# 1

# Introduction

During the past 10 years, a massive surge in foreign direct investment (FDI) has led to the deepest integration of the world economy in history. FDI, as a share of the world's total fixed capital formation, rose almost 80 percent. FDI now contributes 5 to 6 percent of total capital formation in the United States and Europe and an astounding 20 percent in China.[1]

But FDI does not contribute only capital to the world economy. Foreign operations of large multinational firms also help to transform the economies in which they operate through technology transfer, and by introducing new and better management techniques, providing market access to other countries, and increasing competition.

The recent surge in FDI has forced many governments to reconsider attitudes and policies toward FDI and global corporations. In the developing world in particular, these firms have long been viewed with suspicion. In many countries, such firms stood accused of exploiting the local economy to benefit the economy of the firm's home nation and creating an unhealthy dependence of the host nation upon foreign capital. But the positive contributions of FDI and global corporations to

1. More correctly, FDI contributes these percentages to gross national saving augmented by net capital flows from abroad. Because by the national income identities $I = S + NCF$, where $I$ is gross domestic investment, $S$ is gross domestic saving, and $NCF$ is net capital flows from abroad ($NCF$ bears a negative sign if there is a net capital outflow) and because FDI is a component of $NCF$, FDI contributes the same percentage to $I$ as it does to $S + NCF$. FDI is best seen in this light as a source of financing of real domestic investment rather than an actual component of it.



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economic development in a number of host nations during the past decade (the outstanding examples, almost at opposite ends of the spectrum in terms of total population, are China and Singapore) has shown that they play a significant role in raising growth levels, efficiency, and living standards.

This study focuses on the relationships between national governments and global corporations in light of this transformation. The main conclusion is that new rules on international investment by these corporations and their worldwide operations are urgently needed.

Chiefly, such rules should reinforce a worldwide trend toward liberalization of policies on FDI, offsetting the more restrictive and interventionist policies of the 1970s and early 1980s. The global benefits of international capital flow and technology transfer as well as those accruing to individual nations are maximized when policies are liberal—that is, when restrictions are minimal. Therefore, one reason for new international rules is to lock in the liberalization that has taken place and continues to occur. But even in the face of this trend toward liberalization, there remain government laws and policies that distort international investment flows and resulting commercial activities. The distortions impose major costs on the world economy in terms of lost output. Thus, another rationale for new rules is to capture the significant potential gains from getting rid of the distortions. A third rationale is to reduce conflicts between governments over FDI and the multinational firm, conflicts that can also reduce the net benefits accruing from FDI.

The case for new international rules to govern investment is built on four premises: that globalization is increasing, global firms face national policies, conflicts are inevitable, and the goals of both global firms and governments are legitimate.

**1. Growing numbers of corporations are increasingly global in terms of the scope of their operations and the nature of their concerns.** The internationalization of business is not a new thing, of course (some history of international business is provided in chapter 2). However, an unprecedented surge in FDI began about 10 years ago and continues into the present. The result is an increase in the global spread of corporate activities that profoundly changes the world economic landscape, with implications that are not yet fully understood.

How great is this globalization? The next chapter details salient facts and figures. But, as a way of introduction, let us note that in 1993 FDI flows worldwide represented 4.1 percent of the world's gross fixed capital formation (GFCF);[2] during 1981-85 this percentage was 2.3 percent (UNCTAD, *World Investment Report 1995*, annex table 5). This percentage varied substantially from nation to nation and from region to region.

2. FDI outflows were $222 billion while GFCF was $5,351 billion.



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For example, FDI inflows as a percentage of GFCF in 1993 was 5.1 percent for the United States, 5.8 percent for the European Union, 9.1 percent for East Asia, 20 percent for China, and an incredible 43 percent for Singapore (which, however, is something of a special case—the whole nation being a single city). But for the capital-starved least-developed economies, the figure was only 3.3 percent, and for some such nations it was much lower (for example, 0.2 percent for Kenya).

Two things must be remembered about these figures. First, FDI is undertaken mostly by the world's largest and most technologically dynamic firms. Second, the foreign investment these firms make does not represent their total direct investment; typically they also invest in their home nations (thus the global figure almost surely understates the importance of these firms in global capital formation, a subject dealt with in the following chapter).

