Home Country Measures and FDI: Implications for Host Country Development

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CONTENTS

Preface

Countries adopt several measures to encourage outward foreign direct investment (FDI), a large part of which is by transnational corporations (TNCs), as they feel this promotes their national interest. These measures - known as home country measures (HCMs) - have attracted attention of the international community recently. Most of the home countries are a select few developed countries, in which most TNCs are headquartered.

It is now recognised that many of these measures can promote or restrict FDI in developing countries. There are also talks that HCMs should be subject to disciplines in a possible multilateral investment framework (MIF) at the World Trade Organisation (WTO) for promotion of FDI in developing countries and regulation of corporate behaviour.

HCMs range from technical assistance, financial support and fiscal measures to measures for increasing market access and ensuring transfer of technology. These measures have the potential to facilitate economic growth and development in developing countries to the extent FDI can have a positive effect on economic growth and development.

However there could be some negative effects as well. There could be problems of double taxation and the abuse of transfer price mechanism by companies. Some developing countries could benefit from preferential treatment of developed countries at the expense of the others. Similarly rules-of-origin and anti-dumping restrictions may discourage outward FDI.

CUTS has attempted to highlight such issues relating to investment through a series of Monographs on Investment and Competition Policy. This is the latest one in the series.

This monograph discusses categories of HCMs that can influence outward FDI, the impact of HCMs on the economic development of host countries and the relationship between international investment agreement and HCMs. It argues that effective coordination by developed home countries can promote growth and development in developing host countries. We are thankful to Poonam Sarmah, New Delhi for researching and writing the paper for us.

Jaipur
July 2003

Pradeep S. Mehta
Secretary General

Chapter 1

Introduction: FDI, Market Failure and Government Intervention

Foreign Direct Investment (FDI) assumes significance as it can induce paradigm shifts in consumption, production and technology. While the key participants in FDI activity include the capital-importing host country as well as the investing firm, the capital-exporting home country too has an important role to play as will be seen in course of this paper. Each participant has specific motives and acts as an influencer in the direction of FDI flows.

Host countries seek FDI for the perceived benefits of backward and forward linkages, technology and skills, integration into international marketing, distribution and production networks as well as supplementing national savings. The host country's broad policy objectives are to maximise the potential benefits derived from FDI and minimise the negative effects, e.g., balance of payments problems, crowding out of domestic industry, transfer pricing, abuse of market power, labour issues and environmental effects.

However, neither inflows of FDI nor the benefits from such inflows are automatic. The outcomes are dependent on the interplay of forces among the key influencers.

Host countries: In order to attract FDI, host countries are responsible for improving economic systems, infrastructure and human capital while at the same time putting in place environmental, social and competition safeguards (See Box 1).

Investing firm[1] : FDI incorporates sharing or transfer of certain proprietary assets termed as 'ownership advantages' of Transnational Corporations (TNCs), which include capital, proprietary technology, skills and management and market access. A foreign firm decides to invest abroad as it wishes to derive optimum benefits from its firm specific or ownership assets and it finds location-specific advantages in the host country, such as access to large markets, lower resource and production costs, etc. It, therefore, finds advantages in internalising operations rather than relying on markets to exchange goods and services and this need gets strengthened in the context of increasing knowledge intensity in operations.

Home countries: Through their laws, regulations, policies and practical home country measures, they have the potential to exert significant influence on the flow of FDI to developing countries.

There has been a large body of work that looks at how TNCs choose their investment destinations, behave in host countries and the impact of investment climates in the host country for attracting and sustaining TNCs. However, the policy and regulatory stance of the capital-exporting country has been largely neglected.

Two intuitive questions may arise in this context. Firstly, in a globalising market economy, does the home country have much significance, as most investment decisions must be market-determined? Secondly, does the home country consider the outflow of investment on a profit/market motivation or are larger international considerations at stake? The first question is easily answered in terms of market-failure driven need for intervention. The second question is a cause for concern because, even as the home country's strategic role in directing investment for development becomes evident, the realisation of this role does not.

The Role of Government Intervention

Government intervention is motivated by two primary kinds of market failures: information or co-ordination failures in the international investment process and the divergence of private interests of investors from the economic and social interests of host economies. At the same time, weak bargaining and regulatory capabilities on the part of host country governments can result in an unfavourable distribution of benefits from the perspective of the society, e.g., negative effects on competition or the environment. FDI differs from local investment decision-making, as the perspective is that of the TNC or the home country and neither is likely to be more committed to the host economy than their interests.

This paper is focused on the potential role of the developed countries as the countries of origin on the direction and development impact of FDI flows into developing countries. The paper seeks to highlight various measures adopted by home countries to influence outbound FDI and to draw attention to issues and implications for developing host countries in this context.

Box 1: The Host Country Perspective:
Developing Country Objectives

- Higher growth rates;
- Modernisation of economic activity;
- Diversification of economic activity;
- Higher quantity and quality of employment;
- Broadly-based development and dissemination of industrial skills;
- Development of domestic research & technology capability;
- Stimulation of investment in backward regions and rural areas;
- Maximisation of public revenue;
- Avoidance of foreign takeovers of domestic firms;
- Control over pattern of economic development; and
- Balance of payments equilibrium.

Chapter 2

Categories of HCMs: Issues and Implications

Home countries adopt measures (HCMs) to support outward FDI as they see it in their national interest and/or in the interest of firms headquartered in their territories. Such interests can be derived from commercial, strategic or humanitarian motivations, as well as international commitments and obligations.

HCMs have not received much attention so far, as they were historically understood to be unilaterally designed measures adopted by developed countries, primarily focused on promoting the interests of their own TNCs. However, the past few years have brought about the recognition that these measures may restrict, permit or promote FDI and, thereby, influence both the quantity and quality of investment flows to developing countries. This may, directly or indirectly, impact development. The policy debate revolves around the actions developed countries might take to promote FDI, especially in developing countries[2] .

