

Nunnenkamp, Peter

**Article — Accepted Manuscript (Postprint)**

## FDI for development? Assessing the case for a multilateral investment agreement from the perspective of developing countries

The journal of world investment

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Nunnenkamp, Peter (2003) : FDI for development? Assessing the case for a multilateral investment agreement from the perspective of developing countries, The journal of world investment, ISSN 1424-1196, Werner, Geneva, Vol. 4, Iss. 4, pp. 585-593

This Version is available at:

<https://hdl.handle.net/10419/3117>

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## FDI for Development?

### Assessing the Case for a Multilateral Investment Agreement from the Perspective of Developing Countries

#### I. INTRODUCTION

The vast majority of development economists argues that there is a clear case for free trade. As one survey of empirical studies notes, “openness to trade has unambiguously helped the representative Third World economy” (Lindert and Williamson as quoted in World Bank 2002: 5). By contrast, recent studies reveal ambiguous effects of capital flows to developing countries (DCs).<sup>1</sup> This indicates that the case for free capital flows is considerably weaker than the case for free trade.

Nevertheless, major industrialized countries (ICs) and international financial institutions, notably the IMF, urged DCs to remove capital-account restrictions until recently. After serious financial crises in Asia and Latin America, however, previous supporters of unrestricted capital mobility, including the IMF, took a

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<sup>1</sup> For instance, Rodrik (1998: 61) found “no evidence that countries without capital controls have grown faster”.

more differentiated position. According to the newly emerging consensus, debt-related capital flows, especially if they are short-term, are too risky for DCs to rely upon (*The Economist* 2003). At the same time, DCs are strongly advised to open up to inflows of foreign direct investment (FDI). This type of inflow is considered superior to foreign debt for several reasons, including being less volatile and carrying additional benefits such as technology transfers.

Policymakers in most DCs seem to agree. Almost all DCs are now eager to take part in the worldwide competition for FDI. FDI regulations and restrictions have been relaxed substantially since the early 1990s. In 1991-2001, about 95 percent of all changes in national FDI regimes, reported by UNCTAD (2002: 7), were meant to treat FDI more favorably. Apart from unilateral liberalization measures, DCs have entered into numerous bilateral and plurilateral investment treaties that offer protection to foreign direct investors. Against this backdrop, it may come as a surprise that various DCs are strictly opposed to multilateral negotiations on investment in the so-called Doha Development Round of the World Trade Organization (WTO).

As argued in the following, the opponents to a multilateral investment agreement have a point. In strictly economic terms, the case for such an agreement is considerably weaker than its proponents are claiming. For political-economy reasons, however, it does not appear promising if DCs attempted to block WTO negotiations on investment. Rather, they should

consider the option to offer investment-related concessions of the sort ICs are asking for. By doing so, DCs would improve their chances to get quid pro quo-concessions from ICs in areas of vital interest to DCs.

This article proceeds in several steps, in order to substantiate this proposition:

- The first question is why the standard arguments advanced by the proponents of a multilateral framework for investment (MFI) are not compelling.
- Second, the requests of some DCs for what they consider to be a “balanced” or “development friendly” MFI, including, e.g., binding corporate obligations, are shown to be equally unconvincing.
- Third, the strategic options are discussed which DCs have when ICs insist on WTO negotiations on investment.

## **II. HOW STRONG IS THE CASE FOR A MFI?**

According to the Doha WTO Ministerial Declaration, the purpose of a new framework on investment is “to secure transparent, stable, and predictable conditions for long-term cross-border investment” (WTO 2001: Paragraph 20). In other words, a MFI is primarily perceived to reduce so-called transaction costs and, thereby, to stimulate higher FDI flows. Transaction costs that may hinder FDI flows to DCs include: entry restrictions such as approval procedures

