Mexico	10-14 September 2003
Doha, Qatar	9-13 November 2001
Seattle, US	30 November-3 December 1999
Geneva, Switzerland	18-20 May 1998
Singapore	9-13 December 1996

Considerable divisions have existed between developed and developing countries on investment-related issues in the WTO framework. Since the agreement came into effect in 1995, operational details have caused contention between developed and developing countries. Some developing members argue that they lack the capacity to identify measures that are inconsistent with the TRIMs Agreement and hence are unable to meet notification deadlines set out for the transition periods. In some cases, members that did notify do not appear prepared to meet the deadlines. Many members implemented strategies that seemingly addressed the implications of compliance for the affected industries, but did not actually implement alternative policies.[8]

Furthermore, governments of developing countries have argued that the process for negotiating extensions to the duration of transition periods should be undertaken through a multilateral framework.[9] In contrast, EU, Japan, and US argued that requests for deadline extensions should only be considered on a "case-by-case" basis and should be negotiated bilaterally (Greenfield 2001). The bilateral nature of this process has caused concern among developing country governments that the developed countries could use the threat of rejecting requests for an extension as bargaining leverage against developing countries. Since the 1999 Seattle talks, the WTO Council for Trade in Goods has held several meetings to resolve the dispute over extension procedures. This was partly resolved in July 2000 when it was decided that the Council chair would oversee multilateral negotiations. However, requests will still be dealt with on a case-by-case basis and are open to bilateral pressure from EU, Japan, and US.

The extremely brief preamble of the TRIMs Agreement states that it takes into account the trade, development, and financial needs of developing countries. Some applications for extensions cited the financial crises that hit East Asia and

[8]Implementation is difficult in some cases. For example, Romania had a legally binding contract between the government and a firm that included a policy not in compliance with the TRIMs Agreement, but the removal of this would have had legal consequences for the national government.

[9]This position was advanced by the governments of Brazil, Malaysia, Mexico, and Pakistan.

Latin America. However, some developed countries argue that structural adjustment should not be considered a defense, as this is part of any obligation to liberalize**.**

More fundamentally, several developing counties are of the view that TRIMs and other investment measures are domestic investment issues that should therefore not involve GATT/WTO officials. They also assert that the mandate of the GATT and WTO is confined to trade and does not extend to investment. Some fear they would be deprived of a major means of exercising control over foreign firms operating locally if their right to impose TRIMs or other investment measures were removed. Some developing countries consider that policies such as domestic content requirements are essential policy tools for industrialization. They believe developing countries should be allowed to use TRIMs and other investment measures flexibly in pursuit of developmental objectives because each country's unique needs and circumstances require sufficient freedom and flexibility to pursue one's own policies. They are of the view that, although the TRIMs Agreement established uniform obligations for all members, it does not take account of structural inequalities and disparities in levels of development; technological capabilities; or social, regional, and environmental conditions among them, nor incorporate a meaningful development dimension. A legally binding treaty on foreign investment would reduce the degree of flexibility available (Ganesan 1998).

Many developing countries continue to object to the inclusion of investment and other Singapore issues in the Doha Round negotiating agenda.[10] Panagariya (2001) points out a number of major factors behind objections to a multilateral agreement on investment by developing countries. These include asymmetries in the obligations they must undertake in these areas and in the distribution of benefits, limited capacity to negotiate, and limited resources for implementation.

A major reason for their reluctance is that liberalization of investment is more constrained by political factors than by trade.[11] Many developing countries find political sensitivities demand discretion in how investment liberalization proceeds. Investment is a sensitive issue in terms of national sovereignty, and this adds another dimension to policies aimed at controlling the extent and character of foreign production within a nation's own borders (McCulloch 1991). Concerns relating to national sovereignty tend to figure prominently in cases of foreign direct

[10]These countries include Egypt, India, Indonesia, Kenya, Malaysia, Nigeria, Pakistan, Sri Lanka, Tanzania, and Thailand.

[11]Panagariya (2001) pointed out that trade is generally easier to liberalize than investment, which is easier to liberalize than labor flows. Within trade, goods trade is easier to liberalize than services trade. Within investment, FDI is easier to liberalize than portfolio investment. And within labor, opening up to immigration of skilled labor is easier than to unskilled labor.

investment. This arises from the fact that direct investment means long-term ownership and control over assets, resources, and enterprises.