The promotion of outward direct investment has traditionally been the domain of developed countries, but in recent years, a number of developing countries and economies in transition have also begun to promote the outward investment of their enterprises. They do so for reasons of improving access to overseas markets, resources and technologies, as well as to strengthen the competitive advantage of their mature industries.

Categories of HCMs:

1. Information provision and technical assistance;
2. Financial support;
3. Investment insurance;
4. Fiscal measures;
5. Measures based on market access; and
6. Measures aimed at promoting or facilitating transfer of technology.

1. Information Provision and Technical Assistance

The international investor essentially seeks to answer whether it is worth his while to invest in the country, as opposed to competing opportunities. As the degree of risk increases with the degree of unfamiliarity about a potential investment destination, validated information about the investment climate in a potential investment destination is important for the FDI decision. Efforts of the host developing countries are supported, particularly for dissemination of information, by home country governments and concerned international institutions. Industrial countries also support bilateral and multilateral investment promotion programmes to help potential investors from those countries learn about investment opportunities in developing countries.

General Information Services

Most countries provide general information on investment conditions through their foreign ministries, trade promotion agencies and Department of Foreign Investments (DFIs). Besides, organised sources, like the Overseas Private Information Corporation (OPIC) in the US, provide information covering a country/region's economy, political condition, business practices, investment incentives and trade laws. Other examples include the German Federal Office for Foreign Trade Information (BFAI) and Japan's External Trade Organisation (JETRO).

Specific Investment Opportunities Databases

A few countries have developed databases of specific investment opportunities in, or investment inquiries from, developing countries. These include the OPIC, The Association of German Chambers of Industry and Commerce and JETRO. OPIC, Mondimpresa in Italy, JETRO, Finnfund in Finland and Danish International Investment Funds: The Industrialisation Fund for Developing Countries (IFU) in Denmark also provide data on home country firms to firms from least developed countries (LDCs) looking for partners.

Proactive Measures

Seminars, workshops and investment missions provide useful occasions for personal exchanges when prospective investors meet with government officials and potential local business partners in developing countries. Joint consultative groups on investment, e.g., the Japanese-Indian "Fast-Track" groups, or joint Chambers of Commerce and Industry, e.g., the Indo-German Chamber of Commerce play a valuable role. The European Union's Asia-Invest Programme also covers a wide range of mechanisms for this purpose.

Technical Assistance to Facilitate Outward FDI

It covers a range of assistance to host governments to improve their regulatory regimes and enhance institutional capabilities to attract, receive, employ and benefit from FDI. Technical assistance is provided to investing enterprises, particularly small and medium sized enterprises (SMEs), as well as host country joint venture partners. Provisions can also be found in several regional agreements, notably the European Community agreements with developing countries, Cotonou[3] and Association of South-East Asian Nations (ASEAN), and at the multilateral level, e.g., World Bank Group's Multilateral Investment Guarantee Agency (MIGA)[4] and International Finance Corporation (IFC).

Key benefits: Such measures help overcome market imperfections[5] that otherwise act as disadvantageous for developing countries, especially when an economy's relatively small size, geographic distance or limited prior experience with foreign investors tend to exclude it from customary lists of prospective FDI destinations. These particularly help SMEs in investing abroad, which, on their own, lack the resources needed to conduct a global search of unconventional FDI sites.

2. Financial Support

Financial support facilitates feasibility studies, project development and actual grants, loans or equity participation for investment projects in eligible developing countries. Special support can be offered for FDI in sectors such as infrastructure or for ventures undertaken by SMEs or jointly with local business partners.

Public organisations, including development finance corporations in developed countries, support outward FDI by SMEs, such as the Commonwealth Development Corporation in the United Kingdom. The assistance provides both loan and equity financing for projects in developing countries, sometimes by taking minority equity positions. Along with their own annual investment funds, these institutions can also garner additional private financing for foreign investment and exert considerable leverage in determining the nature of projects (See Box 2).

3. Investment Insurance

The principal purpose of such HCMs is to protect the investing firm and the resulting offset of risk helps to encourage outward FDI. These involve the coverage of political and other non-commercial risks not normally included under conventional, private insurance policies. As developing countries tend to pose greater political risks, such HCMs can effectively support FDI directed into such countries. National investment insurance programmes in many developed countries provide coverage for expropriation, war and repatriation risks. Countries such as Austria, Sweden and the United Kingdom cover all outward FDI, while others such as Finland, the Netherlands, Switzerland and the United States limit coverage to developing countries.

Regional bodies, such as the Inter-Arab Investment Guarantee Corporation provide security against the non-commercial risks which may confront inter-regional investment and that are difficult for investors to avert. The Cotonou[6] Agreement states: "co-operation shall ensure the increasing availability and use of risk insurance as a risk-mitigating mechanism in order to boost investor confidence in the African, Caribbean and Pacific (ACP) States". Support is to cover reinsurance schemes, partial guarantees for debt-financing and national and regional guarantee funds.