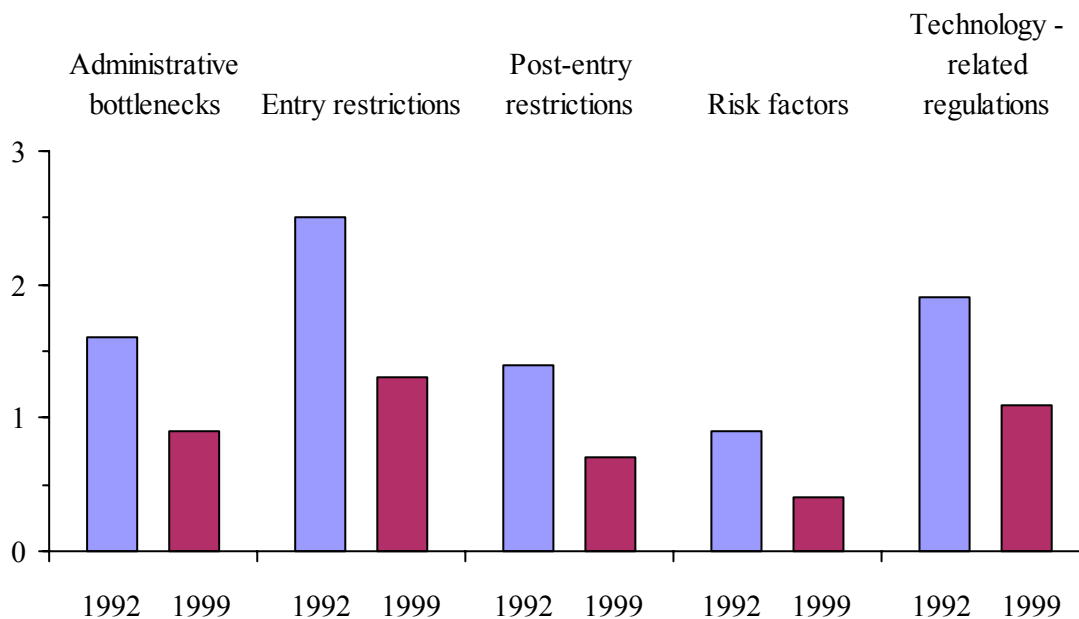
and limited access to specific industries; post-entry restrictions, notably performance requirements, related to local content, exports etc., that are imposed on foreign investors; and risk factors embedded in the legal and regulatory systems of host countries.

Particularly the business community in ICs claims that binding multilateral rules and disciplines on FDI would be in the interest of WTO members at all levels of economic development. A MFI could indeed be in the mutual interest of home and host countries of FDI if transaction costs were lowered significantly in this way, and if DCs could derive more benefits from additional FDI. It is open to question, however, whether these conditions are met. First of all, there appears to be less potential for transaction-cost reductions to be realized multilaterally than the proponents of a MFI assume. According to survey results presented by the European Round Table of Industrialists (2000), transaction costs of the sort just mentioned are no longer perceived to be a major bottleneck to FDI. The average score of the 28 DCs included in the survey declined to about half the score in 1992 for each of the five indicators of transaction costs listed in Figure 1. Given the range of survey results from 0 to 6, with lower values indicating a more liberal treatment of FDI, the evidence points to substantial unilateral liberalizations of FDI regulations in the past.

Furthermore, multilateral negotiations would have little effect on transaction costs unless the intransparency resulting from overlapping legal instruments and

the intricate net of bilateral and plurilateral investment treaties were to be overcome by a MFI. This is highly unlikely. What can reasonably be expected from the Doha Round is a kind of “WTO plus” investment framework. This means that a MFI would define the smallest common denominator of all WTO members, while more substantive agreements with limited membership would remain in place. It is difficult to imagine substantially reduced transaction costs in such a setting.

Figure 1 — Transaction – Cost – Related Impediments to FDI in 28 Developing Countries<sup>a</sup>, 1992 and 1999



<sup>a</sup>Survey results range from 0 (most liberal) to 6 (most restrictive).

Source: European Round Table of Industrialists (2000).

It is also open to question whether FDI flows would actually increase, as argued by many proponents of a MFI, simply because transaction costs were reduced.

Nunnenkamp and Spatz (2002) performed various empirical estimates on the determinants of FDI in DCs. It turned out that transaction cost-related variables play at best a marginal role as drivers of FDI, notably compared to market-related determinants (market size, per capita income). It fits into this picture that the absence of multilaterally binding FDI rules has not prevented the tremendous boom of FDI in DCs in the 1990s. Moreover, other empirical studies revealed that bilateral investment treaties (BITs) did not exert a significant impact on FDI flows to signatory countries, even though various BITs offer investors a degree of protection that goes far beyond what can reasonably be achieved in the Doha Round (UNCTAD 1998; World Bank 2003).

Finally, even if FDI flows were stimulated by a MFI, it is anything but guaranteed that all DCs could derive economic benefits from FDI. To the extent that such benefits are reflected in higher economic growth of developing host countries, the available empirical evidence is at odds with the euphoria about FDI prevailing among policymakers.<sup>2</sup> As it seems, DCs must have reached a minimum level of economic development before they can capture growth-enhancing effects of FDI. Weak markets and institutions typically prevailing in poor DCs tend to seriously constrain the growth effects of FDI. Consequently, the international community is focusing on the wrong question when, e.g., the

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<sup>2</sup> For a detailed discussion, see Nunnenkamp (2002).