A second reason is that many developing countries wish to ensure a degree of certainty that the benefits of a future agreement outweigh the risks of trade sanctions before they are willing to commit to negotiations. Third, many developing countries lack the capacity to negotiate effectively on a wide-ranging agenda. The problem is not merely one of financial resources, but also involves such factors as human resources. Based on their experience with the Uruguay Round Agreement, some developing countries fear that they will fail to implement the negotiated agreements in a timely fashion and then be left exposed to the risk of trade sanctions. Furthermore, since developed countries already meet the standards likely to be negotiated with respect to the Singapore issues, liberalization in these areas places a proportionately greater burden on developing countries. The use of TRIMs and other investment regulations tends to be relatively high in developing countries. Moreover, from the national standpoint, it is not clear that the implementation of these agreements on a priority basis represents the best use of the limited resources and political goodwill available to the governments.

This raft of concerns explains the ongoing reluctance of some developing countries to negotiate on investment in the WTO framework. A month prior to the Seattle WTO talks the Indian government argued for the TRIMs Agreement to be substantially revised and circulated a set of proposals on behalf of Cuba, Dominican Republic, Egypt, El Salvador, Honduras, Indonesia, Malaysia, Nigeria, Pakistan, Sri Lanka, and Uganda with this end in mind. The proposal even went as far as stating that "developing countries should be exempted from the disciplines on the application of domestic content requirement by providing for an enabling provision in Article 2 or Article 4 to this effect." It challenged the existing WTO TRIMs mechanism and its possible restriction of developing countries' capacity for national development (Greenfield 2001).

At the Doha Ministerial Conference, a number of countries continued to state that the use of domestic content requirements constitutes an extremely useful policy tool that effectively links FDI with domestic economic activities, and acts as an important instrument in the development process in several other ways. They also stated that joint venture requirements encourage indigenization. Some countries have questioned the equity of requiring a more rapid pace of implementation for developing countries than that accepted by developed countries in other Uruguay Round/WTO trade obligations. Other countries have been concerned about the dislocations and difficult adjustments that will be forced on uncompetitive firms and workers. The tone has suggested that some developing country authorities might wish to reopen the TRIMs Agreement (Moran 2002).

To date, it is still unclear whether the Doha Round will negotiate investment-related issues, and what form and scope the negotiations will take if they do proceed. Furthermore, it is not clear whether any new talks center around exten-

sion of the TRIMs agreement, or a new comprehensive multilateral investment agreement will be considered. This reflects the continuing differences of opinions between developing and developed countries. The next subsection explores some issues that might arise in future negotiations.

D. Issues in Trade and Investment for Future Negotiations

A new round of multilateral trade negotiations was launched at the Fourth Session of the Ministerial Conference of the WTO held in Doha, Qatar, in November 2001. The Session also set up a Work Program that includes a negotiating agenda and steps for meeting the challenges facing the multilateral trading system. Despite this, the content, priorities, and points of contention that might emerge in the Doha Round remain far from certain.

The Doha Ministerial Declaration identified seven items with a clear negotiating mandate when it launched the Doha Work Program: implementation; agriculture; services; market access for nonagricultural products; trade and environment; WTO rules including antidumping, subsidies and countervailing measures, and provisions for regional trade agreements; and TRIPS and dispute settlement. However, investment and other Singapore issues were excluded from this list and only considered as a study program.

The Uruguay Round demonstrated that the inclusion of investment policies in the GATT/WTO negotiation agenda is a contentious issue for many. The inclusion of TRIMs in the Uruguay Round negotiations was a major break with past practice and was strongly opposed by some capital-importing developing countries. The creation of a WTO Working Group on Trade and Investment at the WTO Ministerial meeting in Singapore in 1996 also encountered strong opposition from developing countries. Despite this, the Working Group was given the task of drafting investment rules under the WTO regime. This has been regarded as having ushered in a new round of negotiations on investment under the auspices of the WTO. The Uruguay Round experience and the more recent Singapore Ministerial Declaration indicate that it will not be easy for the new WTO round to totally dismiss investment issues. However, investment is still a divisive issue, most noticeably between developed and developing countries.