At the multilateral level, the Multilateral Investment Guarantee Agency (MIGA) has been providing political risk insurance, covering transfer restriction, expropriation, breach of contract, war and civil disturbance to private foreign investors investing in developing countries since 1990. MIGA works as a complement to national and regional FDI guarantee programmes as well as private insurers to issue guarantees, including co-insurance. Inspite of MIGA's joint sponsorship by developed and developing countries, its services

Box 2: Examples of Programmes Providing Financial Support

- The Export-Import Bank of **Japan** can provide loans to foreign Governments or banks to fund equity investments and loans to joint ventures with Japanese enterprises, in addition to direct loans to Japanese enterprises, for FDI. Other Japanese programmes, ASEAN Finance Corporation and the ASEAN Japan Development Co., focus on regional FDI promotion, particularly for developing countries in Asia.
- **Germany** sponsors programmes offering both equity capital participation in FDI projects, through the German Finance Company for Investment in Developing Countries, and loans for German investors, from the Kreditanstalt für Wiederaufbau.
- **Denmark** provides the Danish Industrialisation Fund for Developing Countries, funded by Danish International Development Agency (DANIDA), to promote investment in developing countries in collaboration with Danish firms. It usually also holds a seat on the board of directors, together with the Danish company investing in the project.
- Asia-Invest is another **European Union** programme that provides a range of financing initiatives, including the Business Priming Fund, to assist SMEs with market entry and business co-operation (Asia-Invest Secretariat, 2001).

have, so far, been primarily utilised by developed country firms. In a bid to improve coverage for investments by investors from developing countries, MIGA encourages South-South investments, i.e., investments made by developing country investors, by offering reduced fees.

4. Fiscal Measures

Fiscal HCMs refer to the provision of tax incentives by home countries to companies investing in developing countries. These include tax breaks through the granting of tax exemptions, deferrals or credits for taxation of foreign source income as well as general tax-sparing provisions. Although every country claims the right to tax income originating within its borders, national philosophies regarding the taxation of foreign earnings differ. Switzerland and Argentina, for example, have adopted a "territorial" principle of taxation, taxing only income generated within their borders[7]. The United States follows a "worldwide" principle, taxing US corporations and individuals on income earned inside and outside its national boundaries.

Double Taxation Treaties

By imposing tax on foreign source income of resident companies, home countries may create potential situations of double taxation of such income, i.e. the imposition of tax in host as well as home countries. Countries sign tax treaties to reduce double taxation and co-ordinate efforts to control tax avoidance and evasion efforts of TNCs. Signatories to these treaties, generally, agree on how taxes will be imposed, shared or eliminated on business income earned in one taxing jurisdiction by nationals of another.

The conclusion of a treaty between two developed countries is facilitated if they have approximately similar levels of development. Under such conditions, the reciprocal flows of trade and investment and the respective gain or loss of revenue to the parties from reducing taxes on those flows tend to be relatively equal in magnitude.

However, this may not be the case when the negotiating parties are vastly at different stages of economic development. Besides, a loss of revenue that may be of relatively minor importance to a developed country can constitute a heavy sacrifice for a developing country. For many developing countries, the scarcity of foreign exchange resulting from outflows of tax-exempt locally produced income may be of even greater importance than the loss of revenue. For developing countries, therefore, there may be no perceived gains unless the treaties are designed to ensure that revenue losses would be offset by benefits flowing from the treaty.

As treaties indicate co-operative taxation by treaty partners, it is expected that treaties increase investment. However, it is by no means certain that treaties do so and the effect of tax treaties on FDI is an open question. There are conflicting arguments that treaties could even have a dampening effect on FDI as they are geared to reduce tax avoidance and other tax-saving strategies by firms. There have been doubts whether FDI promotion is even a primary goal of treaty formation and several empirical studies[8] find no evidence that bilateral tax treaties increase FDI activity.

Bilateral international tax treaties govern host country taxation of global FDI flows and mainly follow the principles and provisions of the Organisations for Economic Co-operation and Development (OECD) Model Tax Convention in which double taxation is avoided by allocating tax rights between the host and home countries. It is highly significant that the OECD's Model Tax Convention recommends that the host country should adjust downward the tax imposed on a TNC's foreign affiliate in order to avoid double taxation. Such a response decreases the tax revenue obtained by a host country government. At the same time, the OECD guidelines for multinational enterprises ask companies to refrain from seeking or accepting exemptions from regulatory frameworks in the host country, including financial incentives. In reality, the corporation tax paid by the foreign firm is often outweighed by the subsidies and grants it receives, thanks to the generous tax concessions from host governments.

Moreover, even if the home country were to grant credit for taxes paid abroad to relieve the double tax burden, it may effectively receive higher tax revenue on income from foreign sources. After benefiting from host country tax concessions, the firm may be able to claim fewer foreign tax credits against its tax obligations due in the home country. The net impact is that while the host country loses tax revenue, the home country does not have to. The tax benefit granted to the investor by the host country may thereby, be appropriated by the home country.

Tax-sparing Policies

One way of resolving this problem is by home country adoption of a tax-sparing policy that grants investors tax credits for the full amount of taxes that would have been paid to the host country, had the host not given any tax incentive (UNCTAD, 2000). Tax sparing is the practice of adjusting home country taxation of foreign investment income to permit investors to receive full benefits of host country tax reductions. The International Chamber of Commerce[9] in 1972 had endorsed tax-sparing provisions and said that home country Governments "should refrain from frustrating the effects of development relief granted by host countries in respect of new investment by affording appropriate matching relief".

Interestingly, most high-income capital-exporting countries grant "tax-sparing" for FDI in developing countries, while the United States does not.[10] Hines' (1998) evidence suggests that 'tax-sparing' influences the level and location of foreign direct investment and the willingness of foreign governments to offer tax concessions (See Box 3).

Box 3: Examples of Double Taxation Treaties with Tax-sparing Provisions
Australia - China (1988), Article 23; Canada - Argentina (1993), Article 23; Canada - China (1986), Article 21; Denmark - Poland (1994), Protocol; Germany - Turkey (1985), Article 23 (1); Japan - Bangladesh (1991), Article 23; Netherlands - Bangladesh (1993), Article 23; New Zealand - Singapore (1993), Protocol; Spain - India (1993), Article 25; Sweden - Malta (1995), Article 22 (2); and United Kingdom - Indonesia (1993), Article 21.
*Sourc*e: OECD, 1998.