UN (2002: 5) argues that the central challenge is to attract FDI to a larger number of DCs. Succeeding in this respect would solve only the minor part of the problem. The crux is that a low level of development tends to constrain the role FDI can play in promoting economic growth in DCs.

In summary, there are various reasons why the effects of a MFI on FDI in DCs are likely to fall short of high expectations, at least as long as the focus of a MFI is on transaction-cost reductions as suggested by its proponents in ICs. This invites the next question, namely whether DCs would fare better if they succeeded in reaching a “balanced” and “development friendly” agreement.

### **III. HOW SENSIBLE ARE THE DEMANDS OF DCs?**

DCs have two major requests which they consider essential for improving the development impact, i.e., the “quality” of FDI. As concerns their own FDI policies, DCs insist on flexibility which would allow them to pursue selective and targeted FDI policies. At the same time, DCs argue that a balanced MFI must include binding corporate obligations, ranging from precautions against unfair business practices to obligatory technology transfers. Both requests are meant to foster the development friendliness of FDI. The subsequent paragraphs rather suggest that this amounts to wishful thinking.

DCs do have a point when they regard existing bilateral and plurilateral investment agreements as biased in favor of business interests. According to the



World Bank (2003: 127), “the negotiating asymmetries that are common to bilateral agreements have led to treaties in which developing countries have taken on substantive obligations without any reciprocity other than the promise of increases in future private investment.” Yet, it is questionable whether development objectives would be easier to achieve, and higher quality FDI be attracted, if a MFI contained binding corporate obligations. If corporate obligations really bite, e.g., by rendering technology transfers mandatory, foreign investors always have the option not at all to invest, especially where they consider the protection of intellectual property rights to be deficient. Hence, DCs should be aware that they face a trade-off: the more binding corporate obligations become, the less FDI they may get.

A similar trade-off exists when DCs insist on flexible and selective FDI policies. It comes at the cost of transparency and predictability if DCs are not prepared to tie their own hands. In other words, the transaction-cost argument, discussed in the previous section, might become irrelevant altogether if FDI rules were to become rather flexible. More importantly, the argument for flexibility and selectivity rests on a dubious assumption, namely that “development clauses”, performance requirements and the like are effective in promoting economic development. Previous experience with performance requirements such as local-content rules, technology-sharing obligations and local equity participation in the form of joint ventures suggests otherwise. A detailed account of performance requirements found FDI to be harmful to the growth and welfare of developing

host countries when foreign investors were burdened with high local content, mandatory joint ventures and technology-sharing requirements (Moran 1998).

There is another aspect of performance requirements that many DCs tend to ignore. When FDI is undertaken in spite of restrictive performance requirements, it is frequently because foreign investors are granted compensatory advantages in the form of tax incentives and financial subsidies. For example, subsidies to attract FDI in automobile factories amounted to hundreds of thousands of dollars per job to be created in various countries, including several DCs (Oman 2001).

The “race to the top” in offering FDI incentives is difficult to stop, even though the economic case for not taking part in incentives-based competition may be strong. Politically, it may not be feasible to withdraw incentives unilaterally. Policy coordination seems key to escape this dilemma. Potentially, a MFI could make an important contribution towards this end. Realistically, however, little is to be expected from the Doha Round. This pessimism is not only because OECD countries failed in the 1990s already to tackle the problem of FDI subsidies.<sup>3</sup> In addition, many DCs insist on preferential treatment with regard to FDI

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<sup>3</sup> The critical issue of incentives-based competition for FDI had been removed from the agenda of OECD countries even before the negotiations on the Multilateral Agreement on Investment among themselves broke down completely in 1998; for details, see Nunnenkamp and Pant (2003).

incentives. They request only ICs to refrain from incentives-based competition, while they would like to maintain this option for themselves.

The insistence of DCs on preferential treatment is highly unlikely to deliver the desired results. The preferential treatment DCs have “enjoyed” for decades in the GATT framework for trade is a clear reminder in this regard. Various studies show that trade preferences, well-intended as they were, did the poorest GATT members no good in promoting their world-market integration. Bhagwati (2002: 26) notes: “The rich countries, denied reciprocal concessions from the poor countries, wound up concentrating on liberalising trade in products of interest largely to themselves”. The implication for multilateral negotiations on incentives-based competition for FDI is obvious: DCs cannot achieve much unless they are prepared to forgo flexibility on their own part.