At Doha, India took the position that according to the Singapore Declaration, negotiations on the Singapore issues could not be launched without a clear consensus. In Paragraphs 20 and 22 of the Doha Declaration (WTO 2001), trade ministers agreed "that negotiations will take place after the Fifth Session of the Ministerial Conference [in Cancun, Mexico, in September 2003] on the basis of a decision to be taken, by explicit consensus, at that session on the modalities of negotiations" (Paragraph 20). Given the difficulties in reaching consensus, there remains uncertainty as to whether negotiations on the Singapore issues, including TRIMs, will take place as part of the Doha Round.

The Doha Declaration does not spell out the scope for potential negotiations on trade and investment. The Declaration asks the Working Group on the Relationship between Trade and Investment to focus on a wide range of topics including scope and definition, transparency, nondiscrimination, modalities for pre-establishment commitments based on a GATS-type positive-list approach, development provisions, exceptions and balance-of-payments safeguards, consultation, and settlement of disputes between Members. The framework is intended to reflect the interests of home and host countries in a balanced manner and to take account of the development policies and objectives of host governments as well as their right to regulate in the public interest (WTO 2001, Paragraph 22). The September 2003 Ministerial Conference in Cancun, Mexico, is expected to be characterized by rigorous debate on the structure and content of subsequent trade and investment negotiations.

While broad trends about the future direction of negotiations on investment can be discerned, many uncertainties remain. It is still not clear how the negotiations will evolve. There is no agreement so far either among developed countries, or between developed countries and developing countries. For example, the US accorded high priority to electronic commerce and labor standards. The EU, on the other hand, attaches more importance to investment and competition policy (Srinivasan 2002). Given the complexity and sensitivity of the issues involved, the negotiation of a comprehensive investment package will be difficult.

Bora (2001) outlines three possibilities for what will emerge for TRIMs. The first is the establishment of a comprehensive agenda as envisaged in the original mandate drafted at Punta del Este in 1986. Such a package would include an instrument that deals with both market access issues and establishment and performance requirements. While this approach would consider the existing TRIMs Agreement as a basic framework, it will also seek to transform it into a more comprehensive framework. The European Union had articulated this view in the context of preparations for the Seattle Ministerial meeting, but was opposed by many developing countries. Another option would be to renovate the existing framework by adding an extension or minor changes, such as extending or modifying the list contained in the annex. This option may also prove to be a difficult path for negotiation, as the debate about trade effects of investment measures has not been resolved. Furthermore, adding more examples of TRIMs to the Illustrative List will add to the uncertainty about which aspects of an industrial policy can or will be challenged in the WTO. The third approach could be to leave the TRIMs Agreement as it is until all WTO members have completed implementing their obligations. This standstill approach may be acceptable to countries that requested extensions of their transition periods, but is unlikely to receive much support from developed country members and perhaps a significant majority of developing country members that have faithfully implemented their obligations. Furthermore, given that there is now an agreement on almost all outstanding im-

plementation issues, it will be difficult to make the case that the status quo is sufficient.

While none of these possibilities will be brought about easily, the Uruguay Round experience shows that countries can make progress even without a clearly defined agenda at the outset of negotiations. Countries need to anticipate various options that could emerge. Good preparation will allow more progress during the negotiation process. Observed investment measures are often the end result of a bargaining process, and understanding these issues has important implications for the subsequent possible trade and investment negotiations. Some issues that may be of importance to developing countries are considered below.

1. Bargaining Strategies

Panagariya (2001) points out that developing countries have limited bargaining power due to their limited share of world markets, large numbers with few large players, varying levels of income, and diverse policy regimes they pursue. These characteristics make the development of common positions and common bargaining strategies among them difficult, and create incentives for free riding. In contrast, developed countries typically have much larger bargaining power, given their large share of world trade. Also, since a small number of them—EU, Japan, and US—are very large, they are better able to solve the free-rider problem by negotiation.

