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Foreword

The ERD Working Paper Series is a forum for ongoing and recently completed research and policy studies undertaken in the Asian Development Bank or on its behalf. The Series is a quick-disseminating, informal publication meant to stimulate discussion and elicit feedback. Papers published under this Series could subsequently be revised for publication as articles in professional journals or chapters in books.

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Abstract

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

A. Trends in Foreign Direct Investment

Until the 1980s, most developing countries viewed foreign direct investment (FDI) with great wariness. The presence of multinational corporations (MNCs) was perceived to impinge on national sovereignty and security. The foreign-based center of decision making and international mobility raised suspicions about MNCs' commitment to the host economy. The sheer size and magnitude of FDI by 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 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 aggressively offered, particularly to MNCs that supported developing countries' industrial policies. This led to a rapid expansion of FDI flows around the world during the last 20 years. From only $53.7 billion in 1980, FDI outflows reached $1.4 trillion in 2000.

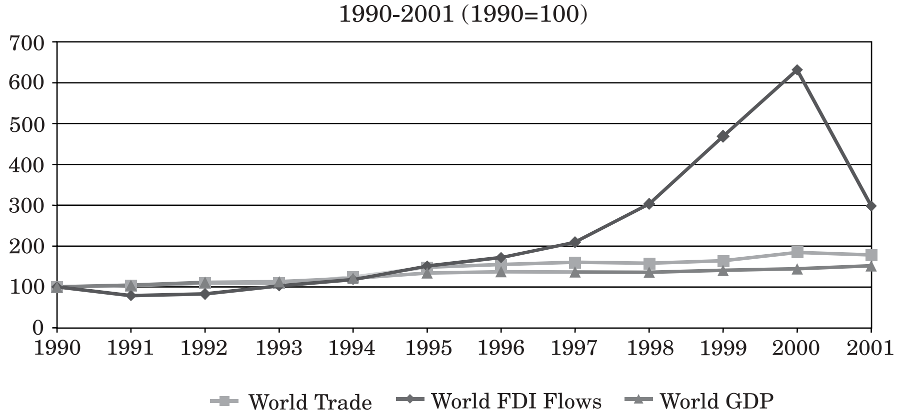
The upsurge in FDI has substantially changed the international economic landscape. A notable characteristic of this change is its phenomenal speed. Since 1980, the growth of world FDI outflows has overtaken the growth of world exports (Figure 1). This swift expansion in FDI outflows was more pronounced 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 (2003), FDI outflows: UNCTAD (2002).

Relative to world output, total trade and FDI flows have risen tremendously since the early 1990s (Figure 2). In particular, world FDI flows have climbed sharply since 1993, increasing more than six times as of 2000, before falling abruptly in 2001 as a result of the global slowdown and stock market decline. Meanwhile, world trade and output have been growing at a more modest pace, not even doubling in value between 1990 and 2000.

Figure 2. **Index of World Trade, FDI Flows and Output,**
1990-2001 (1990=100)



Note: World trade is defined as the sum of exports and imports, FDI flows as the sum of inflows and outflows.
Sources: Trade: IMF (2003), FDI flows: UNCTAD (2002), GDP: World Bank (2003).

The geographic pattern of FDI outflows hardly changed 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 Asia and the Pacific 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 also continued to be the biggest recipients of FDI inflows. While economies in Asia and the Pacific started to receive 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 have become 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, which was one of the top 10 FDI destinations in the early 1990s, has been dropped from the list and replaced by India in the late 1990s (Table 1). Meanwhile, Hong Kong, China has overtaken Malaysia and Singapore as a preferred FDI destination. While the total value of FDI inflows to the top 10 Asian destinations substantially increased during the last decade, Asia's share in the world total dropped significantly.