TNC Transfer-pricing Practices

Transfer-pricing practices used by TNCs can also pose complications for tax incentives due to possible abuse of tax concessions. A major problem for governments devising tax measures for TNCs is to tackle manipulation of transfer pricing by TNCs in order to under-report their profits and to reduce their tax liabilities thereby. TNCs shift income on paper to reduce their worldwide tax bill. By setting prices on intra-company sales of products and services, TNCs tend to locate profits in lower tax countries, including tax havens, and tax-deductible expenses in higher tax countries. Host countries stand to lose revenue.

Another complication from the host country's perspective is that, the home country's tax authority may re-allocate a TNC's pricing standards in ways that increase tax liability in the home country and reduce its contribution to the host country's revenues.

One solution is that the international community agrees to allow states to tax multinationals on a global unitary basis, with appropriate mechanisms to allocate tax revenues internationally. As a standard method, tax authorities require companies to use the 'arm's length' principle, which requires that prices charged between subsidiaries are equivalent to those charged between unrelated parties for comparable transactions. For this, one needs to find similar transactions and the method needs sophisticated audit techniques. Many tax administrations are unable to handle this on their own and developing countries do not have adequate resources and expertise to monitor and claim tax liabilities. Moreover, because they are often anxious to attract FDI, developing countries may be unwilling to establish rigorous scrutiny of transfer pricing.

Transfer pricing continues to be a major issue for both taxpayers and tax administrators and the debate is led by the US. The Advance Pricing Arrangement (APA) process, which the US Internal Revenue Service (IRS) introduced in 1991, is intended to provide a framework agreement between the taxpayer and the IRS in advance and thus avoid, or reduce, the debate at the time of audit.[11] Other tax administrations that have responded by introducing or updating their own APA programmes include Australia, Canada, Japan, Korea, Mexico, New Zealand, Spain and The Netherlands.

Key issues in any APA are the predictions made about the future and the assumptions on which the predictions are based. The OECD suggests that while it may be possible to predict an appropriate method, a target for future prices or profit levels would be less reliable, although ranges of results may be possible. Bilateral or multilateral APAs are to be preferred to unilateral arrangements.

APAs offer an opportunity for taxpayers and tax authorities to consider transfer-pricing issues in a non-adversarial manner. Multilateral APAs should reduce the possibility of double taxation, although this is less likely with unilateral APAs. Moreover, taxpayers may over-allocate income to the APA country and, thus, pose a potential problem in the non-APA countries involved. Further difficulties arise if APAs are not flexible enough to reflect changes in critical assumptions such as market conditions.

The OECD suggests that if such programmes are developed then multilateral, rather than unilateral, APAs should be the priority, countries using APAs should co-ordinate their procedures and access should be available to all, including “small” taxpayers.

5. Investment-Related Trade Measures (IRTMs)

IRTMs constitute HCMs, as they influence the volume, sectoral composition and geographic distribution of FDI in host countries.

Market access regulations

These regulations influence the relative profitability of FDI in various developing countries, by enhancing the host country’s attractiveness for export-oriented FDI through the favoured treatment like granting of special tariffs, quotas or duty preferences to imports from select developing countries. These preferences create an incentive to locate FDI in favoured host countries, when a significant portion of the FDI project’s output is intended for export sale in the home country’s market.

The Generalised System of Preferences (GSP)

It is an example whereby developed countries offer preferential treatment, low or duty-free status, in their markets to products originating from the 'favoured' developing countries. While it is often argued that preferential market access schemes help developing countries to sell their products in industrial country markets, evidence suggests that the benefits under many of these schemes may be small and, often, sensitive products of specific interest to developing countries may not be covered.

The other side of the coin is the possible diversionary effect on FDI flows, at the expense of developing countries not included in a particular GSP scheme. TNCs have, effectively, utilised trade preference schemes by locating FDI in lower-wage developing countries that benefit from duty reductions on goods exported back to the United States.

Box 4: Impact of Trade Preferences on FDI

- Korean manufacturers of VCRs moved production from Asia to Mexico to gain access to all markets in North America [as provided for by the North American Free Trade Agreement (NAFTA)].
- Mexico and Caribbean countries qualifying for preferential tariff reductions attracted most of the sharp growth in outflow of FDI ($971mn to $1.3bn) from United States' apparel firms from 1993-1997. During this period, the share of total apparel imports from Mexico and qualifying Caribbean countries rose from 16 percent to 27 percent, while Asia's share declined. The investment pattern shifted again after Mexico's NAFTA benefits gave it a new trade advantage over FDI located in the Caribbean. The shift reportedly caused some 250 apparel plants to close in the Caribbean countries. And, from the home country, the US, the preference to imports from Mexico with NAFTA was because the alternative would have been third-country suppliers with lower US content, such as China. (US content in apparel imports from Mexico is 64 percent higher than for apparel imports from many other countries).

Conversely, these HCMs can also be used to restrict imports from foreign facilities, thereby discouraging potential FDI outflows that might, otherwise, seek comparative advantage production sites in developing countries whose exports could compete to service the home country market. Market access preferences are granted by countries as well as regional groupings on case-specific terms and their regulations encompass measures related to product certification and country-of-origin definitions (See Box 4).