Given the heterogeneity of developing countries, the impact and implications of any multilateral agreement will vary widely among them. Nearly 90 percent of the flows to developing countries have been received by only about 20 countries, of which the People's Republic of China alone has received over one third. These differences mean that developing countries have limited common ground and find it difficult to act collectively, rendering consensus extremely difficult (Ganesan 1998).

Nevertheless, a number of strategies to enhance developing countries' negotiating power are available. Developing countries need to think strategically prior to negotiations to define a realistic negotiating position. Developing countries also need to build their research capacity at least to the point that they can astutely assess the studies done by outside researchers. They must also invest resources in disseminating research to other countries to make their case more forcefully and to gain widespread acceptance. It is similarly important that developing countries try to evolve a collective or common stand on key issues where their interests coincide with each other. In some cases, their interests also overlap with the concerns of more developed countries (Panagariya 2001).

2. Is a WTO Agreement on Investment Necessary?

Mundell (1957) argued that free trade is a substitute for factor movements, so that in the presence of free trade there would be little or no FDI. By this logic, there would be no need for TRIMs in the absence of FDI, if the latter were due to free factor movements. Ariff (1989) also argued that TRIMs only arise because of pre-existing distortions. Such distortions make domestic market orientation an attractive proposition to foreign investors. TRIMs and other foreign investment regulations would become largely a nonissue if liberalization succeeded in dismantling tariff and nontariff barriers to trade. For example, local content requirements tend to raise production costs and render final products uncompetitive. A local content program can only be sustained behind protectionist walls. Similarly, elimination of protection will diminish the need for export incentives. Therefore, the more successful the WTO is in trade liberalization, the less it will need to worry about an investment agreement. This raises two questions: should liberalization focus on trade, and is an agreement on TRIMs or a broader investment agreement needed?

The reality is that trade and FDI coexist. Impediments to trade are a factor in the growth of FDI, but other market imperfections also have important influences on the decisions of firms to invest abroad. Real market conditions seldom approximate the free trade model. Oligopoly rather than perfect competition is a characteristic of many market structures in which foreign firms operate, and these firms have considerable discretion over the choice of market in which they operate (Balasubramanyam 1991). Even for trade barriers, it would be unrealistic to assume that all trade barriers will disappear soon. In these circumstances, TRIMs and other restrictions on foreign investment, as well as incentives to promote it, may exist for a long time.

Despite different views on the relationship between trade, trade barriers, and foreign investment, it is important to acknowledge that problems of barriers or incentives on foreign investment partly result from the incomplete liberalization of trade. For example, without tariffs, quotas, and other import barriers, there would be less rent to extract and thus less scope for performance requirements. Thus, trade liberalization can also induce more liberal investment regimes.

Nevertheless, an agreement on investment may strengthen the investment climate of host countries and also contribute to trade liberalization. Foreign investment and trade are not necessarily substitutes for each other. Often they have a complementary relationship. Effects of restrictions on trade or investment are empirically indistinguishable from one another. Barriers to investment therefore need to be reduced under multilateral disciplines, just as barriers to trade have been reduced under GATT/WTO rules. As with the multilateral trade rules introduced through the Uruguay Round, a multilateral framework of rules may be necessary for investment in order to cope with the dynamics of an ongoing integration of the

world economy (Ganesan 1998). In recent years, TRIMs have been reduced or dismantled as the TRIMs Agreement is implemented. Such measures have also been reduced as countries carry out economic reform and liberalization. The reduction and elimination of TRIMs is a strong argument for the establishment of a more comprehensive multilateral investment agreement.

3. Is WTO the Right Forum for Discussing Investment Issues?

The question of whether the WTO is the best forum for discussion of issues related to foreign investment continues to be controversial. A number of regional investment packages have been negotiated or completed outside the WTO framework. From 1995 to 1998 OECD member countries negotiated unsuccessfully to establish a Multilateral Agreement on Investment. FDI-related regulation is also dealt with by the United Nations Conference on Trade and Development, and the International Centre for Settlement of Investment Disputes. The North American Free Trade Agreement (NAFTA) also contains a comprehensive investment package.