Table 1. **Top 10 FDI Destinations in Developing Asia (annual average, $ million)**

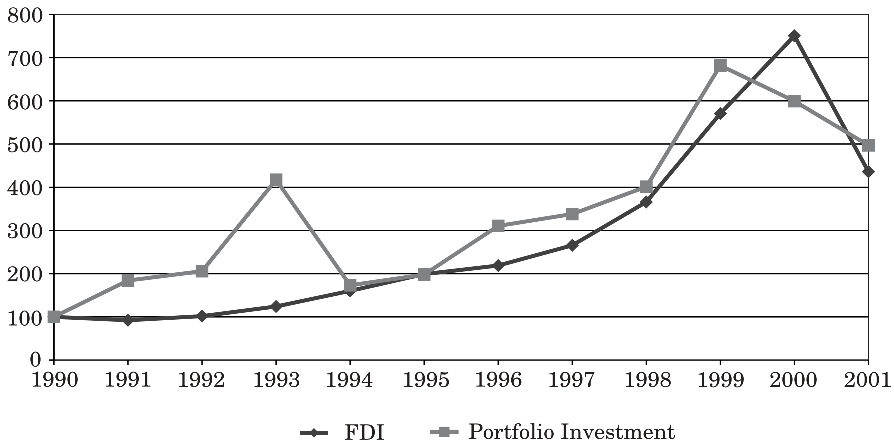
Rank	Host Economy	1991-1993	Rank	Host Economy	1998-2000
1	China, People's Rep. of	14,346	1	China, People's Rep. of	41,614
2	Malaysia	4,729	2	Hong Kong, China	33,768
3	Singapore	3,926	3	Korea, Rep. of	8,009
4	Hong Kong, China	2,082	4	Singapore	7,866
5	Thailand	1,978	5	Thailand	3,839
6	Indonesia	1,754	6	Malaysia	3,466
7	Taipei,China	1,022	7	Taipei,China	2,692
8	Korea, Rep. of	832	8	India	2,373
9	Philippines	670	9	Viet Nam	1,491
10	Viet Nam	539	10	Philippines	1,190
	Total	31,877		Total	106,309
	(Percent of World Total)	17.3		(Percent of World Total)	9.7

Source: UNCTAD (2002).

B. Rationale for Foreign Direct Investment

Capital flows from one nation to another to earn a higher return where it is more productive and to diversify risks. The potential impact of international capital movements is thus an increase in world output and welfare. Capital movement may take the form of either private capital flows (such as portfolio investment or FDI) or public capital flows (such as loans or aid). For the purposes of this paper, the discussion will focus on private capital inflows in general, and FDI in particular. Distinguishing characteristics of FDI are its stability and ease of service relative to commercial debt or portfolio investment, as well as its inclusion of nonfinancial assets to production and sales processes (Figure 3).

Figure 3. **Index of Foreign Direct and Portfolio Investment Inflows**
1990-2001 (1990=100)



Source: IMF (2003).

Aside from increasing output and income, there are other potential benefits to host countries from encouraging capital inflows:

(i) *Foreign firms bring superior technology*. The extent of benefits to host countries depends on whether the technology spreads freely to existing firms.

(ii) *Foreign investment increases competition in the host economy*. The entry of a new firm in a nontradable sector increases the 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) find that about half of each dollar of capital inflow translates into an increase in domestic investment. Their findings suggest a foreign resource transfer equal to 53-69 percent of the inflow of financial capital. The remainder is diverted into reserve accumulation or capital outflows. However, when the capital inflows take the form of FDI, their results suggest 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). One implication is that governments may encourage potential exporters to locate near each other by creating export processing zones, conferring special benefits such as duty-free imports of inputs, subsidized infrastructure, or tax holidays, to help reduce costs for domestic firms of breaking into foreign markets. Export processing zones are a useful transitional device in the absence of broad-based reform, but may introduce spatial distortions when governments locate the zones in inappropriate places.

(v) *Foreign investment can aid in bridging a host country's foreign exchange gap.* Growth requires investment and investment requires saving—whether domestic or foreign. Two gaps may exist in the economy: insufficient saving to support capital accumulation to achieve a given growth target; and insufficient foreign exchange to transform domestic to foreign resources. If investment requires imported inputs, then domestic saving may not guarantee growth if the saving cannot be converted to foreign exchange to acquire imports. 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 large inflows of capital without large declines in its rate of return. However, if capital grows much faster than the productivity of labor, its productivity will fall, which might reduce its rate of return significantly.

