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POLICY COMPETITION FOR FOREIGN DIRECT INVESTMENT: THE GLOBAL AND REGIONAL DIMENSIONS

DANIEL CHUDNOVSKY AND ANDRÉS LÓPEZ
CENIT, Buenos Aires

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CONTENTS

page

5 **ABSTRACT**

7 **INTRODUCTION**

8 **I. THE IMPACT OF FDI ON ECONOMIC AND SOCIAL DEVELOPMENT: THE ISSUES AT STAKE**

10 **II. POLICY COMPETITION FOR FDI: EMPIRICAL EVIDENCE AND POLICY DEBATES**

10 A) THE DEBATE ON INCENTIVES AND PERFORMANCE REQUIREMENTS ON FDI: A BRIEF OVERVIEW

13 B) POLICY COMPETITION FOR FDI: ISSUES AND TRENDS

15 C) THE EMPIRICAL EVIDENCE ON POLICY COMPETITION FOR FDI

17 **III. POLICY COMPETITION FOR FDI: THE MULTILATERAL DIMENSION**

18 A) THE URUGUAY ROUND AGREEMENTS AND THE WTO

20 B) THE MULTILATERAL AGREEMENT ON INVESTMENTS (MAI)

23 C) A MULTILATERAL FRAMEWORK ON INVESTMENTS: IMPACT ON DEVELOPING COUNTRIES

24 **IV. POLICY COMPETITION FOR FDI: THE REGIONAL DIMENSION**

25 A) THE TREATY OF ROME

28 B) FDI-RELATED POLICIES IN MERCOSUR

31 **V. CONCLUDING REMARKS AND POLICY SUGGESTIONS**

34 **BIBLIOGRAPHICAL REFERENCES**

ABSTRACT

As governments have liberalised their economic policy regimes, competition for foreign direct investment (FDI) has become more widespread. This kind of competition involves the granting of fiscal and financial incentives by both national and subnational governments –the latter playing an increasingly important role in this game. While governments have a collective interest in refraining from such bidding wars, they get engaged because, otherwise, they fear that FDI will be diverted to other countries offering more incentives. Moreover, the resistance to abandon incentives is as strong or even stronger among developed countries than in developing countries. This is the main reason why incentives will persist even if an agreement is reached in future negotiations. The paper addresses these issues, focusing on recent developments at the multilateral and regional levels.

I. INTRODUCTION

Today developing as well as developed countries' governments are competing, often fiercely, to attract increasing volumes of foreign direct investment (FDI). This new attitude in developing countries is part of a broader change from relatively closed and state-led to more open and market-friendly policy regimes. Most of the former barriers and regulations have been dismantled and an intense competition for FDI is taking place. This competition, which often includes special concessions and/or substantial fiscal and financial incentives, occurs at national as well as sub-national levels.

Among MERCOSUR countries, not only most regulations and barriers have been dismantled but specific policies, and even "bidding wars", to attract FDI have been adopted (especially in the automobile sector). This competition has raised four main criticisms:

i) it "artificially" distorts investment decisions and could thus have significant indirect effects on intra-regional trade;

ii) it drains fiscal resources which could eventually be used to tackle deficiencies in many areas (education, health, housing, etc.);

iii) it may negatively affect the fiscal balance of the states granting the incentives;

iv) it pays little attention to the increase of spillovers which could arise from investment decisions.

This paper addresses the main issues regarding policy competition for FDI. The first section discusses the impact of FDI on social and economic development and the FDI-related policy alternatives. Section two describes the logic of the competition for FDI and the existing empirical evidence on its effects. Section three deals with the existing multilateral disciplines on investments, paying special attention to the issues of incentives and performance requirements on FDI. The main arguments for and against the establishment of a Multilateral Framework on Investments (MFI) are also examined. Section four deals with the regional dimension of FDI policy competition, analyzing the case of the European Union. This section also briefly deals with FDI-related policies and bidding wars within MERCOSUR. Section five presents the concluding remarks and some policy recommendations.

Today developing as well as developed countries' governments are competing, often fiercely, to attract increasing volumes of FDI.

I. THE IMPACT OF FDI ON ECONOMIC AND SOCIAL DEVELOPMENT: THE ISSUES AT STAKE

FDI is generally considered as a driving force for the integration of developing countries into the globalization process. Although most FDI is concentrated in developed countries, developing countries have made the biggest gains in the 1990s in terms of FDI inflows: from an annual average of US$ 22 billion in 1984-89 (19 per cent of global inflows) to US$ 145 billion in 1995-1998 (32 per cent of global inflows). However, a small number of developing countries in Asia and Latin America (notably China and Brazil) has attracted most of the recent flows of FDI.

According to Lall (1998), there are three main options of FDI-related policies available for developing countries:
i) a "passive open doors" strategy;
ii) selective policies that use FDI as one way among others to access foreign created assets while intervening to promote the development of local competitive capabilities;
iii) pro-active policies to attract and guide FDI to activities that most benefit local development.

Which are the main arguments for a "passive open doors" policy? At microeconomic level, FDI is seen as a potentially powerful instrument for improving access to international markets, for obtaining the technological and organizational capabilities required to produce and export goods and services, and, thus, for enhancing the international competitiveness of the host country. FDI is also seen as a source of spillovers through technology diffusion, workers training, linkages with domestic firms, etc. At macroeconomic level, FDI may significantly contribute to finance current account deficits in the host countries. Moreover, since Multinational Corporations (MNCs) investment strategies are guided by long term considerations and, once installed, have large sunk costs, FDI is less volatile than portfolio investment and other types of international financial flows. For both reasons, an increasing volume of FDI is often taken as a vital contribution to the development process.

According to Lall (1998), this strategy will attract FDI seeking to exploit existing locational advantages, such as domestic markets, natural resources or low cost labor. Even if this kind of FDI will yield some externalities, host countries will not take full advantage of the benefits that MNCs can bring. In fact, there are few, if any, countries which have followed a totally passive policy towards FDI. Argentina has completely liberalized its FDI regime; yet, it applies some sectoral or specific instruments to attract inflows under the automotive and mining regimes and the privatization program.

Competition, which often includes special concessions and/or substantial fiscal and financial incentives, occurs at national as well as at sub-national levels.

Japan, Korea and, to a lesser extent, Taiwan, are among the countries that have adopted the more selective strategy (although Taiwan also has resorted to elements of the pro-active strategy). In turn, Singapore –a country with one of the highest ratios between inward FDI and domestic GDP- is the best example of the pro-active strategy.

The selective strategy, by combining different modes of asset transfer (FDI, licensing, reverse engineering, etc.) with serious efforts to develop the skills and technological capabilities of local enterprises, can lead to larger benefits for the long-term development of host countries. However, "this strategy can only be conducted successfully in an export-oriented setting where interventions are counter-balanced by competitive pressures from world markets" (Lall, 1998, p. 440).

The main rationale for these more activist approaches is that the potential benefits that FDI

may entail should not be taken for granted and, perhaps more important, should be confronted with the costs derived from FDI presence. As Dunning (1993) states, "many countries in the world are dependent on MNCs as providers of resources, capabilities and markets, as creators of jobs and wealth, as suppliers of foreign currency, as stimulators of entrepreneurship and worker motivation, and as raisers of demand expectancies" (p. 284). But while MNCs are interested in a limited number of private economic goals, governments have a broader range of objectives (GDP growth, full employment, distribution of income and wealth, sovereignty in decision-making, political and cultural identity, environmental protection, etc.). In the same vein, whereas MNCs are interested in maximizing global profits or sales, governments are interested in maximizing the welfare of their own citizens. The pro-active strategy, if accompanied by measures designed to provide the skills, technological backup and infrastructure required by more complex activities, may lead to greater benefits for host countries. However, an excessive dependence on FDI may not lead to the development of domestic capabilities.

In this scenario, some host countries may be worse-off as a result of MNCs' activity. National control over strategic economic sectors may be lost, indigenous enterprises may be displaced in certain activities and jobs may be lost, the local environment may suffer, etc. Even if the net benefits are positive, it is possible to assume that host countries are often not as well-off as they could be. This implies a difficult counterfactual analysis; in other words, the question to be answered in each case is what would have occurred in the absence of MNCs or in the absence of a set of policies aimed to increase the net benefits received by host countries from MNCs presence and to build strong national entrepreneurial and technological capabilities.

The contribution of FDI to economic development depends not only on its volume but also on its quality. The type of investment involved, the sectors targeted, the kind of assets MNCs bring and the role affiliates play within the global network of the corporation are important determinants. At the same time, the characteristics of host countries affect not only the amount and kind of FDI that is attracted but also its contribution to growth, competitiveness and sustainable human development. These characteristics include the macroeconomic situation, trade, competition, sectoral and specific policies towards foreign and domestic enterprises, economic performance (GDP growth, price stability, etc.) and structural factors (market size, the availability of natural resources, the quantity and quality of human resources, the physical and technological infrastructure, business ethics, the legal system, etc). The characteristics of indigenous entrepreneurs (i.e. the sectors in which they operate, their corporate structures, strategies, innovative capabilities, organizational procedures, risk attitudes, etc.) are also major determinants (Dunning, 1994).

Though FDI may play a positive role, leading to economic diversification and higher exports, generating employment and externalities and strengthening the local system of innovation, its role may also be detrimental. This is the case when FDI operates as an enclave that exploits natural resources with bad environmental practices, when foreign affiliates take advantage of their proprietary assets to crowd out local competitors or to engage in market distorting practices, etc.

As for the impact of FDI on the balance of payments, it is obvious that not only the initial inflow must be considered. Remittances will have a negative effect on the balance of payments sooner or later. Profits are remitted abroad as dividends and, sometimes, as royalty and interest payments by means of transfer pricing of merchandise imports and exports. Moreover, MNCs may exhibit a greater import propensity than local firms, as documented in several studies (see Chudnovsky & López, 1998). Thus, in the long term, many FDI projects may end up having a negative contribution to the balance of payments. At the same time, new developments in financial markets and the expansion of existing instruments -for example, hedging- have greatly blurred the distinction between FDI and portfolio investment in terms of their relative stability. Moreover, profit remittances may be as volatile as portfolio investment flows, especially during an economic crisis (South Centre, 1997).