Despite this, Ganesan (1998) argues that the best forum for developing countries to pursue the multilateral route is the WTO. The WTO would enable developing countries to negotiate a “bottom-up” approach for dealing with investment issues that would take into account some special concerns of developing countries. The WTO route would ensure that all developing country members are party to the Agreement thereby eliminating the possibility of any nonsignatory member country being at a resulting competitive advantage or disadvantage. It would also ensure coherence between the Agreement on Investment and other WTO agreements. Thus, negotiations in the WTO would provide room for balancing the needs of developed and developing countries.

4. Should an Agreement on Investment be Used as a Bargaining Tool?

Some argue that the Uruguay Round was biased against developing countries. For example, the Cairns Group, which includes a number of developing countries from Southeast Asia and Latin America with high potential for agricultural exports, had expected the Uruguay Round Agreement on Agriculture to deliver significantly increased market access for its member countries’ farm products. This expectation was not realized. In the area of market access in industrial products, developing countries cut their tariffs more deeply than developed countries (Finger and Schuknecht 1999). Developing countries also complained that the growth in quotas during the transition had been inadequate. In new areas such as intellectual property, developing countries were required to adopt standards already prevalent in developed countries. This means they had to undertake more adjustment procedures.

The Doha Round aims to balance the benefits more in favor of developing countries. Some argue that a comprehensive new WTO round with a broad agenda would offer many options and trade-offs with greater potential gains for the participants. The conflict over the agreement on foreign investment can be used to highlight imbalances within the WTO regime. It can be used to balance complaints from developing countries about the scaling down of protection in the textiles and garments and agricultural sectors, removal of trade barriers against the poorest countries, intellectual property, tariff peaks and escalation, TRIPS, Dispute Settlement Mechanisms, Antidumping Measures and Safeguard Actions, and the decision making process of the WTO.

Developing countries' relative weakness in negotiation resources means that developed nations have a greater role to play and more responsibility in ensuring a successful outcome for the Doha Round. The weakness of developing countries at the negotiating table is ultimately a weakness of the international system. In one sense, it is in the interest of rich countries to make the system more equal. After all, if the playing field is unequal, then (i) it is likely to give poor results, and (ii) the weaker players will be unhappy, and often will not want to play. So if developed nations want to see good international systems for negotiations, they need to consider how to make the processes more satisfactory from the point of view of developing countries.

5. Is an Investment Agreement a North-South Divide?

Industrialized countries are still overwhelmingly the main source of FDI. Increasingly, however, capital moves not only between developed and developing countries, but also between developed countries. By the mid-1980s, the US had emerged as the world's largest host country in terms of the total value of inward FDI. Thus, developed countries represent both major sources of, and hosts for, FDI. The increased extent of intra-industry FDI among the industrialized nations blurs the distinction, at least among industrial nations, between host and source countries. The investment issue thus is of interest to developed countries as both suppliers and recipients of FDI. Developing countries are mainly recipients of FDI. But a number of developing countries, for example, Hong Kong, China; Republic of Korea; Singapore; and Taipei,China have undertaken investment abroad. Thus for some developing countries, the stake or interest in the TRIMs and other investment issues may be more similar to that of their developed counterparts.

There are different views between and within developed and developing nations. For example, given their generally open capital markets, relatively higher income levels, and preoccupation with agricultural liberalization, countries in Latin America were not particularly opposed to negotiation of TRIMs. Much of the opposition derives from countries in Africa and Asia (Panagariya 2001). Notably, in its submission to the Working Group on the Relationship between Trade

and Investment at the WTO, the Government of the Republic of Korea supported the EU position on banning technology transfer requirements for foreign investment (Greenfield 2001).

Conventional wisdom holds that developing countries engage in trade-distorting investment measures while developed countries do not. However, trade and investment figures clearly show that developed countries also use TRIMs. Most developed countries do not use what they formally call "screening" agencies for inward investment, but instead make available location-based incentive packages for both domestic and international investors. Ireland reports that its special incentive packages have attracted more than 1,200 foreign firms to its economy, and these contribute 70 percent of the country's industrial output and three quarters of its manufactured exports (O'Donovan 2000). German grants to both domestic and foreign firms to settle in the economically depressed former East Germany have exceeded the already generous treatment EU member states used to attract investment to regions lagging behind. The OECD found that almost 90 percent of all domestic support programs in the EU were available to foreign investors (OECD 1996, Moran 2002).