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 and must be carefully considered (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).

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. This led to capacity expansion, productivity growth, declining prices of exportable commodities, and deterioration in the host country's terms of trade, possibly having led to welfare losses. In addition, there are generally no 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. The host countries often import unfinished components and export finished goods or refined components for further processing elsewhere. This type of foreign investment generally provides employment and raises wages, but adds little to the host country's capital stock. 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 belongs 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 the correct policy environment, linkages and leakages emerge, creating a country reputation that influences other potential investors. The Singapore story is a case in point.

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.

II. IMPORTANCE OF THE POLICY CONTEXT

As mentioned above, FDI can potentially supply a combination of technology, management, production procedures, quality control techniques, and access to financing and markets that may not be available locally. These innovations can contribute to dynamic growth and development in host country industries through demonstration and other spillover effects. The accelerating pace of technological change, the spread of integrated production networks, and high costs of most innovation efforts make the benefits increasingly attractive to most potential host countries.

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 in general 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 toward 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 is frequently observed and it has long been a feature of the regulatory framework governing FDI in host countries (McCulloch 1991).

The growing evidence that export-oriented investment can make significant contributions to domestic development has increased the proliferation of incentives to attract such FDI. In addition to other incentives are efforts at the national level to reduce 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.[1] 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, the supply of skilled

[1] The length and cost of the approval process, as well as establishment and operating costs, can vary greatly from one country to another (Lall 2000).

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. (This is true among both more developed and less developed country locations.)

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. There has been strong concern in some locations that labor or environmental standards might be lowered in a "race to the bottom" to attract foreign investment, but there is little empirical support for this actually happening beyond anecdotal evidence (Brooks 1998).

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

Types of Measures	Examples
Screening, admission and 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. EPZs) 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 Reduced taxes for expatriates
Financial incentives	Investment grants Subsidized credits Credit guarantees

continued...

Table 2 (cont'd.)

Types of Measures	Examples
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 1988).

Policies may be the same for all investors, domestic or foreign, or they may be particular to a certain investment, such as special tax or infrastructure provision incentives. Arrangements that commit host country entities to purchase fixed quantities of output on a take-or-pay basis, and especially to pay in a 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 plants 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.[2] 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 into the global sourcing network of the parent company.[3] 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).[4]

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

[3] *Voluntary* joint ventures, on the other hand, to spread risk and increase market access offer less disincentives for technology transfer, at least for more established technologies.

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

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;
(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 suppliers and then contribute to vendor development. This sort of *build up* strategy is most effective in a conducive economic environment.

> *Build up* strategies are composed of a macroeconomic component that provides low inflation and a realistic exchange rate, a microeconomic component that rewards saving and investment, and an institutional component that encourages legal and regulatory consistency and discourages red tape and corruption. They depend upon reliable infrastructure.... Finally, *build up* strategies demonstrate a very high payoff to even modest amounts of vocational training and skill development, often at the high school or vocational school level" (Moran 2002, 18).

Not only does the high payoff 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).

Over 1900 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 International Centre for Settlement of Investment Disputes (ICSID).[5]

Trade-related investment measures (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 (Greenfield 2001). Another measure used is denying foreign corporations access to the host country markets. These measures clearly have a direct impact on trade.

III. WORLD TRADE ORGANIZATION NEGOTIATIONS AND FOREIGN INVESTMENT

A. The Agreement on Trade-related Investment Measures

1. The Agreement

The principal multilateral agreement on FDI is from the 1994 Uruguay Round of the General Agreement on Tariffs and Trade (GATT; the forerunner of the World Trade Organization, or WTO), which included an agreement on trade-related investment measures (the TRIMs Agreement). This agreement was designed to address certain issues relating to investment policies. Formal consideration of TRIMs in the GATT forum took a long time coming. The Uruguay Round of GATT was the first attempt to formulate an agreement covering trade and investment (Ariff 1988).