In sum, FDI can certainly be conducive to growth, competitiveness and sustainable human development in host developing countries. It may have however some, occasionally significant, costs which have to be considered as well. Therefore, a careful assessment of the impact of FDI is called for in order to design and implement policies at national and international levels that may enhance the benefits and reduce the costs of FDI for host countries. For these countries to reap such potential benefits a social or absorptive capability is needed. Empirical evidence shows, in turn, that this capability is often in shortage in most developing countries. Education and training of human resources, a sound science and technology domestic infrastructure, institution-building and the creation or development of markets such as capital markets, and the strengthening of domestic entrepreneurship are all crucial elements in this respect.

II. POLICY COMPETITION FOR FDI: EMPIRICAL EVIDENCE AND POLICY DEBATES

A) THE DEBATE ON INCENTIVES AND PERFORMANCE REQUIREMENTS ON FDI: A BRIEF OVERVIEW

Before dealing with policy competition for FDI, it is important to discuss whether individual countries should or should not grant incentives to investment. In other words, the question is whether an economic rationale for investment incentives can be constructed.

There is a broad consensus on the determinants of FDI inflows. The size, growth rate and perspectives of the host market stand as major determinants in almost any of the available surveys, especially when market-seeking investments are considered. Natural resource and/or labor force availability are relevant in the case of resource seeking, export-oriented investments. However, MNCs seem to be increasingly involved into the so-called "strategic-asset" seeking investments. In this case, the relevant locational advantages are related to the physical, communication and technological infrastructure, the skills of the indigenous labor force, etc. Economic and political stability and a sound regulatory framework seem to be necessary but not sufficient pre-conditions to guarantee a steady flow of foreign investment when the above-mentioned locational advantages are lacking (see UNCTAD, 1992, 1994a; Jun & Singh, 1996; Davidson, 1993).

When there are several potential locations, which share some common "fundamental" attributes, incentives may exert an influence on investment decisions.

There is a similarly broad consensus that incentives do not rank high among the main determinants of FDI inflows, as they are unable per se to attract investments to regions or countries which lack other locational advantages such as an attractive domestic market, natural resources, an skilled labor force, etc. Nonetheless, when several potential locations share some common "fundamental" attributes, incentives may influence investment decisions, especially in highly mobile and cost-oriented projects. Thus, incentives attract investments in specific sectors, regions or countries where it might otherwise not have occurred[1] (UNCTAD, 1994b). The impact of incentives varies according to the strategies and motivations of the investing firm, the market towards which the investment is oriented, the investor's condition of "already established" or "newcomer", the sector and country of origin of the investor, etc. (Aranda & Sauvant, 1996). Moreover, there are discrepancies among different surveys regarding:

(i) the actual influence of incentives;

(ii) the possibility that incentives may be playing an increasing role on investment decisions;

(iii) the more suitable type of incentives to attract "high-quality" FDI inflows -i.e., those that generate substantial spillovers, employ skilled workers and/or are directed towards "modern" or high value-added sectors-; and

(iv) the effectiveness of incentives to reach the targets originally envisaged (Aranda & Sauvant, 1996; Donahue, 1996; Hill, 1996; Jun & Singh, 1996; Mortimore & Peres, 1996; Oman, 1999; Tu & Schive, 1995; UNCTAD, 1992, 1994a).

1. Of course, this statement raises the key question of the possible redundancy of incentives, which might only be properly treated through a counterfactual analysis, which seldom can be performed.

The main theoretical rationale for investment incentives is to correct the failure of markets to reflect spillovers. If an investment creates spillovers that cannot be fully captured by the investing firm, a gap between the private and the social return of the investment emerges. Incentives would thus help to close that gap. Incentives can also be granted to offset the effects of other policy interventions (i.e., the exemption of duties to compensate for the effects of protectionist tariffs). Moreover, for countries in which there is a dearth of FDI, incentives can be a way to attract "pioneer" investors. If this policy succeeds, a sort of "demonstration effect" could arise, inducing further and self-sustaining FDI flows. Finally, incentives are sometimes granted as a compensation for the introduction of performance requirements (PR) which MNCs must accept in order to invest in a certain host country.

PRs such as local content, export commitments, R&D expenditures, job creation, etc. have been extensively, though not exclusively, used by developing countries governments[2]. In principle, they are designed to ensure that the operations of foreign firms are attune with the policy objectives of the host country and with its overall strategy of social and economic development. For instance, PRs may be an instrument to control anti-competitive business practices by MNCs.

In some cases, a bargain can be struck in which an incentive that is highly valued by the investor and implies a low marginal cost to the host country (such as the access to the benefits of an existing free trade zone) is traded for a PR involving a low marginal cost to the investor but a high real or perceived value to the host country (e.g. a commitment for local expenditure on R&D). In this way, a balance between the host country's interests and the investor's could be achieved (UNCTAD, 1994b). Of course, this is an overly optimistic bargaining scenario, since it is also possible that the incentive involved has more than a "marginal" cost (as it is often the case) and/or that the PR may be unacceptable to MNCs.

Incentives as well as PR are mainly supported by those who consider that market forces do not lead to the socially desirable amount or composition of FDI, do not prevent FDI to have deleterious effects for host countries' development objectives and/or fail to align the private and social returns of investments. In turn, orthodoxy questions the efficacy of incentives and is generally hostile to PR. Incentives could be useful to promote regional development, to correct market failures, or to realize positive externalities but in most cases they are seen by the orthodoxy as a "second best" solution. Given that incentives are often used to compensate for other regulations, the "first best" solution would be to remove the "distortion" in question. In turn, if a government seeks to foster development in a certain region, the first best solution is to increase the spending on physical and human capital right there. The orthodox criticism is even more virulent regarding sectoral or firm targeted incentives policies, as these entail a "distortion" of the resource allocation that "free market forces" would produce.

The WTO (1996) makes additional critiques to the use of incentives, based on:
i) distributional considerations: investment incentives transfer part of the value of FDI-related spillovers from the host countries to MNCs. The more intense the competition among potential hosts the greater the proportion of spillovers which is transferred to the MNCs;
ii) knowledge considerations: advocacy of incentives heavily relies on the assumption that governments have a detailed knowledge of the value of the positive externalities associated with each FDI project, but in practice it is almost impossible to estimate these effects;
iii) political economy considerations: the benefits from a particular FDI project are likely to accrue to certain groups while the costs of incentives are likely to be spread across society. This opens the door for politically influential special interest groups to lobby the government to provide incentives which primarily benefit them, but which are largely paid for by other groups;
iv) local investors may feel discriminated vis-a-vis foreign investors. To circumvent such discrimination, local investors register themselves in many cases as companies in another country from where they invest in their own countries under the banner of foreign investment.

The WTO has argued that only under very stringent conditions investment incentives can correct market failures; this could be the case when a country is trying to deal with

2.
Sometimes investment incentives operate as de facto performance requirements. This is the case, for example, of a tax rebate depending on the size of local operations, or labor training grants depending on the size of the labor force at the local plant (UNCTAD, 1994b).

structural problems in a certain region. Even if an adequate incentive could be granted, its costs would surely surpass potential benefits due to the lack of detailed knowledge, the burden of administrative and monitoring tasks, the new distortions introduced by the incentives and the scope of rent-seeking activities. Incentives are also seen as an important source of distortions in international trade and in the international allocation of investment resources. This explains why incentives were addressed in different agreements at the Uruguay Round of the GATT. In this regard, the orthodox view argues that developing countries are at a disadvantage when investment incentives are in place, as they skew investment and trade in favor of countries with "deep pockets" to afford such incentives (more on this below).

In turn, PRs are seen as second best solutions, whose outcome is uncertain and which lead to rent-seeking behavior. In general, orthodox models tend to underline that PRs are welfare-reducing, except under very stringent circumstances. It has also been stated that the effectiveness of PRs has declined. As foreign affiliates of MNCs become more oriented towards global or regional markets and as the number of countries eager to attract FDI grows, the tolerance of MNCs for these kind of requirements is likely to be much smaller than in the past. In this scenario, PRs may be at best ineffective and at worst counter-productive, since FDI would prefer countries in which such requirements are not pushed (OECD, 1998b).

Strong as these arguments look, they nonetheless have some flaws which mainly stem from the assumption of "perfect competition". When "imperfect competition" assumptions are introduced, the outcome of policy measures such as incentives or PR is indeterminate: "the prospect of capturing a share of the rents and externalities from the operations of international investors ..... raises the stakes for those who are successful in attracting (or holding) them and imposes large opportunity costs on those who are not successful or do not take part in the competition" (Moran, 1998, p. 3). In this light, the fact that many developing countries do not have enough capabilities to design, implement, monitor and enforce FDI-related activist policies and that rent-seeking activities are a real threat calls for the strengthening of a system of checks and balances rather than a general ban on any kind of public intervention.

In addition, the empirical evidence is not conclusive regarding the use of incentives and PRs. There are failed as well as successful experiences, which suggests that the outcome depends on a set of institutional, historical, international, political, social and economic conditions, as well as on chance. Besides, incentives and PRs may assume, in practice, different forms and may have different goals. For example, Moran (1998) rejects the case for import related PRs (such as local content requirements -which, according to the author, have neither empirical nor theoretical grounds-); the same applies to joint-venture and technology-transfer requirements. On the contrary, Moran supports export related PRs as they may induce investors to include developing and transition economy sites within their sourcing networks, benefiting not only firm and host-country welfare, but also global welfare. This is particularly important because several studies show that world-scale sized plants may generate substantial spillovers and dynamic advantages to host countries. There is also evidence that, if export requirements are not in place, market failures may arise and that kind of investments may not take place.