**2. Despite the 10-year trend toward globalization of business that began during the mid-1980s and continues into the mid-1990s, global corporations operate in a world economy that remains imperfectly integrated and a political system wherein nation-states, pursuing interests that are necessarily national, set regulatory and other policies.** These include policies for the defense of *national* currencies (and thus exchange rates and trade balances), internationally *immobile* factors of production (notably unskilled labor and to some extent land), and *national* security. Also, many governments are concerned about the international competitiveness of national industries and how to enhance this competitiveness.

National priorities and goals are not necessarily the same as those of the firms themselves. Consequently, one major debate in many nations is to what extent policies should ensure that global firms do meet these national priorities and goals. But here a problem arises. Policies that are effective to maximize the benefits one nation derives unilaterally from the activities of global firms might not be optimal from a global perspective. Rather, such policies can have a "beggar-thy-neighbor" effect, such that benefits are transferred from one nation to another. Likewise, if all nations simultaneously pursue such policies, the consequent misallocation of resources causes a net reduction of world economic efficiency and welfare over that which would obtain if nations were collectively to abstain from such policies.[3] Finally, these policies might not be optimal from the perspective of the global firm in its efforts to rationalize its worldwide activities.

This is one reason for new international rules: to constrain "beggar-thy-neighbor" policies that are collectively self-defeating. Governments have already accepted constraints in their trade policies, as expressed in World Trade Organization (WTO) rules, and the overall desirability of

3. In the formal parlance of economics, the result will be "Pareto-suboptimal."



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these constraints is well understood. This study will build the case that similar constraints ought to govern FDI policies.

**3. Conflicts inevitably arise between governments and between business enterprises and governments; these can lead to inefficiencies and/or misallocations of resources that reduce global and national welfare.** The potential for such conflicts is not limited to those between host countries and global firms. Home countries might also pursue policies to ensure that firms based in their territories meet local goals (the failed Burke-Hartke bill of the 1970s in the United States represents such an example; similar policies have been discussed in other countries that are home to FDI, including France and Japan). Such policies raise the same issues of potential inefficiency and/or misallocation of resources as host-country policies do.

The potential benefit of eliminating these distortions is very high. In 1992, sales of multinational corporations' foreign affiliates worldwide has been estimated to be about $5.2 trillion dollars (UNCTAD, *World Investment Report 1995*, table I.13). These sales represent output generated somewhere in the economies in which these firms operate (although not necessarily in the affiliates themselves).[4] If the distortions and inefficiencies generated by government policies that would be curbed under international rules were to represent only 1 percent of this total value added, the addition to world output would be $52 billion per annum, a figure that by itself would surely justify some effort to create such rules.

But is the 1 percent figure even approximately accurate? No one really knows, although, if anything, the figure is probably higher. The only claim here is that the potential gains to eliminating inefficiencies generated by government policies toward international business activity are immense even on a very conservative estimate. That the estimate is probably conservative can be argued (although not proved) by means of examples:

- During the late 1980s, a multinational firm producing a chemically based product used in high-technology applications faced rapidly increasing demand in East Asia and realized that it needed to augment its production capacity. Two choices were available. First, it could increase the capacity of an existing facility in a major East Asian nation. Second, it could create an entirely new facility in some other East Asian country.

  Economic analysis done by the firm revealed that the first alternative would result in lower costs (i.e., increased efficiency) than the second alternative, irrespective of where the new plant might be

4. There is, however, some double counting in this figure because some of the sales of these affiliates are to other affiliates. Such sales should be removed from the total. Alas, the data do not exist that would permit this adjustment.



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located. However, one East Asian nation offered the firm a large subsidy to create a new plant within its national territory. The firm proceeded to negotiate a still larger subsidy, one large enough to compensate it for the higher costs of doing so (and then some) and then went ahead with the second alternative by creating a new plant in that country.

In this case, the subsidy represented a transfer from the taxpayers of the country granting the investment incentive to the firm and its shareholders. But, more worrisome, the subsidy represented compensation for increased costs (and hence lower efficiency), the implications of which are that potential world output was reduced. The subsidy was in the range of $100 million.