A combination of factors led to the inclusion of investment in the work program of the Uruguay Round negotiations. There was a changing perception of the role of foreign direct

[5] 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.

investment in development and intense debate on the linkages between GATT rules and foreign investment policy arising from the US-Canada dispute over Canada's application of performance measures on foreign firms (Bora 2001).

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 (Greenfield 2001). Brazil and India maintained that investment was outside the GATT's competence, while other developing countries tended to take a defensive position with regard to TRIMs (Ariff 1988). 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 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 the volume of trade, 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 rather than 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, a brief TRIMs Agreement was only reached after lengthy debate. The Agreement came into effect on 1 January 1995 as part of the Uruguay Round of negotiations. The TRIMs Agreement included the following terms (see Appendix):

(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.

[6] As noted below, the TRIMs Agreement does not define "investment" and "investors" and can therefore be considered nationality neutral.

Furthermore, services are covered by the WTO General Agreement on Trade in Services (GATS), and export subsidies are covered in the Subsidies Agreement.[7] As such, technology 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.

[7] As an example of the implications of this, a recent WTO ruling as part of its drive to eliminate export subsidies will require Thailand to phase out by 2004 a number of foreign investment incentives (*Asian Wall Streeet Journal* 2002).

2. TRIMs in Practice

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 they still had a variety of policies in existence, however. Most 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 were foreign exchange balancing requirements (Bora 2001).

Fifteen of the 194 disputes brought to the WTO since January 1995 involved the TRIMs Agreement. In some cases, the same issue was the subject of several complaints so that more than one WTO member found itself defending one particular policy against a number of other members. For example, between July 1996 and May 1997, four separate complaints were lodged with the WTO by EU, Japanese, and US governments against Brazil's auto industry measures (Greenfield 2001). EU, Japan, and US each filed notifications against the same Indonesian policy. Similarly, the EU and Japan have filed notifications against Canada (Bora 2001).

TRIMs are rarely applied in isolation. Complaints often list other policies in addition to those claimed to be inconsistent with the TRIMs Agreement. The most common agreement to be cited in conjunction with TRIMs is the Agreement on Subsidies and Countervailing Measures. The Agreement on Trade-Related Aspects of Intellectual Property Rights was also listed in one case. In the two cases where TRIMs arose in the agriculture sector the Agreement on Agriculture is also alleged to have been violated.

Discussion of extension requests occurs within the WTO Council for Trade in Goods. Countries submit an extension request to the Council and then have to justify the request and submit themselves to detailed questioning from other members, generally EU, Japan, and US. The first round of extension requests has now been largely settled.

A number of countries requested extensions of the transition period. Argentina, Malaysia, Thailand, and Philippines cited financial crises as a major factor for their extension requests that added to their structural adjustment problems. Colombia and Pakistan cited specific development reasons for their extension requests. Colombia detailed difficulties in transforming its economic model, especially in terms of substituting away from 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 the interaction between preferential trade agreements and multilateral obligations (Bora 2001).[8]

[8] Argentina's request stated specifically that negotiations within the context of the MERCOSUR Common Automotive Policy were important. Mexico did not specifically mention NAFTA in their request, but it has been noted that there is an inconsistency in the phase out period for TRIMs in NAFTA and in the WTO.

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.

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. The Doha Declaration continues to attach the usual operational qualifications of "trade related aspects only" for investment and competition policy.

B. Reactions to and Evaluations of the TRIMs Agreement

1. Reactions

Considerable divisions still exist between developed and developing countries on investment-related issues. Many developing countries in Africa and Asia continue to object to the inclusion of TRIMs and other Singapore Issues in the negotiating agenda.[9] 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.

More specifically, one reason for their reluctance is that liberalization of investment is more constrained by political factors than by trade[10]. 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 investment. This arises from the fact that investment means long-term ownership and control over assets, resources, and enterprises (Ganesan 1998).

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,

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

[10] 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 to immigration of skilled labor is easier than to unskilled labor.