Once perfect competition assumptions are dismissed and the lessons of experience are taking into account, there are reasons that may justify the implementation of investment incentives programs:

i) when there are regions that are underdeveloped/backward or that have high unemployment rates and which, by themselves, are not able to attract the investment flows that are needed to foster development;

ii) when governments are interested in promoting investments in some specific sectors, when they look for export-oriented investments or when they try to increase the spillovers of the investments (in terms of suppliers development, human resources training, technological absorption, etc.); and

iii) when there might be a discrepancy between FDI and the host country's development objectives.

The danger of "political" capture of the incentives programs does exist and the issue should deserve special attention. The difficulties to monitor and enforce incentives are also well known, especially in Latin American countries. Governments seldom perform detailed studies on the costs and benefits of incentive packages (see UNCTAD, 1999b, for a discussion about the almost insurmountable difficulties inherent to any attempt to precisely estimate the costs and benefits of an incentive program)[3] . Furthermore, spillovers do not seem to be the main immediate reason why incentives are offered. There are generally politically-oriented reasons, as governments tend to search for investments because they are supposed to bring new jobs to their countries/regions -jobs that would go to other countries/regions if incentives were absent-. In this scenario, the danger of bidding wars in which the costs of incentives exceed the social benefits for host countries must be seriously evaluated (see below).

The global scenario as well as the pattern of trade and investment flows must also be considered. Investments are now more geographically mobile, so that regulation could be more difficult than in the past. In turn, the technological gap between native firms and MNCs, especially when it comes to high-tech activities, seems to have expanded. This could mean that -except for the few countries which have "unique" locational advantages (i.e., the domestic Chinese market)- stringent PRs could have an innocuous or even a counter-productive effect (diverting investments to countries where such requirements are not present or are weaker). In turn, forbidding entry into a particular sector could increase the technological gap even further.

Last but not least, if "fundamentals" are lacking (market size, growth perspectives, domestic infrastructure, skilled human resources, etc.) incentives will not attract significant "high-quality" flows of FDI and PRs won't yield their expected results. For example, Cantwell & Mudambi (1998) have analyzed the effects of incentives on R&D activity. The authors find that while government support affects R&D investments at the margin, other variables are primary determinants of the location of R&D activities (domestic infrastructure, skilled human resources, local linkages with other innovative firms and research institutions, etc.): "locations in which indigenous firms have an innovative tradition will best attract firms from the leading foreign centers in the industry in question, with a view to the extension of their R&D-intensive networks" (p. 19).

B) POLICY COMPETITION FOR FDI: ISSUES AND TRENDS

Notwithstanding the debate, most governments seem to be persuaded that incentives "work". Furthermore, the evidence clearly shows that a greater number of governments are involved in investments competition than in the 1980s and that the overall 'cost-per-job' of the typical incentives package has risen (see Aranda & Sauvant, 1996; OECD, 1998a; Oman, 1999)[4]. Competition has become more widespread as governments have liberalized their policy regimes. This competition is mostly intra-regional, since governments seek to compete with neighboring countries for investments that are already, in principle, destined for their region. It occurs not only among national governments but also among sub-national governments, which seem to play an increasingly important role in this game.

Investors often define a "short-list" of locations and negotiate conditions and possible incentives with each of the competing governments. Investors may openly foster competition among authorities, or even "ask for their best offers" before making the final site selection (Oman, 1999), feeding the so-called "bidding wars" for investments.

Investment incentives include:

i) financial incentives (involving the transfer of funds directly to foreign investors by the host government -investment grants, subsidized credits, loan guarantees, etc.-);

ii) fiscal incentives (designed to reduce the overall tax burden for a foreign investor -tax holidays, tax rebates, accelerated depreciation allowances, exemptions from import duties or duty drawbacks; specific deductions from gross earnings for income-tax

3.
For example, regarding spillovers, their measurement is not only difficult but it is also important to assess if those spillovers are or not fully internalized by MNCs; it is evident that if full internalization occurs, there would be no room for incentives on this basis (Aranda & Sauvant, 1996).

4.
To illustrate the extension of this phenomenon it is worth reminding that a survey made in the early 1990s showed that among 103 countries covered only four did not have any type of fiscal incentives, only 24 out of 83 did not have financial incentives and only 8 out of 67 did not have any type of "indirect" incentives (UNCTAD, 1995). In turn, a survey made by Deloitte and Touche on some 40 countries showed that nearly 85 per cent of the countries surveyed had fiscal incentives to attract investments (UNCTAD, 1999b).

purposes, deductions from social security contributions, etc.-);

iii) indirect incentives (designed to enhance the profitability of a FDI project in various indirect ways -subsidized land and dedicated infrastructure, preferential access to government contracts, special regulatory treatment, granting of monopolistic positions, etc.- (Aranda & Sauvant, 1996; WTO, 1996)[5].

A large and growing number of countries targets incentives to attract investment into specific types of activities or areas. These targets include:

i) specific sectors (high-tech and high-value-added manufacturing, infrastructure, etc.);

ii) specific regions (generally those that are poorer or where unemployment is high);

iii) export-oriented investments;

iv) the attraction of regional headquarters of MNCs;

v) specific MNCs activities that generate spillovers or contribute to solve certain social problems -R&D, labor training, job creation, etc.

Even if governments tend in principle not to differentiate between domestic and foreign investment in the design or implementation of incentives, there are important exceptions to this rule. Moreover, foreign investors tend to make an extensive use of incentives, since they are often designed to attract "mobile" investment projects[6].

Consequently, any debate on FDI-related policies must take into account that incentives exist, that most governments apply them, and that they are here to stay, at least in the foreseeable future. Moreover, contrary to what one might presume, the resistance to abandon incentives is as strong or even stronger among developed countries than in developing countries.

Oman (1999) suggests two possible outcomes regarding policy competition for FDI. The first one is based on a "positive-sum game hypothesis", according to which competition produces net benefits for investors and host economies alike. The reasoning is that governments know the high priority investors attach to the "fundamentals" vis-a-vis fiscal and financial incentives per se. Governments thus seek to improve domestic supplies of human capital and infrastructure as well as to ensure political and macroeconomic stability. A corollary of this hypothesis is that intensified competition to attract FDI leads governments to "do a better job on the fundamentals". Hence, in addition to induce governments to take actions that enhance growth and productivity levels (even in the absence of additional FDI), those actions are likely to increase the global supply of FDI. In turn, since FDI can produce significant spillovers in the host economy, the increased level of global FDI should come closer to socially desirable levels.

Investors may openly foster competition among authorities, or even "ask for their best offers" before making the final site selection.

The opposite scenario corresponds to the "negative-sum-game hypothesis". In this scenario, the benefits that could materialize tend to be offset by a sort of "prisoner's dilemma". That is, as competition heats up, governments engage in costly "bidding wars" that push up the level of public subsidies offered to investors up to a point that could be unjustifiable from society's perspective. While governments have a collective interest in refraining from such bidding wars, they get involved anyway because of their fear that, if they refrain from doing so, FDI will be diverted to other countries offering more incentives. There are many other potential negative consequences of "bidding wars":

i) public funds addressed to incentives could be used more productively to finance public goods such as human capital formation and infrastructure;

ii) incentive programs place already-established investors at a competitive disadvantage vis-a-vis the "newcomers" receiving the incentives. This may even induce "round-tripping" (i.e., investing abroad in order to return as a "new" foreign investment);

iii) if governments make an extensive use of incentives (which may also lack transparency),

5. A significant part of policy competition for investments is related to the so-called "tax havens". Though the treatment of the problem of tax havens exceeds the objectives of this paper, it is worth reminding some of the main issues involved in this phenomenon: i) tax havens are part of the so-called "harmful tax competition", which has been defined as "the use of tax policies and practices that are judged by the international tax community to be overly aggressive in distorting the global allocation of capital investment and the associated tax base and in creating new opportunities for international tax evasion" (OECD, 1998a); ii) there has been an "explosion" since 1985 in the use of zero- or low-tax jurisdictions as locations for FDI recorded by companies resident in the G-7 countries; iii) globalization has tended to blur the distinction between the national and the international effects of taxation. The potential impact of one country's tax policies on other economies has thus greatly increased in recent years. Furthermore, globalization is having some major negative effects on taxation and tax systems, since it opens new ways by which companies and individuals can avoid taxes, and countries can develop tax policies aimed at diverting geographically mobile capital; iv) investors in tax havens who reside in non-haven countries may significantly reduce their domestic tax liability and become "free riders" who benefit from public spending in their home country without contributing to its financing. In turn, governments and residents of tax havens can be "free riders" that benefit from the positive international spillover effects of public goods and services that are supplied and paid for by non-haven countries; v) two main types of tax-induced distortions can be distinguished: a) those related to companies' decisions on where to locate real investment; (b) those that arise from firms' paper "transactions" designed to "strip" income and profits generated in a high-tax jurisdiction in order to transfer them, on paper, to a low-tax juris-

potential investors will perceive this situation as unsustainable, reducing rather than enhancing their propensity to invest in the economy;
iv) competition may create downward pressures on environmental and labor standards.

In sum, investors would be the immediate beneficiaries of bidding wars, at the expense of governments and host economies.