Rules-of-Origin

These requirements are linked to trade preference schemes for developing countries and can have either positive or negative impact on FDI flows. When formulated in a positive manner, rules-of-origin can promote high quality FDI in favoured developing countries by restricting trade preferences to goods substantially produced in those countries. But, unless rules-of-origin specify a level of value-added production in the developing country prior to export, corporations can be tempted to trans-ship goods through a favoured export location rather than establishing significant new production facilities there. However, rules-of-origin, which are too strict or specify particular stages of production inappropriate for a developing country's circumstances, can serve to restrict or nullify a trade preference system's potential advantages. Rules-of-origin or anti-dumping based restrictions can regulate the imposition of import duties and indirectly discourage outbound FDI by companies that might otherwise serve the home country market more productively and profitably from foreign locations.

When defined in the context of a regional trade agreement, rules-of-origin can affect FDI location decisions by according a relative trade advantage to internal producers in the region vis-à-vis production facilities located outside the trade area (See Box 5).

Box 5: Instances of Negative Impact of Rules-of-Origin on FDI

- The North American Free Trade Agreement (NAFTA) rules-of-origin reportedly influenced the United States TNCs to invest in new facilities at the low cost destination within the free trade area rather than lower-cost Asian investment sites and to shift production from Asia to Mexico.
- Similarly, a rule-of-origin definition that required locating the wafer fabrication stage of semiconductor manufacturer in the European Union, in order to avoid a 14 percent tariff, reportedly increased such investment within the European Union, at the expense of less costly sites in Asia and the United States.

(UNCTAD, 1999c, p. 15)

Anti-dumping Regulations

The regulations constitute a HCM that can adversely influence FDI by inhibiting competitive home market access for exports from a TNC's existing or prospective foreign facilities. Increased anti-dumping investigations and prosecutions over the past two decades have heightened business concern that a prospective FDI project in a developing country might run afoul of such regulations, threatening import penalties on intended export sales back to the home country market. This increased risk and uncertainty may cause TNCs to forego beneficial and cost-effective FDI projects. The restrictive impact of anti-dumping procedures may especially be disadvantageous to FDI prospects for economies in transition.

Product Certification Standards

These are HCMs that can be specified unilaterally or agreed upon in some form of regional trade agreement and influence FDI decisions and location patterns by affecting market access. These entail that imported products meet specific standards in areas like product safety, quality or environmental impact and can be tailored to preclude or hinder market access for exports from FDI projects whose viability may be dependent on competitive access to the home country market.

International trade rules are just beginning to address many sectoral and issue-specific permutations for HCMs in this area, and no particular attention is being paid to the potential for distortions to FDI location decisions, as opposed to trade flows. In the meantime, these effects can influence FDI decisions by defining profit projections for existing or potential foreign facilities, perhaps discouraging FDI that, otherwise, might be drawn to developing countries with comparative production advantages.

Export Promotion Devices

Measures aimed at supporting the supply capacity of the host country for exports to the home country. These take the form of direct or indirect export financing programmes aimed at re-importing semi-processed goods, i.e., buy-back trade arrangements, as well as support for the establishment of export processing zones (EPZs) through financial and technical assistance or promotion of exports of existing EPZs. However, a number of foreign investors build and operate EPZs primarily to co-ordinate their international trade and processing needs in a bid to develop their markets and channels. The Japanese Sumitomo Corporation has developed 14 EPZs in Asian countries in support of its manufacturing and distribution network.

Export promotion would also cover taxation measures that have an effect on export income, such as the United States Foreign Sales Corporation programme, whereby companies can gain tax advantages by establishing a foreign-based entity through which their exports are channelled.

Extra-territorial Controls

Applying national regulations outside a home country's borders to TNC operations within another country constitutes extra-territorial HCMs. These can include HCMs such as competition policy or trade controls. The concept may also extend to HCMs in the areas of labour relations, environment or corporate social responsibility standards. For private foreign investors, potential conflicts over national jurisdictions can act as disincentives to investment as they do not want to be caught in between home and host country laws, where they are subject to the authority and potential sanctions of two, or more, sovereign Governments with interests that may conflict.

6. Transfer of Technology

The issue of transfer of technology is one of the core issue for host country development through FDI. Technology transfer can be interpreted in terms of the transfer of 'know-why' and 'know-how', the former being a more thorough transfer of knowledge that can not only be assimilated but also adapted to local conditions. While the transfer of know-how can add value through incremental knowledge gains, it is 'know-why' that can result in further application of 'know-how' – i.e., innovation capabilities that can be successfully commercialised. This refers to process and product innovations that increase efficiency and productivity as well as competitiveness of the products.

Box 6: HCMs Encouraging Transfer of Technology

- Support for technology partnerships between firms from developed and developing countries is provided through access to advanced technology and/or through learning while interacting. For example, the Technology Partnership Initiative in the United Kingdom, which lays special emphasis on environment-friendly technologies in Argentina, Ethiopia, Ghana, India, Nigeria, Oman and Uganda.
- Promoting the transfer of specific technology forms the core of several developed country initiatives. For example, through its Asia-Ecobest project, the European Union's Regional Institute of Environmental Technology (RIET) promotes the use of technologies adapted to Asian environmental needs through the provision of ad-hoc technical assistance and expertise.
- Measures relating to research and development (R&D) may be targeted at specific technological problems of developing countries and provide a platform for public-private co-operation through joint R&D arrangements between host and home countries. For example, the French Centre de Coopération Internationale en Recherche Agronomique pour le Développement (CIRAD) undertakes joint research activities on genetic resources, food, nutrition technologies and biotechnology that are of interest to developing countries with R&D institutions in more than 90 countries.

Measures geared to facilitation of transfer of technology exist in a number of home countries and several international agreements. They are aimed at strengthening a host country's capabilities to acquire new commercialised technologies. This involves regulatory reforms that establish the framework for transferring privately held competitive technology (See Box 6).