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 tends to be relatively high in developing countries (Balasubramanyam 1991). 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.

Several developing counties are of the view that TRIMs 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 were removed (Balasubramanyam 1991). 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 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. A legally binding treaty on foreign investment reduces such flexibility. 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, and to incorporate a meaningful development dimension (Ganesan 1998).

Operational details also cause contention between developed and developing countries (Greenfield 2001). For example, 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.[11] 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 in developing country governments that the threat by developed countries to reject a request for an extension forms 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.

There are a number of contentious issues relating to the transition periods. 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. In some cases, members that did notify do not appear prepared to meet the deadlines. Many members implemented

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

strategies that seemingly addressed the implications of compliance for the affected industries, but did not actually implement alternative policies.[12]

This raft of concerns explains the ongoing reluctance of some developing countries to negotiate on TRIMs. 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 in several other ways as an important instrument in the development process. 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).

2. Evaluation

The final TRIMs Agreement was a compromise between some developed countries that wanted TRIMs to be a comprehensive agreement on the investment-trade relationship and some developing countries that were opposed to the inclusion of TRIMs on the GATT agenda. The more than six years since the TRIMs Agreement came into effect has displayed the Agreement's weaknesses and strengths.

The Agreement's brevity underlies its compromise on comprehensiveness. The whole text of the TRIMs Agreement is only five pages long. In essence, the TRIMs Agreement only clarified the application of GATT Articles III.4 on national treatment and XI.1 on quantitative restrictions. It does not involve any new rules or disciplines. It is far less comprehensive than many other investment provisions, or attempts to establish investment rules, including nonbinding ones such as those of the Asia-Pacific Economic Cooperation forum or the World Bank Guidelines. This restrictiveness partly explains Greenfield's (2001) assertion that the TRIMs Agreement is less significant than the WTO agreements on services, intellectual property rights, and agriculture.

[12] 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.

The definition in the TRIMs Agreement may also be deficient. It is far from clear what constitutes a trade-related investment measure. Investment is not clearly defined, although it usually seems to refer to foreign direct investment. Such ambiguity makes it difficult to negotiate policy measures. For example, there was no consensus as to whether or not a specific policy instrument was indeed trade-distorting. Currently the only two commonly acknowledged TRIMs are local content requirements and trade balancing requirements. In other areas, the lack of a precise definition has caused considerable disagreement and continues to be the subject of dispute among WTO members.

The TRIMs Agreement is restricted to a narrow range of trade-related investment measures affecting trade in goods only. It leaves the legal status of the remainder uncertain. Some argue that in order to provide effective discipline of performance requirements, the agreement must be extended to encompass investment incentives and competition policy (Morrissey and Rai 1995). In particular, investment polices can have an important though typically indirect influence on issues such as protection and trade liberalization. There would be some advantage in reevaluating the consequences of all national investment policies, not merely the subset incorporated within TRIMs (McCulloch 1991).

The TRIMs Agreement allows developing and least developed countries to request an extension of the transition period for eliminating TRIMs. The request is considered on the basis of the "development, trade and financial needs" of that country. However, the Agreement does not explain how these requests will be decided or what "needs" could be considered (Greenfield 2001).

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. 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 the 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. This section outlines a number of issues that need to be considered.

1. Will TRIMs be Renegotiated?

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, the TRIMs issue, together with other Singapore issues, was excluded from this list and only considered as a study program (Panagariya 2001).

The Uruguay Round demonstrated that the inclusion of investment policies in the GATT/WTO negotiation agenda is a contentious issue for many. Indeed, the inclusion of TRIMs in the Uruguay Round negotiations was a major break with past practice and was strongly opposed by some capital importing nations (Ariff 1988). 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 created to draft investment rules under the WTO regime. This has been regarded as having ushered in a new round of negotiation 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 trade and investment issues. TRIMs 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.

2. Scope of Negotiations

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 the 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 2003 Ministerial Conference 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. The 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 assure investors receive a hearing (Moran 2002).