A useful distinction can be made between "incentives-based" and "rules-based" competition. The former refers mainly to the fiscal, financial and indirect incentives already mentioned. These incentives may be granted automatically (subject to qualifying conditions) or discretionally. Discretion may be seen as a necessary condition for a successful negotiation with investors that ensures an efficient targeting of incentives; yet, it also reduces transparency and increases the scope for bribery and corruption. In turn, incentives may be linked to PR -regarding local content, export levels, employment creation, etc.-; in these cases, incentives may be seen as a compensation for the disincentive effect of the PRs. In addition to those covered by Oman's survey, there are other instruments which governments may employ to attract or retain investments. In many cases, even if these instruments are not originally designed to influence investment flows, they may have significant effects on investors' decisions. This is notably the case of the so-called investment-related trade measures –i.e., a mix of rules and incentives-, which include tariffs, quotas, export programs, export processing zones (EPZs), anti-dumping measures, regional agreements, rules of origin, national standards, etc. (see UNCTAD, 1999a). As a way of incentives-based competition, the number and influence of investment-promotion agencies (IPAs) has expanded. IPAs are created to attract investments through different mechanisms, often including attractive incentives "packages". Many IPAs are increasingly adopting targeted policies on a sectoral- and even on a firm-specific basis. According to Moran (1998), this kind of "marketing" effort does yield impressive results, as the evidence shows a high payoff for countries which make aggressive efforts to attract FDI, i.e., benefits with a net present value of almost four dollars for every dollar expended. Moreover, some of these agencies have succeeded in attracting high-quality investments without excessive special concessions for MNCs (this seems to be the case of the Intel investment in Costa Rica, according to Spar, 1998).

The Welsh Development Agency (WDA) is one of the most famous IPAs, and its experience has been vastly examined, since many of its initiatives are regarded internationally as models of best practice. The WDA intervenes not only in negotiations leading to initial investments by foreign firms (trying to fulfill the requirement of inward investors), but it has also taken several initiatives to offer after-care services[7]. Interestingly enough, WDA policy has shifted towards a more sectoral focused approach and has prioritized the attraction of investments in sectors such as electronics or automotive vehicles. Among its initiatives can be mentioned a program for supplying chain development, an initiative geared to offer specialized training for investors in certain sectors, and programs concerned with assisting the globalization of indigenous firms through partnerships with similar foreign firms (Phelps et al, 2000).

In turn, "rules-based" competition may range from changes in environmental and labor standards (or in the enforcement levels of those standards) to the signing of regional-integration treaties, the tightening of the protection of intellectual property rights, the strengthening of judicial systems, the establishment of EPZs, the privatization of state-owned enterprises, market deregulation, and the liberalization of trade and investment policies. The enhancement of economic and political stability may also be considered as part of a "rules-based" competition for FDI.

C) THE EMPIRICAL EVIDENCE ON POLICY COMPETITION FOR FDI

On the basis of a multi-country study undertaken by the OECD Development Centre (Oman, 1999) a brief review of the most recent and authoritative report on this issue is presented below. The evidence seems to be inconsistent with the more extreme versions of both the "positive-sum game" and the "negative-sum game" hypotheses. Regarding the former, it has not been found that policy competition for FDI has been a primary determinant of certain government actions, which would have not otherwise been pursued, such as

diction for tax purposes; vi) "companies may actively seek out tax breaks and encourage countries to match preferences available in other countries. In these cases governments may find themselves in a 'prisoner's dilemma' where they collectively would be better off by not offering incentives but each feels compelled to offer the incentive to maintain a competitive business environment... In this context, and in the absence of international co-operation, there is little incentive for a country which provides a harmful preferential tax regime to eliminate it since this could merely lead the activity to move to another country which continues to offer a preferential treatment" (OECD, 1998a). See OECD (2000) for a report on harmful tax regimes and tax havens which includes policy proposals for tackling this issue at global level. In this report, the OECD has identified, besides tax havens, more than 60 potentially harmful preferential tax regimes within the OECD area.

6.
In fact, financial liberalization has increased the mobility of capital, making it easier for potential investors to make host governments to compete against each other in their bids to attract an investment project.

7.
The WDA visits every inward investing company at least once a year to keep abreast of development and to help with further expansion.

investing in education and modern infrastructure. Policy competition does not seem to have contributed to increase the global supply of FDI (actually, causality seems to have run in the opposite way). Nonetheless, some evidence exists that competition for FDI has helped to foster "better government" in many developing countries. It also has, in some cases, made a contribution to enhance the local supply of infrastructure and education. At the same time, the findings of the survey support the hypothesis that an improved endowment of human resources and modern infrastructure tends to act as a powerful attraction for FDI.

However, the evidence does not lend strong support to the view that competition for FDI is unleashing uncontrolled bidding wars that push investment incentives above socially justifiable levels, although this statement must be qualified given the difficulty to assess properly the costs of incentives and the benefits of investments. This is particularly so taking into account that, in practice, governments are generally reluctant to give information on these issues. In addition, there have not been found "races to the bottom" in environmental or labor standards (though the danger of such "races" does exist). In fact, the evidence shows that competition for FDI may exert some upward pressure on those standards, especially in the case of investments in relatively "clean" and knowledge or skill-intensive manufacturing and service industries.

Nonetheless, bidding wars do obviously exist and it is fairly probable that policy competition has allowed investors to increase their share of the benefits accruing from their investments. Some incentive regimes designed to stimulate the social and economic development of poorer or disadvantaged regions have fallen short of this objective and may have, in fact, exacerbated rather than reduced regional income inequalities. For example, in OECD countries regional-development policies may have been co-opted for the pursuit of policy competition that does not mainly benefit the poorest segments of the population or those most suffering from unemployment (Oman, 1999). In contrast, in developing and emerging economies some evidence of policy competition benefiting poorer areas may be found, as in the Northeast of Brazil. There is also evidence of the tendency for policy competition to favor large firms at the expense of smaller firms. At the same time, the lack of transparency of many incentive deals has created possibilities for corruption and rent seeking. Mytelka (2000) adds one further objection to "bidding wars", namely, that they seldom attract the kind of FDI which fosters innovation and learning.

The lack of transparency of many incentive deals has created possibilities for corruption and rent seeking.

In this connection, "rules-based" competition may have some advantages (Oman, 1999):
i) except when environmental or labor standards are lowered, benefits may extend not only to investors but to the whole society (i.e., when governments improve the judicial system, sign regional agreements or when legal, political and economic stability and predictability are achieved, etc.)[8];
ii) many of the "rules-based" competition policies involve creating more stable, predictable and transparent rules for investors and governments alike.
iii) it gives less room for bribery and corruption;

Competition for FDI is intense and still growing; however, new peaks are not expected for three reasons:
i) the upsurge in global FDI flows has been a stimulus, rather than an effect, of competition for FDI. Even when global FDI flows may continue to rise in the longer run, there is little reason to expect a further surge in its level vis-a-vis those of world trade and output;
ii) while a turn away from inward-oriented and often FDI hostile development strategies has taken place over the last 15 years, most countries have already made that shift;
iii) incentives-based competition tends to be highly concentrated in the auto industry. It is unlikely that in the near future investment levels in this industry will match those experienced in the last two decades, since there is a significant worldwide productive overcapacity in this sector.

Caution is required, nonetheless, on three fronts. The first one is transparency. Concretely,

8. Nonetheless, "indirect" incentives in the form of subsidized infrastructure or labor training may also generate spillovers.

the question is how to ensure the accountability of government officials involved in the negotiation of incentives. The issue of transparency also points to the need for governments to be able to monitor their own use of incentives. The second front is what Oman defines as "bounded competition", which means that policy competition is disciplined by a regulatory framework which set rules for the granting of aid and establish procedures and sanctions in order to guarantee their enforcement. According to Oman, bounded competition should be the objective of any regional or multilateral arrangement on FDI, since an outright suppression of competition is not feasible. Finally, developing countries, whose financial resources are often scarce, should move from incentives-based towards rules-based means of attracting FDI (while maintaining or strengthening their defense of workers rights and the environment). Nonetheless, some case studies surveyed by Oman show successful experiences with the use of incentives to attract FDI (for example, Singapore, where incentives were often sectorally and functionally targeted), though it must be noted also that this country had also gotten the "fundamentals" right -political and economic stability, adequate infrastructure, a well qualified labor force, etc.-.

III. POLICY COMPETITION FOR FDI: THE MULTILATERAL DIMENSION

There are no multilateral rules on investment as there are for trade issues. Investment incentives are one of the areas with less coverage within the "patchwork" of international rules regarding investment issues and only some PR have begun to be tackled in the context of the GATT.

In this scenario, efforts to define regional or multilateral rules on investments have been made for many years. One of the most relevant international agreements in this field is the Energy Charter Treaty (ECT), signed in 1994, which has 49 members plus the European Union. The ECT has been considered as the "most ambitious attempt to date to set up an international regime for both investment and trade" (Andrews-Speed & Walde, 1996). Despite its broad scope, the ECT has no provisions on investment incentives.

The main international rules on investments are the so-called bilateral investment treaties (BITs), which are mostly limited to the protection of investments once they are made. The number of BITs reached 1513 by the end of 1997. Of these, 249 were between developing countries. Just in 1997, 27 per cent of the 153 treaties concluded that year were between developing countries. Apart from BITs, there are numerous bilateral treaties aimed at avoiding double taxation (UNCTAD, 1998). By the end of 1996, almost all Latin American countries had signed at least one BIT (SELA, 1997). Some of these BITs follow the "U.S." matrix guaranteeing the application of the national treatment (NT) and most favored nation (MFN) clauses not only at the post-establishment but also at the pre-establishment stage. Others are similar to the "European" model -which adopts the more traditional criterion of granting NT and MFN rights only at the post-establishment stage-. The U.S. matrix usually contains other provisions not covered by the European model -such as PR, entry of key personnel, etc.-. Such matrix contains, thus, what has been termed "high-level" disciplines regarding investment issues.

However, the proliferation of BITs does not lead, per se, to a Multilateral Framework on Investments (MFI), since coverage and discipline levels are very heterogeneous; even inconsistent rules may be established in different agreements. Current members of the WTO would have to sign 7503 agreements should they wish to provide investment protection for their nationals through bilateral treaties according to the WTO (1996).