On the other hand, measures like restrictive conditions on the use of patents and refusal of licensing restrict the transfer of technology on various grounds such as national security or economic competitiveness. Most developed countries implement a system of export and technology transfer controls for dual-use goods and technologies with significant military applications, and co-ordinate their actions through the Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies adopted in 1991.

The Lomé IV Convention incorporates a favourable provision for the promotion of technology transfer to developing countries. Article 85 states: "With a view to assist the ACP States to develop their technological base and indigenous capacity for scientific and technological development, facilitating the acquisition, transfer and adaptation of technology on terms that will seek to bring about the greatest possible benefits and minimise costs, the Community, through the instruments of development finance co-operation is prepared, inter alia, to contribute to: (a) the establishment and strengthening of industry-related scientific and technical infrastructure in the ACP States; .... (b) the identification, evaluation and acquisition of industrial technology, including the negotiation on favourable terms and conditions of foreign technology, patents and other industrial property, in particular through financing or through other suitable arrangements with firms and institutions within the Community". The Cotonou Agreement (2000)[12] reaffirmed the importance of technology transfer objectives, calling for co-operation in the "development of scientific, technological and research infrastructure and services including the enhancement, transfer and absorption of new technologies".

Despite the fact that encouragement of technology transfer to developing countries has been a recurrent issue on the international economic agenda of the past three decades, most developing countries remain net consumers rather than producers of technology and pay more in royalties and licence fees than they earn from their efforts to attract technology.

There is little evidence to suggest that TNCs facilitate the technological advancement of their host nations in the case of developing countries or that HCMs have been successful in addressing the issue. Data for Japanese and United States TNCs suggest that bulk of the R&D expenditure is undertaken by parent firms in their home countries and in other developed countries. There is also growing evidence that shows that FDI through mergers and acquisitions

(M&As) has transferred a high degree of 'operating and organisational' technology, but not of 'production technology'. Developing countries attract only marginal shares of foreign affiliate research and much of what they get relates to production, adaptation and technical support, which is in the form of 'know-how', rather than relating to innovation, 'know-why'.

Issue of Critical Concern

Restrictive Business Practices in Licensing Agreements

The core issue debated under the Draft UNCTAD Code of Conduct on the Transfer of Technology[13] (TOT) was the acceptance of the proprietary nature of technology, particularly for patentable knowledge, by TNCs and their home governments.

Developing countries questioned this assumption and put forward the alternative view that technology was in the nature of a necessary public good for LDCs and, therefore, some of the private property related assumptions of the international system for the protection of intellectual property should be amended in the interests of developing countries (Muchlinski 1999, pp. 438-444[14]).

Their intention was to ensure that technology transfer terms do not effectively prevent a recipient in a developing host country from the unrestricted use of the technology and its attendant know-how, after the expiry of the agreement and that developing host countries are free to pursue suitable policies, including the imposition of performance requirements upon technology transferors, where deemed necessary. The Draft TOT Code, however, had to be abandoned due to disagreement between developing and developed country models of technology transfer regulation.

Much of the debate has now been overtaken by the orientation of the TRIPs[15] Agreement. The TRIPs Agreement sets standards relating to the protection of patents, copyright and related rights, trademarks and geographical indications, trade secrets and confidential information, integrated circuit design and industrial design and covers both substantive standards and specific issues of enforcement that are generally applicable to these.

Many technology-related provisions in International Investment Agreements (IIAs), such as TRIPs, rely on HCMs for their implementation. For example, Article 66.2 of the TRIPs Agreement stipulates that developed countries "shall provide incentives to enterprises and institutions in their territories" in order to promote and encourage transfer of technology to LDCs to "enable them to create a sound and viable technological base". Though this provision leaves great leeway to member states to determine what kind of incentives to apply, it does require the establishment of some system encouraging transfer of technology to LDCs.

IPR Protection in the TRIPs Agreement

The current debate on IPRs is dominated largely by two extreme positions. Some advocate IPRs as an effective instrument for advancing technology as a facilitator for technology transfer to developing countries. Others take the contrasting position that IPRs, as currently conceived, solely defend the interests of advanced countries.

However, serious questions are being raised on the potential role of IPRs in technology transfer and investment flows to developing countries. The following instances pose pertinent issues (See Box 7):

Box 7: Implications of IPR Protection for Technology Transfer
• A report submitted to the Council for TRIPs by Kenya states that strong IPR protection, on the scale required by TRIPs, does not, by itself, lead to increased FDI nor does it encourage technology transfer or local innovation in developing countries (SUNS, 2000[16]). • A country case study on South Korea[17], based on a long period of research on the behaviour of firms in technology transfer and local capacity building in South Korea, finds that IPR protection would hinder, rather than facilitate, technology transfer and indigenous learning activities in the early stage of industrialisation when learning takes place through reverse-engineering[18] and duplicative imitation of mature foreign products. • At the WTO Tech Transfer Group Setting up Work Programme[19], Brazil recently reiterated that strong (IPR) regimes were having a negative impact on technology transfer, even as both the US and EU, openly in favour of strong IPR regimes, denied these claims.

Chapter 3

Home Country Measures: Issues and Implications Favouring Whom?

While developed countries have removed most national restrictions on outward FDI and conspicuously endorse FDI promotion, particularly to developing countries in their declarations in international agreements, their policy declarations are often not linked to specific obligations for adopting HCMs. The weak link between the explicit needs of developing countries and the design and execution of HCMs, as well as the often uncertain commitment to the duration of assistance, may diminish the beneficial impact such programmes can have on development.

As home country facilitation of outward investment appears to be intrinsically linked to home country strategic/market objectives, the case for a detailed re-examination of the design and impact of existing HCMs becomes that much stronger.

The home country perspective is particularly evident in the design of many fiscal assistance programmes as well as preferential market access measures.