Another area of concern by developing countries is that the current TRIMs Agreement does not contain a basic definition of investment, but 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 (MAI), 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 new language in the context of disciplining policies, but only refers to the GATT articles, there has been some confusion regarding whether or not a policy that violated GATT articles automatically meant that it violated 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 program 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.

The 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 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.

TRIMs are typically used in conjunction with a number of other policies. One aspect, which was not taken into account during the Uruguay Round negotiations, 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 the incentives. Views are still divided on how to deal with both incentives and regulations.

Ambiguity in the wording of the TRIMs Agreement has made 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).

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, placed investment and competition policy near the top of the agenda (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. This approach would consider the existing TRIMs Agreement as a basic framework. The European Union had articulated this view in the context of preparations for the Seattle Conference, 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 implementation 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.

IV. 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.

TRIMs 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 TRIMs is for host countries to obtain the maximum possible share of the gains from FDI. However, economic theory has established that 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 the locational decisions of MNCs relative to other locational advantages (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 to adopt or maintain 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 is much broader than reflected merely by economic growth and income per capita. It 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 comes at a massive cost to society to 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 conventional 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 (1988) points out that some of the 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 actually alter the allocation of resources in production and trade or merely affect the distribution of rents between firms and host countries. Ariff (1988) argues that 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 recipients of FDI may benefit from greater discipline resulting from the TRIMs exercise. Since many developing countries compete with one another to offer foreign investors generous fiscal, infrastructural, and financial incentives, some discipline in this regard could yield additional revenue for the government of host countries.

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.

A. 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 the 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 the agreement will vary widely among them. The vast majority of low-income developing economies currently receive the fringe of FDI flows. Nearly 90 percent of the flows to developing countries have been received by 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. These differences between developing country positions renders consensus extremely difficult (Ganesan 1998).

Nevertheless, potential strategies to enhance developing countries' negotiating power exist. Developing countries need to think strategically prior to negotiations. They need to develop a clear idea of the final outcome each country seeks. They should then ask if there is a feasible path to achieve the outcome. If not, they must modify the outcome and repeat the exercise until the most desirable and feasible outcome is identified. Such an exercise will lead to defining 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, as well as with more developed countries (Panagariya 2001).

B. Is the Agreement on TRIMs 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 (1988) also argued that TRIMs only arise because of pre-existing distortions. Such distortions make domestic market orientation an attractive proposition to foreign investors. TRIMs 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 TRIMs. This raises two questions: should liberalization focus on trade, and is an agreement on TRIMs necessary?

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 may exist for a long time.

Some argue that foreign investment and trade are inextricably entwined. They are not substitutes, but are complementary to one another. 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).

Despite different views, an important implication is that problems of TRIMs partly result from the incomplete liberalization of trade. Without tariffs, quotas, and other import barriers, there would be less rent to extract and thus less scope for performance requirements.

C. Is WTO the Right Forum for Discussing the Issues?

The question of whether the WTO is the best forum for discussion of issues related to FDI continues to be controversial.

A number of regional investment packages have been negotiated or completed outside the WTO framework. In September 1995 OECD member countries established the MAI. FDI-related regulation is also dealt with by the United Nations Conference on Trade and Development, and the World Bank's ICSID. 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 pursuing the multilateral route is the WTO. The WTO will enable developing countries to negotiate a "bottom-up" approach for dealing with investment issues that will take into account some special concerns of developing countries. The WTO route will 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 will also ensure coherence between the Agreement on Investment and other WTO agreements. Thus, negotiations in the WTO will provide room for balancing the needs of developed and developing countries.

D. Should TRIMS 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 farm products by its member countries. 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.

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 TRIMs 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.

Such a strategy is not without its problems. It is doubtful whether TRIMs can successfully serve as such a bargaining tool. As discussed above and below, liberalizing investment regimes can be in the interest of developing countries. Therefore, any special treatment in this area may hurt their own interests. Further research needs to be conducted on the validity of the strategy of using TRIMs negotiations as a bargaining chip.