The GATT/WTO and the OECD have been the main fora where the issue of multilateral disciplines on investment incentives has been addressed. During the Uruguay Round of the GATT investment issues were addressed in different agreements. Besides, two working groups were established in 1996 -one on trade and investment issues and the other one on trade and competition policy-, and the built-in agenda of the Uruguay Round Agreements

calls for further discussion on incentives in the near future. In turn, the OECD has taken some steps towards the establishment of multilateral rules since 1976, when a Declaration on International Investment and Multinational Enterprises was issued. This Declaration calls for NT, and includes an Instrument on Investment Incentives and Disincentives aimed at greater transparency in subsidy practices. The OECD has also defined a Code of Liberalization of Capital Movements and the Guidelines for Multinational Enterprises. However, these instruments have not introduced "high-level" disciplines as some of them are non-binding and most lack effective dispute settlement procedures. This led to the initiative to launch the Multilateral Agreement on Investments (MAI) in 1995. As seen below, MAI negotiations ended by April 1998 without having reached the expected agreement.

A) THE URUGUAY ROUND AGREEMENTS AND THE WTO

Five of the agreements signed during the Uruguay Round of the GATT contain provisions on investments: the Agreement on Trade-Related Investment Measures (TRIMs), the General Agreement on Trade in Services (GATS), the Agreement on Trade-Related Aspects on Intellectual Property Rights (TRIPs), the Agreement on Subsidies and Countervailing Measures (ASCMs) and the Understanding on Rules and Procedures Governing the Settlement of Disputes. More recently, the basic telecommunications agreement and the financial services agreement signed in 1997 extended multilateral rules on investment to two sectors of considerable economic significance.

Since investment was seen as one of the means of delivering services, the GATS covers a wide range of investment issues in the services sectors. With the exception of the prohibition of measures "which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service" (article XVI, 2.e), the GATS does not include any provisions regarding incentives or PR. As for the TRIPs agreement, even if it does not contain provisions regarding investment incentives or PR, it was supposed to create an environment conducive to investment by enhancing the protection of intellectual property rights.

The TRIMs agreement deals primarily with PR, which could lead to distortive effects on trade. It does not deal with investment per se but only with those PR directly related to trade. The list of prohibited measures include:

i) local content requirements;

ii) trade-balancing requirements;

iii) foreign exchange-balancing requirements;

iv) those which restrict the export of products, whether specified in terms of the particular type, volume or value of products or of a proportion of volume or value of local production.

Prohibited practices include those that are mandatory in nature and those with which compliance is necessary in order to obtain an advantage. A five year transition period was established in order to eliminate prohibited TRIMs in developing countries, which can be extended if developing countries find difficulties.

Despite the efforts of the U.S. and other developed countries, a group of other TRIMs did not fall under the prohibition of the agreement (Graham, 1997). Non-prohibited TRIMs include, for example, export requirements, product mandating requirements[9], foreign exchange restrictions, technology transfer requirements, licensing requirements, remittance restrictions and local equity requirements (Low & Subramanian, 1995).

Finally, the Agreement on Subsidies and Countervailing Measures (ASCMs) makes some financial and fiscal incentives inconsistent with WTO rules (Sanin, 1997; Sauve, 1994). A subsidy is defined as a financial contribution -grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services, the purchase of goods, etc.- by a government or any public body within the territory of a WTO member, which confers a benefit to its recipient. The ASCMs applies not only to measures of national governments, but also to measures applied by sub-national governments and of such public bodies as state-owned companies (Tussie & Lengyel, 1998).

9. They demand that an investor supplies certain markets with a designated product or products manufactured from a specified facility or operation, or commits itself to assign to the affiliated company concerned the exclusive right to export specified products worldwide or to certain regional markets.

Some types of investment incentives may fall under the Agreement on Subsidies and Countervailing Measures disciplines. Fiscal incentives would generally be considered as subsidies, since they fall within the definition of "government revenue ... otherwise due [that] is foregone or not collected (e.g., fiscal incentives such as tax credits)". Financial incentives would meet the ASCMs definition of "a government practice [that] involves a direct transfer of funds (e.g., grants, loans and equity infusion)". Furthermore, at least some kinds of indirect incentives would appear to be subsidies; for example, the provision of land and infrastructure at less than market prices would appear to fall within the definition of "a government provid[ing] goods or services other than general infrastructure, or purchas[ing] goods" (WTO, 1996). Nonetheless, the thrust of the ASCMs is toward trade in goods and, as such, may not be easily applied to investment incentives because the flows of goods by definition occur only after the investment has been made. Thus, by the time production and exportation of a subsidized project have started, investment incentives will have ended. In this case, neither a recommendation to withdraw or modify a subsidy nor a countervailing duty applied to the exported goods will be able to "undo" or to change an investment that already has been made.

Although the ACSM requires WTO members to notify their subsidy programmes, in practice there have been delays and some countries have failed with the obligation to notify or have claimed to have no subsidy programmes. A bigger problem is that outside the EU, many countries (including the United States and Canada) have provided little or no subisidy information for sub-national governments. Moreover, it has been observed that it is no clear how rules are going to work in practice with sub-national incentives, since different uncertainties arise regarding, for instance, who should be the complaining party in many cases (Thomas, 1998)[10].

In addition to the above provisions, the Ministerial Conference held a decision in Singapore in December 1996 to establish a working group to examine the relationship between trade and investment and another which should study the interaction between trade and competition policy and anti-competitive practices (the latter being of special interest for developing countries, which had tried to include this issue at the Uruguay Round agenda). This was so notwithstanding the resistance of many developing countries, which were split between those ready to include investment issues at the WTO agenda, and those (Egypt, India, Indonesia, Malaysia, Tanzania, etc.) arguing that incentives could only be addressed in the context of the built-in agenda of TRIMs (De la Guardia, 1997). Both groups have delivered extensive reports on their activities and on the discussion held on the issues under study.

Among the issues discussed by the trade and investment working group were:
i) the implications of the relationship between trade and investment for development and economic growth (economic parameters relating to macroeconomic stability - such as domestic savings, fiscal position and the balance of payments-; industrialization, privatization, employment, income and wealth distribution, competitiveness, transfer of technology and managerial skills; domestic conditions of competition and market structures);
ii) the economic relationship between trade and investment (the degree of correlation between trade and investment flows; the determinants of the relationship between trade and investment; the impact of business strategies, practices and decision-making on trade and investment; the relationship between the mobility of capital and the mobility of labor; the impact of trade policies and measures on investment flows; the impact of investment policies and measures on trade; country experiences regarding national investment policies, including investment incentives and disincentives; the relationship between foreign investment and competition policy);
iii) stocktaking and analysis of existing international instruments and activities regarding trade and investment (existing WTO provisions; bilateral, regional, plurilateral and multilateral agreements and initiatives; implications for trade and investment flows of existing international instruments).

Both Working Groups are conducting an "educational" work and their decisions do not

10.
Thomas (1998) analyzes the case of the subsidies for Mercedes Benz investment in Alabama in 1993. In this particular case, the United States would not complain about its own subsidy, and the individual US states do not have standing to do so. The EU would presumably not complain since an EU firm is the beneficiary. Finally, Japan might not complain because many Japanese firms have benefited from similar subsidies in the United States.

prejudice any future decision[11], but it is probable that the issue of investment may eventually be included in the WTO agenda. In fact, the built-in agenda of TRIMs, the GATS and the ASCMs will surely call for this inclusion. In this sense, the advantages of the WTO over other fora such as the OECD, lie in its global coverage and its dispute settlement system. Nonetheless, some developing countries fear that the dispute-settlement mechanisms of WTO will tilt the balance in favor of MNCs. Further, before discussing the pros and cons of an MFI from the point of view of developing countries, a brief analysis of the failed MAI is required.

B) THE MULTILATERAL AGREEMENT ON INVESTMENTS (MAI)

The OECD Ministers decided to launch negotiations on a MAI in May 1995[12]. The basic argument for doing that was that regional agreements were necessarily partial in their geographic coverage and that existing OECD instruments were not binding or comprehensive and lacked effective dispute settlement procedures. It is important to note that the original objective of the MAI was to set "high standards" for the treatment and protection of investments. It was a comprehensive agreement, covering all economic sectors, and with a broad definition of "investment", including FDI, portfolio investments, real estate investments and rights under contract. Differently from most of the existing BITs, the MAI was to provide guarantees at the pre-establishment stage. The MAI aimed also to cover measures taken at all levels of government (central, state, provincial, local). The MAI adopted the principles of NT (the MAI Parties would commit themselves to treat foreign investors and their investments no less favorably than they treat their own investors) and of MFN (the MAI Parties would agree not to discriminate among the investors or investments of different MAI Parties). Other important provisions to be included in the MAI dealt with issues such as transparency, free transfer of investment-related payments, entry and stay of key personnel, expropriations and dispute resolutions.

The extent of the exemptions and reservations proposed was so huge that it made many of its supporters doubt there would be an improvement over the existing national investment remes.

The MAI applied a "top-down" approach under which the only exceptions permitted were to be those listed when adhering to the agreement (negative lists), and which would be subject to progressive liberalization. It also included "general exceptions" (under which any country would be able to take measures necessary to protect its national security or to ensure the integrity and stability of its financial system) and "temporary safeguards" (under which any country would be able to take measures necessary to respond to a balance of payments crisis). By virtue of country-specific exceptions or reservations each country would be able to maintain laws and regulations not conforming to MAI disciplines.

Even if negotiated among OECD countries, it was conceived as an open agreement, and it was expected that many developing countries would join. In fact, five non-OECD countries -Argentina, Brazil[13], Chile, Hong Kong, and the Slovak Republic- joined the negotiations as "observers", and expressed their intention to join eventually.

Regarding PR, the aim was to go further than existing rules by extending them first to the field of services, and, second, to requirements that distort investment flows even if the investment in question is unrelated to international trade. Banned PR[14] were those related to:

i) export levels;
ii) local content;
iii) local purchases;
iv) trade or foreign exchange balancing;
v) ratio of local sales to exports;
vi) technology transfer (except when used to remedy violations of domestic competition laws);
vii) headquarters location;
viii) exclusive supply to certain markets;
ix) R&D investments;

11. This clarification was principally due to the insistence of the U.S. delegation. This reflects the fact that the U.S. prefers to negotiate within the OECD, since its main objective is to negotiate "high-level" disciplines (De la Guardia, 1997).