Box 8: The *raison d'être* **for HCMs effectively constitutes**:

- Furthering the economic integration of the home country into the world economy;
- Overcoming market access problems;
- Better utilisation of domestic exports; and
- Overcoming domestic supply constraints, especially in the area of raw materials, cheaper labour and skills.

1. HCMs Impact on FDI Flows: Conceptually Possible and Relevant

Conceptually, promotional programmes and measures by home countries could influence the direction and volume of FDI flows, but the presence of the wide range of HCMs does not seem to have influenced any positive trends at the macro level.

Box 9: FDI Inflows by Host Region and Economy (billions of dollars)					
Host Region/Economy	1990	1995	2000	2001	2002*
World ($bn)	202.8	330.5	1492	735	534
Percentage share in total world inflows					
Developed Countries	81.16	61.51	82.27	68.44	65.36
Developing countries					
Asia	11.93	22.75	8.96	13.88	16.85
Africa	1.22	1.74	0.58	2.34	1.12
Latin America & the Caribbean	5.08	9.35	6.39	11.62	11.61
Central & Eastern Europe	0.32	4.45	1.78	3.7	5.06
Least Developed Countries	0.69	0.61	0.25	0.52	NA

Source: UNCTAD, 2001, "World Investment Report", FDI statistics online * UNCTAD projections

- International capital, especially FDI, is attracted to industrial countries due to their opportunity for high returns. Cross-border mergers and acquisitions (M&As) play an important role in supporting increases in developed countries.
- Significantly, higher industrial-country growth is associated with lower FDI inflows to developing countries[20]. In fact, the GDP growth rate of the top seven industrial countries is used to account for a change in the relative attractiveness of emerging markets to international investors.
- The major share of FDI inflows to developing countries goes to the middle-income group, particularly Latin America and Asia, with low-income countries way behind and least developed countries get a minuscule fraction.
- Africa remains heavily under-represented as a host region for FDI. UNCTAD has projected a dramatic, two-thirds, drop in FDI inflows to Africa. The year 2001 was unusual and saw a significant upturn in flows due to two large but one-off transactions, one in Morocco and the other in South Africa.

The fall in world FDI flows – a result both of the global economic slowdown and of uncertainties – is translating into a shrinking of the global FDI pie. For developing countries, the decline means lesser resources for development. At the same time**,** FDI still constitutes a higher proportion of private business investment relative to other sources of finance in most developing countries vis-à-vis developed countries. The ratio is one-half in Africa, one-quarter in

Latin America and one-fifth in Asia. For developing countries that are usually capital-scarce, FDI brings in financial resources that are relatively more stable than other sources of funds. In this context**,** positive HCMs could play a role in directing outward FDI into such countries.

2. Implications for Host Country Development

With the emerging realisation[21] that industrial countries can have an important role in facilitating private capital flows into developing countries, their role in assisting host countries optimise benefits from such inflows is also clear. Although the onus of providing a good investment climate lies with the host country, the case for HCMs is clear, in the context of market failures that can arise from divergences between the private interests of foreign investors and the economic interests of the host country.

3. International Investment Agreements (IIAs) and HCMs

References to HCMs exist in various forms at the international level. International Investment Agreements (IIAs) deal with issues involving incentives, taxation, transfer-pricing, transfer of technology and investment-related trade measures (IRTMs). With the exception of double taxation treaties with tax-sparing provisions and agreements related to investment insurance, especially MIGA, the majority of these are confined to declarations without any specific obligations on home countries.

Bilateral Investment Treaties[22] (BITs) are a principal element of the current framework for FDI. While BITs focus predominantly on protecting investment projects in the host country, they can provide for active measures through provisions calling for the mutual encouragement of investment in the parties' respective territories. The language regarding home country promotion of outward FDI involves no specific obligations in contrast to the specific and binding obligations laid down for the treatment of inward FDI by host countries, particularly in the context of BITs.

At the multilateral[23] level too, commitments concerning HCMs tend to be non-specific in nature. For operational effectiveness, nominal commitments need to progress into binding obligations, accompanied by detailed implementation plans and monitoring mechanisms. The degree of success of IIAs would depend on the range and scope of HCMs addressed by policy provisions. Increased collaboration could improve delivery mechanisms for financial incentives, establish development preferences for the administration of fiscal regulations and enhance technology transfer options for developing countries. Practical outcomes can be improved with provisions containing a more detailed list of measures or a specific implementation process that will translate policy into practice. The ACP-EC Cotonou Agreement[24] offers an example on how this can be done.

It is important for developing countries to deepen their understanding of:

- What policy tools are most important from a development perspective?
- How international rules in the area of investment would affect them?
- What commitments can be sought from home countries to support their development objectives?

Box 10: Investment Provisions in the Cotonou Agreement
Chapter 7: Investment and Private Sector Development Support;
Article 75 Investment promotion;
Article 76 Investment finance and support;
Article 77 Investment guarantees; and
Article 78 Investment protection.

Chapter 4

Inferences and Recommendations

Even though returns vs. risk trade-offs necessarily determine the volume and direction of outbound FDI, HCMs are conceptually relevant, as home country governments can be important actors in FDI strategies and transactions. But, home countries cannot be expected to unilaterally direct outbound investment on a need-for-development-based approach, nor can unilaterally designed HCMs exert any genuine positive influence on host country development. Such measures tend to be geared towards their own strategic interests.

The influence of HCMs can be increased through tailor-made approaches and regional and country targeting. The effectiveness of HCMs would depend on the formulation and administration of measures, as well as the extent to which they complement host country measures.

There is a need for greater awareness and deeper understanding of measures taken by home countries, their functioning, identification of best practices, as well as their influence on the decisions of potential investors.