The divide between developed and developing countries is further bridged by the fact that multinational corporations invest in many countries, both developed and developing. Any WTO-based effort to create a level playing field for national and international companies among home and host countries around the world would be seriously deficient if it ignored the proliferation and escalation of location-based incentives by developed countries.

V. TOWARD OPTIMAL POLICIES FOR FOREIGN INVESTMENT

Many developing countries have introduced policies to encourage foreign investment as part of their national reform programs in recent years and are now reaping the benefits. This strategy was implemented in the belief that economic liberalization can reduce domestic inefficiencies and stimulate growth, as illustrated by the experience of a large number of countries in Asia.

Trade-related investment measures have long been a feature of the regulatory framework governing FDI in most host countries. Most measures were designed to transfer benefits from the operations of foreign firms to the local economy and promote development objectives. In essence, the primary objective of these measures is for host countries to obtain the maximum possible share of the gains from FDI. However, such regulations distort trade and investment and impose welfare losses (Moran 2002). The various regulations used may in fact have lowered, rather than enhanced, the contribution of FDI to national development objectives. In terms of incentives, there is some evidence that incentives play a relatively minor role in decisions about where to locate for MNCs relative to other location-based considerations (Ganesan 1998, Balasubramanyam 1991).

Moran (2002) has provided much evidence to show how counterproductive and damaging domestic content requirements and joint venture requirements can be for host country development. He also demonstrates just how beneficial a policy of allowing wholly owned subsidiaries unfettered by local content mandates can be for host country growth and development.

Thus, TRIMs may be costly and inefficient. Many countries, both developed and developing, have abandoned or scaled back their use. Perhaps the most telling empirical evidence on this issue is not the number of governments that have such policies, but the number of governments that have abandoned them. Indeed, one key feature of the use of policies such as local content schemes and export performance requirements is that they are becoming less popular. Therefore, the appropriate question to be asked is whether or not there are reasonable grounds for adopting or maintaining such policies. The most frequent answer to this question is that these policies are required to "develop" specific industries in order to compete in an open trading environment. Another reason sometimes cited is that structural adjustments involved in removing these types of policies will result in unemployment and loss of technology transfer and opportunities to move into high technology industries (Bora 2001).

The core of the debate on the use of these policies is typically referred to as the "development dimension." In this context, the term development includes elements of self-sufficiency, national pride, and, perhaps most importantly, employment. It also has a technology transfer dimension, where FDI is supposed to induce technology transfer into developing countries. Protection may induce expansion of output and employment in certain sectors. But this expansion often carries a massive cost for the society implementing such a policy.

The upsurge in FDI to developing countries in the 1990s was largely caused by unilateral liberalization of their FDI policies and regulatory regimes. Theoretical and empirical evidence provide strong support for the proposition that neutral policies designed to enhance the efficiency of investment are better suited to attracting foreign investment and enhancing its contribution to development than interventionist methods (Bora 2001). The challenge for the future WTO negotiations on trade and investment is to identify the best ways to foster economic development while taking into account the specific conditions and policies prevailing in a developing country. Ariff (1989) points out that some TRIMs appear to be redundant. For example, export performance requirements that set minimum export-output ratios to qualify for incentives or peaks are scarcely binding in the sense that firms are required to do what they would have done anyway, even in the absence of explicit performance requirements.

A central issue is whether TRIMs and other investment measures actually alter the allocation of resources in production and trade or merely affect the distribution of rents between firms and host countries. Both suppliers and recipients of FDI gain from the liberalization of investment measures. Foreign investors may

benefit from new investment opportunities resulting from liberalized investment regulations, while the host countries may benefit from increased FDI inflows and greater market discipline resulting from this. Since many developing countries compete with one another to offer foreign investors generous fiscal, infrastructure, and financial incentives, the scaling down of TRIMs and other investment incentives could yield additional revenue for the government of host countries.

Overall, it appears that with or without a WTO agreement on investment, many countries have carried out liberalization of investment regimes. This has two possible implications: (i) the WTO framework is redundant; or (ii) the WTO is more necessary as policies converge, and a more comprehensive international agreement on investment becomes increasingly possible and necessary for facilitating the liberalization process and to govern investment measures. Which outcome emerges will depend on the bargaining positions adopted by different countries and the attitudes they hold toward the process.