12. See OECD (1997, 1998c). The OECD Internet website also contains valuable documentation regarding MAI, including the negotiating text and comments to the text.

13. See Guerra de Araujo (1998) for an analysis of the implications of the MAI for Brazil

14. Some of these PR -such as the requirements on local content, trade and foreign exchange balancing and ratio of local sales to exports- are already banned in the TRIMs.

x) employment of local personnel;
xi) establishment of joint venture with domestic participation;
xii) achievement of a minimum level of domestic equity participation.

All requirements were, however, not likely to be prohibited in all circumstances. The first five categories seem to be more distortive and were to be prohibited in all circumstances. In turn, some other PR would be allowed subject to the condition that the requirements were imposed on foreign and domestic investors as well, in connection with:
i) the location of production;
ii) the provision of particular services;
iii) the training or employment of workers;
iv) the construction of particular facilities; and
v) the conduct of R&D.

An exception was also proposed for measures that were necessary to secure compliance with national laws and regulations, protect human, animal or plant life or health, or for the conservation of living or non-living exhaustible natural resources. In addition, the MAI was likely to contain an exception for some trade PR in the context of export promotion and preferential tariffs or quota programs. Similar exceptions were proposed for foreign aid programs, government procurement and privatization. Finally, over and above these exceptions, it would be possible to establish national reservations for specific measures (Ahnlid, 1997; Brooks, 1997).

Notwithstanding these provisions which sharply constrained the scope of the MAI, many countries were reluctant to adopt new disciplines in this area. Moreover, many OECD countries made reservations about one or more of the bans on PR.

Regarding investment incentives, as many observers have pointed out they did not feature prominently. Even if the MAI had been signed, it would not have contained more than an exhortation for transparency, NT and MFN clauses, consultation procedures and a "built-in" agenda. According to a negotiator -Ahnlid (1997)-, a number of influential OECD countries argued that MAI should not seek to discipline investment incentives, while others were proposing the creation of new rules.

Since a requirement to extend incentives to all eligible foreign investors might increase the cost of incentive programs in certain circumstances, some members of the former group of countries argued that the application of non-discrimination principles would probably lead to a certain degree of indirect discipline on investment incentives. However, other countries were in total opposition to the introduction of new rules in this field, arguing that investment incentives were a legitimate and useful policy tool for promotion of economic development. It is worth noting, also, that some countries arguing along these lines sought country specific reservations from the rules on non-discrimination for incentives; in turn, many countries were reluctant to adopt explicitly the criteria of MFN and NT on the issue of investment incentives.

Even countries which were of the view that disciplines on investment incentives were required acknowledged that incentives could be relevant in certain circumstances, such as in the promotion of regional, social, environmental and R&D objectives. The fact that incentives are often granted sub-nationally also seems to have contributed to the reluctance of some participants to agree on disciplines in this area. In addition a number of countries argued that tax incentives, as most other tax measures, should be excluded from MAI. Some countries were also concerned with the fact that any additional disciplines on investment incentives in the MAI could divert foreign investment to non-members and place MAI members at a disadvantage relative to non-members in their ability to retain or attract investment. In fact, though a number of possible options for disciplines were proposed -including a ban on so called positive discrimination (i.e. better treatment for foreign investors than for domestic investors) and an agreement on caps on the magnitude of certain investment incentives-, they were not seriously discussed (Ahnlid, 1997)[15].

In turn, the governments of many developed countries proposed several exceptions from the general rules of the MAI. For example, France and Canada wanted to restrict FDI in cultural industries, the EU wanted to preserve the rights of its investment promotion agencies to discriminate against foreign investors, the U.S. wanted that their states continued to be able to limit foreigner's purchases of farm land, and to preserve their regulations that ban foreign engagement in nuclear power plant operations and that require domestic ownership of television broadcasting stations, etc. The extent of the exemptions and reservations proposed was so huge that it made many of its supporters doubt there would be an improvement over the existing national investment regimes (The Economist, 1998). In addition, NGOs and other non-business groups, which were specially concerned with environmental and labor issues, as well as with the issue of extraterritoriality and national sovereignty (the MAI could be seen as a supranational intrusion on domestic affairs), were among the fiercest opposers to the agreement.

Some influential developing countries also looked with suspicion the negotiations on a MAI. Many prominent officials of countries such as India (Ganesan, 1997, 1998; Ramaiah, 1997), Egypt (Shahin, 1997), Jamaica (Robinson, 1998), Pakistan, Malaysia, etc., expressed different concerns about the MAI preferring BITs, agreements within the ASEAN context and "non-binding principles".

Following Ganesan (1997) and Shahin (1997), the main criticisms of developing countries to the MAI , are the following:

i) it seems improbable that new global disciplines to protect investment will encourage FDI flows, since most developing countries have now open investment regimes. At the same time, even if a country decides to liberalize its investment regime, nothing prevents it from imposing regulations later if the circumstances prescribe it so, while the MAI would forbid this event;

ii) there is no empirical evidence for the view that if there was a multilateral treaty on FDI, the least developed countries would receive increased flows of FDI, since the primary determinants of FDI are the market and investment opportunities that the host country offer, the macroeconomic conditions, growth prospects and investment climate. Therefore, while a MAI may contribute to an improvement in the investment climate of a country, it will not be the dominant factor in directing FDI flows to developing countries;

iii) the MAI disciplines may constrain the ability of host countries to benefit from FDI according with their needs and development strategies. In particular, developing countries should lose their right to set PR on MNCs, according to their development objectives, and it would be more difficult for them to establish incentives geared to attract the specific types of FDI which they see as best suited for their development needs;

iv) while the efforts to finalize a code of conduct for MNCs were formally abandoned in 1993, a MAI would increase their rights without establishing their obligations with respect to host countries;

v) the definition of investment as adopted in the MAI was too broad, going beyond the traditional notion of FDI;

vi) the notion of NT was extended to the pre-establishment stages, impeding developing countries from restricting or excluding FDI of certain industries or activities;

vii) the MAI would not allow an exchange of concessions on FDI for advantages in other areas;

viii) lastly and more broadly, negotiations within the OECD meant that developing countries would be left with the option of only joining or refusing to sign the MAI, without being able to participate in the negotiations and expose their points of view[16].

MAI negotiations were formally abandoned in April 1998. Nonetheless, as said before, it is probable that fresh discussions may be held at the WTO. In this scenario, it seems relevant to analyze the possible impacts of an MFI on developing countries.

15. In a communication intended to initiate the debate on which should be the EU position regarding multilateral negotiations on investment issues, the EC clearly reveals the low priority attached to incentives disciplines in the European countries' agenda. While two pages are devoted to justify the need of global disciplines regarding free access for foreign investors and NT and MFN rights, there is only one sentence related to incentives: "exaggerated investment incentives can distort the flow of investments or lead to an unintended 'race to the bottom' between countries or regions" (EC, 1995, p 9).

16. It is reported that at one meeting held at the headquarters of UNCTAD in 1995, leaders of certain major developing countries indicated that they would not participate in a MAI even if they found the substance of the agreement to their liking because it was not acceptable that the OECD countries force an international agreement upon the developing nations (Graham, 1997).

C) A MULTILATERAL FRAMEWORK ON INVESTMENTS: IMPACT ON DEVELOPING COUNTRIES

Developed countries seem to be, overall, more interested in an MFI than developing

countries, since they are trying mainly to protect the interest of their domestic firms when they embark in FDI operations. In turn, developing countries try to defend what they believe is the public interest and their right to an autonomous strategy for economic development, which, they think, may be in danger if excessive rights to foreign investors are granted. At first glance the dividing line is clear: developed countries -which are the source of FDI outflows- vs. developing FDI-recipient countries. However, this line is blurred since developed countries are not only the main source but also are the main recipients of FDI. Thus, many of them have interest in regulating the presence of foreign MNCs in their territories. In fact, different kind of restrictions and specific policies have been in place in several developed countries for many years. On the other hand, there are different perceptions among developed countries on the effectiveness of certain policy instruments regarding the attraction of investments towards specific sectors or activities, which are supposedly a source of spillovers.

Among developing countries there is an array of different positions as well. First, there are several countries with significant outward investments, in Asia (e.g., Hong Kong, Singapore, Korea, Taiwan, Malaysia and even China) as well as in Latin America (e.g., Argentina, Brazil, Chile, Mexico)[17]. Those countries would probably consider an agreement which grants some guarantees to the investments abroad by their indigenous firms with more enthusiasm, an enthusiasm reinforced if their inward FDI regimes were liberalized, since an MFI would not imply significant new obligations. In this regard, it is important to take into account that Argentina, Brazil, Chile and Hong Kong -all countries which nowadays have very liberal FDI regimes- have actively participated as observers of MAI negotiations and were interested in joining the agreement. In turn, there are many developing countries wishing to preserve their ability to discriminate against foreign investors and to impose requirements.

A second dividing line runs across the different assumptions regarding the impact of FDI on development of host countries and on the possible contradiction of interests with MNCs. Some argue that any "investment-friendly" agreements is per se "development friendly", and others that an MFI must contain explicit "development-friendly" provisions (see Drabek, 1998).

In the first case MNCs are seen to contribute with resources such as capital and modern technology, which are generally scarce in developing countries. A MFI, by giving protection, stability and predictability to foreign investments, and by increasing the credibility of government commitments, should foster FDI to developing countries, thus contributing significantly to development. It could also provide developing countries with better market access opportunities and legal protection for their investments abroad. A MFI could be particularly of interest to small countries that do not boast a large home market and whose bargaining position is weak vis a vis larger foreign investors. By "pooling sovereignty" the MFI could help to prevent a downward competition for investment (OECD, 1998d). Moreover, a MFI would be favorable for developing countries if it contains disciplines on investment incentives, since poorer countries are at disadvantage at bidding wars, as they don't have "deep pockets" to set attractive incentive packages.