E. Is TRIMs a North-South Divide?

TRIMs appears to be an issue on which developed and developing countries take diametrically opposite positions. The major suppliers of foreign capital are developed countries. They would like to see the liberalization of regulations governing foreign investment and performance requirements imposed on foreign investors, while some host countries, mainly developing countries, seem to view such attempts as an assault on their national sovereignty. Ariff (1988), however, argues that the South-North divide is more apparent than real.

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 TRIMs 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; Taipei,China; and Singapore have undertaken investment abroad. Thus for some developing countries, the stake or interest in the TRIMs issue may be more similar to that of their developed counterparts (Ariff 1988, McCulloch 1991).

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 came 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 locational 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, which 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. US locational packages in the form of state and local subsidies have risen from $27,000 per job created in the mid-1980s to approximately $200,000 per job created in the late 1990s (Thomas 2000). 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 locational incentives (Moran 2002).

V. 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. Trade, investment, and technology are increasingly intertwined. The GATT/WTO addresses some issues by means of the GATS, and TRIMs and TRIPS Agreements. Nevertheless, the need for a comprehensive framework for investment within the WTO will be felt in the coming years in order to ensure coherence and consistency between trade and investment policies.

In the long run, 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. 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 1988). 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.

There is great potential for the Doha Round to conclude with an agreement that considerably liberalizes the world trading system and meaningfully integrates the developing and least developed countries. A strengthened WTO under the Doha Round could provide substantial intangible benefits to developing countries. However, there is also a danger that the negotiations might flounder 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 rounds of negotiations, 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 attractive to potential foreign investors and tailored in a way to enhance the benefits for the recipient economy. Basic components would include transparency about investment rules and regulations, with clear identification of agencies responsible for issuing relevant licenses, permits and approvals. Joint venture mandates, technology sharing and domestic content requirements, performance criteria, and negative investment lists would be replaced by positive lists of sectors eligible for national and MFN treatment. Foreign investors could also commit to transparency in their labor and environmental standards and public scrutiny of their conformance with those standards.

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 (Moran 2002). 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 among EU, Japan, and US then were equally 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.

Regional integration efforts have proven effective in attracting FDI. They offer a larger potential market to investors, contribute to macroeconomic and political stability, often involve regulatory reforms favorable to foreign investors, and facilitate enforcement and harmonization of standards and regulations.

Appendix

AGREEMENT ON TRADE-RELATED INVESTMENT MEASURES

Members,

Considering that Ministers agreed in the Punta del Este Declaration that "Following an examination of the operation of GATT Articles related to the trade restrictive and distorting effects of investment measures, negotiations should elaborate, as appropriate, further provisions that may be necessary to avoid such adverse effects on trade";

Desiring to promote the expansion and progressive liberalisation of world trade and to facilitate investment across international frontiers so as to increase the economic growth of all trading partners, particularly developing country Members, while ensuring free competition;

Taking into account the particular trade, development and financial needs of developing country Members, particularly those of the least-developed country Members;

Recognizing that certain investment measures can cause trade-restrictive and distorting effects;

Hereby agree as follows:

Article 1
Coverage

This Agreement applies to investment measures related to trade in goods only (referred to in this Agreement as "TRIMs").

Article 2
National Treatment and Quantitative Restrictions

1. Without prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994.

2. An illustrative list of TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 and the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 is contained in the Annex to this Agreement.

Article 3
Exceptions

All exceptions under GATT 1994 shall apply, as appropriate, to the provisions of this Agreement.

Article 4
Developing Country Members

A developing country Member shall be free to deviate temporarily from the provisions of Article 2 to the extent and in such a manner as Article XVIII of GATT 1994, the Understanding on the Balance-of-Payments Provisions of GATT 1994, and the Declaration on Trade Measures Taken for Balance-of-Payments Purposes adopted on 28 November 1979 (BISD 26S/205-209) permit the Member to deviate from the provisions of Articles III and XI of GATT 1994.