VI. CONCLUSIONS

In recent years, the TRIMs Agreement has become a central issue in the debate on the relevance of multilateral trading agreements and the WTO to developing countries. Until the Tokyo Round began, liberalization efforts under the GATT were concentrated on policies, primarily tariffs, affecting trade in goods. Successive rounds of GATT negotiations achieved major reductions in barriers to trade in goods. Consequently, other issues have become increasingly prominent. The GATT/WTO addresses some issues by means of the GATS, TRIMs, and TRIPS Agreements. Nevertheless, the need for a comprehensive framework for investment within the WTO will intensify in coming years in order to ensure coherence and consistency between trade and investment policies.

In the long run, the establishment of a multilateral framework of rules can contribute to improvement of the investment climate; help create a stable, predictable, and transparent environment for investment; enhance business confidence; and thereby promote the growth of FDI flows to developing countries. These conditions will not only foster foreign investment, but also stimulate domestic investment. Such favorable long-term outcomes, however, may be accompanied by arduous adjustment in developing countries. It is therefore important to try and ensure that beneficial long-term outcomes are balanced by minimum adjustment costs faced by developing countries in the short to medium term.

Debates on measures regulating foreign investment also need to consider the policy framework for domestic investment. Indeed, in many developing countries, it is the local investors who feel that they are being discriminated against while foreign investors are being pampered. Arguably, the privileges granted to foreign investors have tended to thwart the development of local entrepreneurship.

Domestic small-scale industrialists in particular, often feel neglected and overlooked (Ariff 1989).

There is great potential for the Doha Round to conclude with an agreement that considerably liberalizes the world trading system and meaningfully integrates developing and least developed countries. A strengthened WTO under the Doha Round could provide substantial tangible benefits to developing countries. However, there is also a danger that the negotiations might founder on differences relating to the new areas that are tangentially related to trade, such as investment, competition policy, and environment.

The Doha Round has been called the "Development Round." Developing countries need to make an effort to clarify the scope, structure, and content of the negotiations in regard to trade and investment. In order to maximize the benefits accruing from future trade negotiations, as well as to facilitate the success of future WTO negotiation rounds, developing countries need to strengthen their research capabilities. They need to undertake studies that clarify the major benefits and costs they may incur in different scenarios and the subsequent best strategies to carry out negotiations. In particular, the significance of various issues must be examined. They need to have a solid understanding of what has been committed to, and a solid vision of how to implement those obligations. This should include the timing and sequence of liberalization policies to deliver optimal outcomes.

Regardless of the outcome of the Doha Round of WTO negotiations, individual countries can adopt a policy framework that is beneficial to both foreign and domestic investors, as well as to recipient economies as a whole. Basic components of such policies would include transparency about investment rules and regulations, with clear identification of agencies responsible for issuing relevant licenses, permits, and approvals.

The NAFTA experience suggests that the process of working through these important issues, even just to accomplish a "minimal" or "modestly ambitious" package of successful outcomes is fraught with difficulty. This should not deter the effort to push for a successful round. There was no agreed draft at the start of the Punta Del Este Ministerial Meeting that launched the Uruguay Round in 1986. The divisions over agriculture between EU, Japan, and US then were wide, and developing countries were against the inclusion of new issues such as services in the negotiating agenda (Srinivasan 2002). The successful conclusion of the Uruguay Round not only extended the multilateral trade regime to new areas of services and intellectual property rights, but also integrated trade in goods, services, and technology, and established a strong enforcement mechanism. Such experience bodes well for the next round of negotiations. But much clearly focused effort is still needed to ensure success. Given the relative weakness in negotiation resources of developing countries, the onus is on developed countries to take a greater role in ensuring a successful outcome for the Doha Round. The

tilting of the scales in favor of developed countries reflects a weakness of the international system. To a certain extent, it is in the interest of rich countries to level the playing field. Otherwise, negotiations are likely to give poor results or the weaker players will not want to play at all. If developed countries want to ensure the success of negotiations, they need to consider ways to make the game worthwhile playing.

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