Other arguments in favor of the idea that an MFI would be "development-friendly" per se include:
i) regional or bilateral agreements marginalize non-signatory countries, while foreign investors prefer to do business with those countries in which they have a legal protection through an international agreement;
ii) an MFI would reduce transaction costs to MNCs resulting in greater supply of investible funds, or lower costs of FDI or both;
iii) since the agreement would likely include elements that can be seen as "prudential regulations" it would reduce the volatility of capital flows;
iv) an MFI would be an important instrument in order to avoid unilateral restrictions against each countries' exports;
v) since an MFI would include a dispute settlement mechanism, it would give weaker and smaller countries a better chance to defend their rights (Drabek, 1998).

17. See Chudnovsky et al (1999), Dunning et al (1997), Mirza (2000).

In the other camp, a "development-friendly" agreement should follow some guidelines (Ganesan, 1997; Robinson, 1998; Shahin, 1997):
i) only direct investment must be included;
ii) being NT not altogether rejectable, at the establishment and pre-establishment stages it could inhibit the capacity to foster developmental objectives;
iii) developing countries should have certain flexibility in the matter of PR, particularly if they are linked to financial or fiscal incentives;
iv) the MFI should address the anti-competitive and restrictive business practices of the MNCs;
v) a balance must be struck between the rights of foreign investors and their obligations.

Regarding investment incentives, there is no clear-cut position among developing countries on if (and how) they should be included in an MFI. Some developing countries are in favor of maintaining their ability to grant incentives since these are seen as a tool to attract investments to countries or regions which lack some "fundamentals" -i.e. they are a compensation for investors- or to specific sectors which are of "strategic" interest for the host country. At the same time, incentives are often needed to compensate the PR which are imposed on MNCs[18]. Other developing countries are, instead, in favor of imposing international disciplines on this issue, taking specially into account that developed countries make an intensive use of incentives, deviating FDI flows which could go, in a "level-playing field", towards developing countries.

Finally, it is important to take into account that two authoritative opinions have rejected the case for a global agreement on investments. On one hand, UNCTAD (1996) suggests that the current international arrangements concerning FDI regulation are working well and also allow for other countries to enter into existing agreements. UNCTAD also suggests that MNCs are flexible and experienced enough in operating diverse policy frameworks and they can adapt to regulatory differences among countries. Coherence among existing agreements could be ensured, for example, by negotiating a global common framework for BITs. In turn, Oman (1999) states that most competition to attract investments occurs within regions, not between them. Thus, any international co-operation among governments to help limit the potential damage caused by competition to attract FDI would probably be best envisaged at the regional level rather than the global level. Nonetheless, this being true for most of the investments projects, it must also be noticed that globalization has increased the mobility of investments and that some high-tech activities are mostly footloose (the case of the Intel investment in Costa Rica illustrates this point, since the original "short-list" included thirteen Asian and Latin American countries -Spar, 1998-)[19].

The failure of the Seattle Ministerial Session of the WTO, jointly with the abandonment of MAI negotiations, have delayed but not necessarily eliminated the possibility of a multilateral agreement on investments. In any case, investment will surely be one of the key issues in any multilateral negotiations in the future.

IV. POLICY COMPETITION FOR FDI: THE REGIONAL DIMENSION

Given that policy competition is mostly intra-regional, how existing regional agreements have addressed this issue needs to be discussed.

The Asia Pacific Economic Cooperation (APEC) has non-binding principles on investments, which include the minimization of PR distorting trade and investment and a ban for member economies to relax health, safety and environmental regulations as incentives for FDI[20]. The Caribbean Community (CARICOM) set a Scheme for the Harmonization of Fiscal Incentives to Industry in 1973, designed to limit the rivalry for the location of industrial activity, to assist in rationalizing the criteria applied in granting incentives and to reduce regional inequalities by creating preferential incentives for the least developed countries of the region. Nonetheless, the effectiveness of this scheme has been undermined by different factors (Aranda & Sauvant, 1996).

18. Asian developing countries are among the most reluctant to adopt disciplines on this issue. In a workshop recently held in that region to discuss FDI liberalization, financial crises and multilateral rules for investment it is stated that "there was wide agreement that any multilateral framework should not prevent host countries from introducing or maintaining incentives for FDI. These incentives will differ according to the level of development and to financial and macro-economic conditions" (OECD, 1998d).

19. See also Hoekman & Saggi (1999) who also reject the need -and the feasibility- of an MFI, and argue that pursuing further trade liberalization in goods and services on a non-discriminatory basis at a global level should be more fruitful for the purpose of investment liberalization.

20. In turn, it is reported that Singapore is prone to veto the call for prohibition on investment subsidies at the Association of Southeast Asian Nations (ASEAN) (Moran, 1998).

Within the North American Free Trade Agreement (NAFTA) most new PR are banned and old PR must be gradually phased out. Linking a PR to subsidies is prohibited, but with some important exemptions. In effect, Member States can grant incentives conditional upon a requirement to "locate production, provide a service, train or employ workers, construct or expand facilities or carry out R&D" (Eden, 1996). In turn, given the broad scope for sub-national competition within Member States some initiatives to limit it have been taken. In Canada, a Code of Conduct on Incentives has been established, with complaints referred to the Internal Trade Secretariat for consultations, which has had only a modest impact on moderating competition (Thomas, 1998). In the U.S. there has been "no raiding" agreements in the Midwest and Northeast, accompanied by a rise of NGOs dedicated to inform about the perils of incentive races. Nonetheless, the U.S. "remains the outlier in terms of lack of self-discipline" (Moran, 1998, p. 166).

In the case of MERCOSUR, the absence of any effective discipline on incentives -and more broadly the lack of coordination on FDI -related policies- has given room to serious controversies. In this scenario, there is a need to discipline the competition for investments, and to re-direct it towards socially desirable objectives -i.e., for example, fostering development in poorer regions- (see below).

The EU remains the regional agreement with the most comprehensive treatment of incentives, through the provisions contained in the Treaty of Rome. Disciplines have been fairly successful, though they have not been exempt from failures. Since these disciplines might be used as a model for other regional and/or multilateral arrangements, it is relevant to describe them with some details.

A) THE TREATY OF ROME

Article 92 of the Treaty of Rome led to a general ban on subsidies ("State aids") in the common market. Within the EU legal framework, "aid" means any advantage conferred on a firm by the public authorities, without payment or against a payment which corresponds only to a minimal extent to the figure at which the advantage can be valued. State aids may consist for example of subsidies, interest-free loans, low-interest loans, interest rate subsidies, guarantees on preferential terms, relief from taxes or parafiscal charges, the supply of goods or services on preferential terms, or capital injections on terms which would not be acceptable to a private investor. Only selective aids are subject to control by the European Commission (EC), since they must favor certain undertakings or the production of certain goods, and thus affect the balance between the recipient firm and its competitors. In this sense, state aid must be distinguished from general economic support measures, which apply across the board to all firms in all sectors of economic activity. A contribution confined strictly to offsetting an objective disadvantage imposed on the recipient is not caught by Article 92. Likewise State aids below ECU 100 000 over three years are not caught by Article 92. Even above that threshold, the effect of the aid on competition has to be shown. Aid to firms supplying goods or services in which there is no cross-border trade likewise falls outside the scope of Article 92 (EC, 1997).

Notwithstanding the general ban on "competition-distorting" support, Article 92 states some circumstances in which aid is considered compatible with the common market. Support covered by exemptions provided by Article 92 are monitored and controlled by the EC through a vetting system. Member States are required to inform the EC of any plans to grant aid, and to obtain authorization before putting the plan into effect[21]. This system of control, is best understood as one of "bounded competition" for investments (Oman, 1999).

The task of deciding whether or not an exception can be granted is primarily the responsibility of the competition policy directorate of the EC. The decisions of the EC are regularly published to favor transparency about the mechanisms of approval of state aids and to ensure that its discretion is exercised with the proper openness and that public authorities and businesses are clear about their legal position. Nonetheless, criticisms have been raised regarding the lack of transparency and slowness of the EC procedures (Aranda & Sauvant, 1996).

21.

If a Member State fails to comply with its obligation to notify and its obligation to await authorization, the Commission may initiate proceedings either at its own initiative or in response to complaints from competitors.

Countries must apply for authorization to apply aids intended "to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment" -these are called "least favored" or "backward" regions- (Article 93, 3° a) and "to facilitate the development of certain economic activities or of certain economic areas -termed as "development areas"-, where such aid does not adversely affect trading conditions to an extent contrary to the common interest (Article 92, 3° c)[22]. These exemptions allow only aid towards initial investment. Aid towards continued operation, known as "operating aid", does not qualify for authorization, except in backward regions [23].

To assess these incentives a Communication was issued in 1988 addressing the need to establish rates of award which reflect the severity of the regional problem; the need to develop a common method of assessing the value of regional aid; the need for transparency; and the need to restrict regional aid to those areas where it is really justified (Bachtler, 1996).

Backward or "least favored" areas are located in regions which have an abnormally low standard of living (per capita GDP of 75% or less of the EU average) and serious underemployment. Regarding "development areas", a two-stage analysis has to be carried out. In the first place, to qualify for aid under point 3 c, per capita GDP/GVA of the region must be at least 15% below the respective Member State's average, or structural unemployment must be at least 10% above the Member State's average. That figure is then adjusted by reference to an EU average, in such a way that the better the position of the region under consideration compared with the EU average, the greater the disparity there has to be between it and the national average in order to justify the grant of aid. At a second stage results of the first phase are corrected, within limits, to take account of other relevant economic indicators such as the trend and structure of unemployment, the development of employment, net migration, geographic situation or population density[24].