1. A Few Best Practices for HCMs[25]

- Accurate and high-quality information in the appropriate languages on investment opportunities, by modern methods, including the Internet as well as interactive linking of home and host country sources;
- Financing of home country personnel in investment-support and business-facilitation functions in host countries;
- Undertaking FDI promotion training programmes in home countries, including support service and language training and utilising Chambers of Commerce and industry associations;
- Effective use of inter-regional exchange forums on investment promotion issues, involving outward FDI institutions and investment promotion agencies;
- Financial assistance, including equity support to investors, particularly small enterprises (SMEs), for investment in LDCs;

- Investment insurance coverage, particularly for political and country risks;
- Agreements on investment promotion and protection, as well as on the avoidance of double taxation;
- After-care support services to outward investors, such as bridging loans to foreign affiliates facing unexpected crises in host countries;
- Encouraging technology transfer and supporting host countries' absorptive capacity;
- Market access in home countries through schemes such as the Generalised System of Preferences (GSP) schemes, the Africa Growth and Opportunity Act of the United States and the European Commission's proposals concerning market access for LDCs; and
- Creation of export-processing zones to support the supply capacity of a host country for export to a home country.

2. Negative Influences that Need to be Tackled

- Issues related to fiscal HCMs, such as problems posed by double taxation and the abuse of transfer-pricing mechanisms by TNCs as well as home countries;
- Competition among host countries in providing tax incentives that have detrimental implications for host countries, as potential tax revenues from foreign enterprises constitute an important benefit;
- IRTMs that influence FDI location decisions by defining profit projections for existing or potential foreign production facilities (through trade preferences designed by home countries for their own strategic and market gains rather than for encouraging FDI into developing countries); and
- Conflicting issues in technology-transfer related measures so that developing countries are facilitated rather than obstructed in gaining access to and absorbing contemporary and appropriate technologies.

3. Recommendations for Increasing Effectiveness of HCMs[26]

- Effective co-ordination of all aspects of home country efforts to increase awareness of investment opportunities, particularly in developing countries;
- Greater transparency, minimisation of bureaucracy, simplification and standardisation of application and implementation procedures, to maximise HCM utilisation;
- Consultations with developing countries prior to the adoption of new or changed HCMs, in order to provide a better assessment and understanding of how the HCM may affect development interests and objectives;
- Facilitative role of home country governments in capacity-building in host countries to receive and benefit from investment;

- Bilateral and multilateral collaboration between home and host country institutions, such as investment promotion agencies and industry associations, including co-operative training;
- Supporting the establishment of industrial infrastructure in host countries, for example, through the establishment of consortia involving firms from several home countries to invest in major infrastructure projects in developing countries; and
- Ensuring that HCMs, national, regional and international financial assistance programmes and official development assistance are mutually supportive. These include market access measures, measures enhancing the host country's attractiveness for export-oriented FDI, including quotas or duty preferences granted to imports from developing host countries, and export promotion devices.

In order to derive maximum benefit from the HCM-IIA interface, contemporary interpretations of development must be incorporated while formulating IIAs. Moreover, treaty provisions should be tailored to the needs of the participating parties and should specifically reflect the asymmetries between countries. Treaties should reflect real-life economic, social and political considerations. While adopting an approach of gradual liberalisation and built in flexibility, such agreements also need institutional monitoring mechanisms.

A related policy area is that of the social responsibility of corporations. These cover a number of aspects, including development obligations, socio-political obligations, consumer protection, corporate governance and ethical business standards. The challenge is to balance the promotion and protection of liberalised market conditions for investors with the need to pursue development policies.

It would be a significant achievement if the existing policy environment for FDI can be evolved into an explicit, development friendly, well-coordinated institutional framework. This could reduce the role of power-backed bargaining and competition among host countries to provide greater incentives that often detract from their development objectives. The ideal scenario would be if a development-oriented element could be effectively incorporated while the home country designs, incentives and facilitative measures that influence the investing firm's FDI location decision.

It is however, a moot question as to whether home countries can be motivated to take their responsibility of spreading the potential development effects of FDI not just in letter as manifested in various HCMs but also in spirit.

The role of civil society becomes all the more crucial to enhance international awareness, persist in dissemination of wider research and information on the issues at stake, facilitate discussions among stakeholders, follow up progress in implementation and regularly evaluate outcomes.

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Endnotes

1 Assuming here that the transnational corporation (TNC's) motives are broadly representative of the investors' FDI location decision.

2 HCMs–UNCTAD Series on Issues in International Investment Agreements, United Nations, 2001.

3 The Cotonou Agreement includes a commitment in Article 75 on "Investment Promotion" to "disseminate information on investment opportunities and business operating conditions in the ACP States" (ACP: African, Caribbean and Pacific countries).

4 The Convention establishing MIGA specifies in Article 23 on Investment Promotion that the Agency undertake research, information dissemination and technical assistance activities to promote FDI in developing countries as an appropriate complement to the institution's investment insurance function.

5 Market imperfections refer here to conditions of incomplete information for the market participants to make their investment decisions.

6 The European Community and its Member States signed a new Partnership Agreement with the African, Caribbean and Pacific (ACP) States in Cotonou, Benin, on 23 June 2000. This Agreement replaces the Lomé Convention, which has provided the structure for trade and co-operation between the EU and the ACP since 1975.

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18 Reverse engineering refers to activities that take apart an object to see how it works in order to duplicate or enhance the object. It is a practice undertaken not only in older industries but also in computer hardware and software. In the automobile industry, for instance, a manufacturer may purchase a competitor's vehicle, disassemble it, examine the welds and seals and other components of the vehicle for the purpose of enhancing their vehicles with similar components. Reverse engineering requires a great deal of expertise and effort.

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