Article 5
Notification and Transitional Arrangements

1. Members, within 90 days of the date of entry into force of the WTO Agreement, shall notify the Council for Trade in Goods of all TRIMs they are applying that are not in conformity with the provisions of this Agreement. Such TRIMs of general or specific application shall be notified, along with their principal features.[13]

2. Each Member shall eliminate all TRIMs which are notified under paragraph 1 within two years of the date of entry into force of the WTO Agreement in the case of a developed country Member, within five years in the case of a developing country Member, and within seven years in the case of a least-developed country Member.

3. On request, the Council for Trade in Goods may extend the transition period for the elimination of TRIMs notified under paragraph 1 for a developing country Member, including a least-developed country Member, which demonstrates particular difficulties in implementing the provisions of this Agreement. In considering such a request, the Council for Trade in Goods shall take into account the individual development, financial and trade needs of the Member in question.

4. During the transition period, a Member shall not modify the terms of any TRIM which it notifies under paragraph 1 from those prevailing at the date of entry into force of the WTO Agreement so as to increase the degree of inconsistency with the provisions of Article 2. TRIMs introduced less than 180 days before the date of entry into force of the WTO Agreement shall not benefit from the transitional arrangements provided in paragraph 2.

5. Notwithstanding the provisions of Article 2, a Member, in order not to disadvantage established enterprises which are subject to a TRIM notified under paragraph 1, may apply during the transition period the same TRIM to a new investment
   (i) where the products of such investment are like products to those of the established enterprises, and
   (ii) where necessary to avoid distorting the conditions of competition between the new investment and the established enterprises.

   Any TRIM so applied to a new investment shall be notified to the Council for Trade in Goods. The terms of such a TRIM shall be equivalent in their competitive effect to those applicable to the established enterprises, and it shall be terminated at the same time.

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[13] In the case of TRIMs applied under discretionary authority, each specific application shall be notified. Information that would prejudice the legitimate commercial interests of particular enterprises need not be disclosed.

Article 6
Transparency

1. Members reaffirm, with respect to TRIMs, their commitment to obligations on transparency and notification in Article X of GATT 1994, in the undertaking on "Notification" contained in the Understanding Regarding Notification, Consultation, Dispute Settlement and Surveillance adopted on 28 November 1979 and in the Ministerial Decision on Notification Procedures adopted on 15 April 1994.

2. Each Member shall notify the Secretariat of the publications in which TRIMs may be found, including those applied by regional and local governments and authorities within their territories.

3. Each Member shall accord sympathetic consideration to requests for information, and afford adequate opportunity for consultation, on any matter arising from this Agreement raised by another Member. In conformity with Article X of GATT 1994 no Member is required to disclose information the disclosure of which would impede law enforcement or otherwise be contrary to the public interest or would prejudice the legitimate commercial interests of particular enterprises, public or private.

Article 7
Committee on Trade-Related Investment Measures

1. A Committee on Trade-Related Investment Measures (referred to in this Agreement as the "Committee") is hereby established, and shall be open to all Members. The Committee shall elect its own Chairman and Vice-Chairman, and shall meet not less than once a year and otherwise at the request of any Member.

2. The Committee shall carry out responsibilities assigned to it by the Council for Trade in Goods and shall afford Members the opportunity to consult on any matters relating to the operation and implementation of this Agreement.

3. The Committee shall monitor the operation and implementation of this Agreement and shall report thereon annually to the Council for Trade in Goods.

Article 8
Consultation and Dispute Settlement

The provisions of Articles XXII and XXIII of GATT 1994, as elaborated and applied by the Dispute Settlement Understanding, shall apply to consultations and the settlement of disputes under this Agreement.

Article 9
Review by the Council for Trade in Goods

Not later than five years after the date of entry into force of the WTO Agreement, the Council for Trade in Goods shall review the operation of this Agreement and, as appropriate, propose to the Ministerial Conference amendments to its text. In the course of this review, the Council for Trade in Goods shall consider whether the Agreement should be complemented with provisions on investment policy and competition policy.

Annex
Illustrative List

1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

   (a) the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production; or

   (b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

2. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which restrict:

   (a) the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;
   (b) the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise; or
   (c) the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.

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