Furthermore, it would help DCs little if only ICs withdrew FDI incentives. For most FDI projects, DCs compete with each other, rather than with highly developed countries. Much of the competition for FDI is among neighboring countries, or even within particular DCs (Oman 2001). Hence, preferential treatment with regard to incentives would hardly be instrumental to strengthening the bargaining position of DCs in resisting the demand for incentives by foreign investors.

#### **IV. WHICH OPTIONS DO DCs HAVE?**

In light of the reasoning in the previous sections, DCs may be tempted to resist any mandate of the WTO to negotiate on investment. Yet, policymakers in DCs should think twice before drawing such a conclusion. Even though the case for a MFI is fairly weak in strictly economic terms, it may make sense for DCs to agree to multilateral negotiations on investment. In deciding on strategic options, various political-economy factors should be taken into account. The following questions deserve particular attention:

- Could DCs strengthen their bargaining position by negotiating investment under the roof of the WTO, rather than bilaterally with major ICs?
- Do DCs have a reasonable chance to block multilateral negotiations on investment?
- What are the economic costs of making investment-related concessions, and what could DCs achieve in terms of reciprocal concessions from ICs?

As concerns the bargaining strength of DCs, the experience with BITs provides a relevant counterfactual. As noted before, negotiating asymmetries are common to BITs, which typically do not include provisions against restrictive business practices. Hence, DCs may be more successful in pushing for rules on corporate behavior by coordinating their request for corporate obligations to be included in a MFI. On the other hand, many BITs do not prohibit performance requirements,

even though small developing host countries have less bargaining power than the industrialized home countries of foreign investors. This is in contrast to the multilateral agreement on Trade Related Investment Measures (TRIMS), which bans certain types of performance requirements (notably, export requirements and local content obligations).<sup>4</sup> Indications are that the pressure on DCs to abolish performance requirements will mount when it comes to multilateral negotiations on investment. This suggests that multilateral negotiations may improve the bargaining position of DCs in some respects, but not necessarily in all respects.

The answer to the second question is less ambiguous: DCs do not have a reasonable chance to block multilateral negotiations on investment altogether. Critics of a MFI, e.g., Kumar (2001) and Singh (2001), who argue for a united front of DCs against a MFI ignore that conflicts of interest are not only between ICs and DCs, but also within the heterogeneous group of DCs. As mentioned earlier, the prospects of deriving economic benefits from FDI differ considerably across DCs. The demand of ICs for clearly defined multilateral rules may be rejected at no cost by DCs anticipating that they will not attract growth-enhancing FDI, no matter what investment agreement they sign. By

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<sup>4</sup> However, the effectiveness of the TRIMS agreement appears to be limited for conceptual reasons (illustrative list approach, escape clauses) and due to implementation problems (Langhammer 1994: 9; Nunnenkamp and Pant 2003: 25).

contrast, countries for which FDI has more to offer will be more inclined to accept what ICs propose. Moreover, once it comes to multilateral negotiations on investment, many DCs have little choice but to join eventually. DCs with particularly large markets and strong economic fundamentals (e.g., China) could possibly afford to remain outsiders. But smaller and less attractive DCs probably cannot, even though a MFI is unlikely to result in more or higher-quality FDI. The reason is that not taking part could effectively close the door to FDI for these DCs.

Accepting that a purely defensive strategy of DCs is bound to fail, the third question comes to the fore. It is for several reasons that DCs should consider the option to commit themselves to rule-based FDI policies as a bargaining chip, rather than engaging in futile attempts to block multilateral negotiations on investment altogether. The economic costs of giving up flexible and discretionary FDI policies are substantially less than many policymakers in DCs tend to assume. For example, the findings of Moran (1998) indicate that DCs have nothing to lose if they offered to refrain from imposing joint-venture and technology-sharing requirements on foreign investors. Financially, DCs may even gain from such a move as compensatory FDI incentives would no longer be needed.

Furthermore, an offensive strategy is superior to the currently prevailing defensive attitude of DCs since it would provide incentives for quid pro quo-

concessions by ICs. The basic logic of WTO negotiations implies that DCs will become relevant negotiation partners only by offering something on their own. Cross-issue linkage is an important consideration in this regard. The economically valid argument advanced by many DCs that labor mobility is the logical counterpart of capital mobility may be the most relevant case in point.<sup>5</sup> The reluctance of ICs to enter into negotiations on labor mobility so far provided the justification for DCs to reject the demands of ICs for rule-based FDI policies. DCs may fare better by changing strategy, i.e., presenting rule-based FDI policies as a carrot and, thereby, increasing the pressure on ICs to agree to negotiations on labor mobility.

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<sup>5</sup> Hoekman and Saggi (2000) show that the economic arguments for labor mobility are not weaker than those for capital mobility.

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