- Numerous governments protect domestic firms from international competition by restricting direct entry of foreign firms into domestic markets. The result typically is monopoly or olipolistic competition in the domestic market, resulting in the well-understood costs of imperfect competition (higher costs to consumers resulting from both monopoly pricing and inefficiencies in production and distribution).

  Often such protection is most rife in highly regulated markets—for example, those for basic telecommunications and financial services in many nations. The regulation itself often is (or at least originally was) justified as a means to protect consumers from the excesses of monopoly in markets believed to be "natural monopolies"—that is, ones in which only one or a small number of firms can survive. In modern times, the original conditions that in many cases once led to natural monopoly have disappeared but the regulation has not. A consequence is that the regulation more often protects incumbent producers rather than consumers. Opening such markets to international competition would in most such cases increase efficiency as well as reduce prices.

- Wherever governments regulate firms, conflict is likely between governments with differing policies. If not resolved in economically appropriate ways, such conflicts can impose costs in the form of lost or inefficient output. For example, suppose two governments, each reacting to the other, were to require that a multinational firm produce a good or service locally as a condition for doing business within their territories. Costs could be higher with the requirement than without it if consolidating production in one plant would be more efficient than operating two plants.

- A large manufacturing firm sought to establish an affiliate in a large developing country but had to obtain permission from the government to do so. Permission was granted on condition that the affiliate export a certain percentage of its output.

  The firm would not have chosen this particular location for export;



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the economic analysis of the firm indicated that while local manufacture for the domestic market was economical, export was not. However, the value to the firm of the permission to enter the local market overrode the negative value of being forced to export from this site.

Such export performance requirements distort world trade and hence pose a cost to the world economy. In fact, such requirements are now banned under the Trade Related Investment Measures (TRIMs) Agreement implemented under the WTO. However, other types of so-called performance requirements that might have similar distortive effects are still permitted. New rules might enlarge the coverage of the TRIMs agreement, banning such requirements where they impose additional costs on the world economic system.

This premise—that conflicts are inevitable—must be viewed in light of the fourth premise.

**4. The goals and priorities of both global corporations and national governments are legitimate.** This premise differs fundamentally from the view of certain critics of the multinational enterprise during the 1970s, who by and large perceived only the interests of government as legitimate. Much of the relevant academic literature of that time bolstered that view. This literature often stressed the monopoly power of the multinational enterprise and the putative ability of such enterprises to ride roughshod over national interests.

More recent literature (reviewed in chapter 3) takes a much more positive stance toward multinational enterprises, emphasizing, for example, that a great deal of rivalry exists among these firms and that this rivalry can lead to more rapid development and diffusion of desirable new technologies than would take place in a world without such enterprises. Also, an ascendant hypothesis is that in order for *national* firms to be *internationally competitive*, domestically owned firms must be exposed to competition from foreign-owned firms and allowed to develop and operate their own international networks of affiliates and alliances. These ideas are explored further in chapters 2, 3, and 4.

Kindleberger (1969) and Bergsten (1974) long ago argued that enlarging and restructuring international investment rules could reduce costly inefficiencies and misallocations of resources. That the global system needs a major overhaul to deal with the new issues that the globalization of industry raises has been argued as early as the late 1960s and early 1970s as well as more recently (Committee for Economic Development 1990; Ostry 1990; Christy 1991; Investment Canada 1991; Nicolaïdes 1993; Brewer 1996). Unlike most of these works, however, this volume attempts to lay out what new rules are needed.

Ideally, such rules should complement international trade rules administered by the WTO. Indeed, the Uruguay Round created some such rules (see chapter 5) but left much unfinished business in this domain.



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Expanding the WTO's role to encompass international investment and investment-related issues would be the ideal way in which to implement the rules this study envisages. However, the ongoing effort by the Organization for Economic Cooperation and Development (OECD) to develop a Multilateral Agreement on Investment (MAI) as well as other international initiatives on investment might be important way stations on the road to an expanded role for the WTO. Chapter 4 in particular outlines what the specific changes and improvements might be, while chapter 5 evaluates the existing international policy framework in light of current requirements. Chapter 6 concludes by examining institutional issues related to an overhaul of international policies on investment.



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