Western European countries do not explicitly promote FDI over domestic projects yet in practice a huge part of incentives are granted to foreign investors; for example, roughly half the value of all regional development aids in Great Britain have gone to FDI between 1984 and 1995. In turn, a significant part of inflows in the EU have enjoyed incentives. For example, nearly 80 per cent of all greenfield FDI in Ireland has received regional aids according to data for the late 1980s[25].

Nonetheless the data on average actual award rates show a decline in most EU countries over the last 15 years. It must also be noticed that actual award rates are markedly below the ceilings. Moreover, government expenditures on incentives have been declining in most countries, either as a response to community controls or because of national budget constraints (Oman, 1999). In fact, the EC has taken a number of steps in order to tighten its controls, including limits to the overall volume and cuts on certain types of aid either because of the sums involved and/or their special potential to distort competition. The reduction has been proportionately higher in the poorest regions (Aranda & Sauvant, 1996).

Direct financial incentives are the most important form of incentive investment in the EU, and they are mostly in charge of national authorities. In turn, indirect financial contributions are mostly granted at local level. Local assistance, even if the amounts involved are in general substantially lower than those offered by the direct incentive programs, is viewed as having a key role in the later stages of inward investment promotion (Bachtler, 1996). Local assistance usually takes the form of labor market subsidies (including mainly training and employment assistance) and property concessions and preparation of potential investment sites.

One of the consequences of these principles has been the tendency towards greater homogeneity in the forms of assistance offered across the EU. At present, in all the countries the main form of assistance is related to initial investment or job creation. Another key consequence is that the poorer regions are authorized to offer higher levels of

22.
There are other exemption clauses in Article 92. For example, state aids can be permissible if they intend to promote the execution of an important project for common European interest (it has been used, for example, to allow subsidies for the development of the Airbus commercial aircraft). Moreover, there are other forms of state aids within the EU, each one with its own regulations, and which have a sectoral (agriculture, fisheries, coal, railways, etc.) or horizontal coverage (SMEs, R&D, environment, employment, etc.).

23.
Besides the state aids, the EU has implemented some instruments designed to foster the development of the less prosperous countries and regions within the Union. These instruments include the Cohesion Fund and some of the so-called EU s Structural Funds -the European Regional Development Fund (ERDF), the ropean Agricultural Guidance and Guarantee Fund (EAGGF) and the European Social Fund (ESF)-.

24.
There are quantitative limits to regional aid. For backward or "least favored" regions the aid cannot exceed 75% net grant equivalent of initial investment. For development regions it cannot exceed 30%, and depending on the category must often be lower. In fact, the quantitative ceilings vary from region to region, and the 75 and 30% limits apply only to regions where development or employment problems are more serious. A single investment can receive both regional aid and other regionally differentiated aid only provided the sum of the regional aid and the regional component of the other aid do not exceed the above-mentioned ceilings. In turn, there is no threshold on national spending on state aids.

25.
Some incentive measures are specially designed to influence international locational choice. This is the case of the capital grant available in Northern

assistance than the wealthier regions. This is reinforced since the EC can forbid regional aids that would relocate an investment from a less to a more prosperous region.

The EC's ordering from most to least transparent incentives is: i) grants; ii) tax reductions; iii) soft loans or tax deferrals; iv) guarantees; v) equity injections. Capital grants in particular are visible and easy to understand for potential investors and they are flexible and relatively easy to administer and monitor both by governments and the supervisory body. According to a recent evaluation, the EU has been succesful in having most aid given through grants and tax reductions in most Member States (Thomas, 1998).

In balance, the EU approach to disciplining incentives appears to have worked reasonably well. It provides a regulatory framework which grants some measure of autonomy for governments that wish to offer incentives (at the national and sub-national level) but it also confers some autonomy for the supervisory body, and it establishes procedures for enforcement and sanctions, which are backed by provisions for judicial review. However, the aid programs have actually reinforced rather than reduced existing differences in locational "attractiveness", since countries authorized to offer the highest award rates tend to be those that most lack the resources to do so[26]. It has also been observed that the fall in aid in less developed countries has been proportionately greater than in more prosperous states and that several advanced areas of the EU offer regional spending that is competitive (on a per-capita assisted basis) with that of poorer European regions (Thomas, 1998). This has led some authors to suggest that it is by no means clear that regional incentive policies have been able to achieve their basic objective, i.e. to stimulate development in less developed regions, when considered at a European level; in fact, the evidence suggests that competition over incentives has favored the more prosperous countries (Oman, 1999).

One reason maybe that the EC addresses its requests for information and its Decisions on State aids to national governments, although increasingly regional and local authorities deal directly with investors. Since national authorities have little motivation to force sub-national governments to respond to the EC inquiries and Decisions, there is scope for local and regional governments to evade scrutiny. Also the EC may ultimately lack the political independence and the administrative authority that it would need to impose its views vis a vis EU governments. The EC decisions on these issues used to generate controversies with Member States. These disputes have subsided in recent years because the EC has shifted away from "drawing maps" and towards defining the proportion of a country's population eligible for regional assistance. There is also a weakening of the EC ability to impose its views, especially on France and Germany. Both have been able to negotiate major increases in the population ceilings which the Commission intended to set, and then to designate the areas eligible for assistance largely on their own terms. These tensions have led to tighter aid guidelines to ensure both the reduction of regional disparities and genuine support for the less-favored regions. The reduction in aid intensities for large firms is of particular importance, seeking, among other things, to offset the potential for regional aid to induce firms to relocate[27]. Besides, the guidelines stipulate that the aided investments and jobs must remain in the region concerned for at least five years. An amendment to the method for choosing regions coming under Article 92 has also been introduced[28]. Regarding large projects, the new framework lays down rules aimed at reducing any competition-distorting effects by lowering the aid ceiling compared with the maximum ceiling of intensity authorized in the region concerned, and this on the basis of three criteria: the capital-labor ratio; the degree of competition in the relevant market; and the impact on regional development[29]. On the other hand, new rules on investment-linked employment aid have also been introduced to enable Member States to provide more support for labor-intensive investments.

B) FDI-RELATED POLICIES IN MERCOSUR

In 1991 the Treaty of Asunción was signed giving birth to the MERCOSUR, a Customs Union which was to be completed by 1995 among Argentina, Brazil, Paraguay and

Ireland, under which capital investment support of up to 30% of eligible expenditure can be obtained for investment projects, but a discretionary award of up to a further 20% can be offered to desirable internationally-mobile projects. The sectoral focus of many assistance programs sometimes favors clearly FDI. This is the case of the Internationally Traded Services Program in Ireland, focused on service sectors with strong international market potential, such as financial and health-care services, which in practice attracts mainly foreign investors since there are few domestic entrepreneurs in those sectors. The emphasis on the technology content of the projects may be also a de facto discrimination in favor of FDI in some countries. Incentives which favor larger size projects can in fact also discriminate in favor of FDI.

26.
For example, Portugal's per capita spending on regional aids is about one-tenth of Germany's.

27.
The rule on large investment projects is a step towards the objective of adopting a single approach to major awards under regional aid schemes regardless of the sector involved (EC, 1998).

28.
The method will henceforth consist of two stages: i) the fixing by the EC of a ceiling on the population covered by the exemptions in Article 92 at Union level and its distribution among Member States; ii) the notification by Member States of the methods and indicators they wish to use in choosing the eligible regions and of the list of regions they propose for exemption under Article 92. At the same time, the EC fixed the ceiling of coverage of regional aid at 42.7% of the population of the EU for the period 2000-2006, a four percentage points reduction on the current coverage.

29.
These three criteria are each translated into a coefficient the value of which varies with the project's characteristics.

Uruguay. In spite of insufficient institutional building and the lack of several basic coordination and harmonization schemes among Member States, the MERCOSUR had a remarkable success in terms of the growth of intra-regional trade and the attraction of FDI. The participation of MERCOSUR member countries in world FDI inflows has increased from 1.4% in 1984-89 to 4% in 1990-98. In fact, these flows have been mainly concentrated in Argentina -where FDI inflows reached more than U$S 40,000 millions between 1990 and 1998- and in Brazil -almost U$S 70,000 millions in the same period-.

At first glance, this would suggest that regional integration has become a key factor of attraction for FDI as was the case in the 1960s with the emergence of the European Economic Community and in the 1980s and early 1990s with the Europe 1992 project. An enlarged market would not only induce a displacement of exports with FDI but also lead to additional FDI to take advantage of economies of scale and specialization and generate growing intraregional trade. Nonetheless, there have been another locational advantages in place both in Argentina and Brazil: the recovery of macroeconomic stability, the high rate of growth of domestic market size (in Argentina), the adoption of structural reforms, etc. Among the latter, privatization became a powerful tool for attracting FDI in both countries.

Moreover, while most restrictions to the operations of foreign firms have been eliminated in MERCOSUR member countries, the growing interest of national and local governments in attracting investment flows have led to the establishment of incentives mostly at regional or sectoral levels (see Chudnovsky & López, 2000 and Laplane et al, 2000, for recent assessments of investment incentives within MERCOSUR). In some cases like the automobile industry this situation has led to some disputes and fears of investment diversion. In this scenario, arguments have been raised in favor of disciplines on incentives within the MERCOSUR.

The MERCOSUR legal framework for investment lies basically in two protocols signed in 1994: the Colonia Protocol for the Reciprocal Protection and Promotion of Investments (called the "intra-zone" protocol) and the Colonia Protocol on Promotion and Protection of Investments from non-Member States (termed the "extra-zone" Protocol). The "intra-zone" protocol contains, among other provisions, the guarantee of Member States to grant NT and MFN rights not only at the post-establishment, but also at the pre-establishment and establishment stages (transitory exemptions are accepted, though no calendar was fixed for their progressive removal[30]). Performance requirements such as export commitments, local purchases of certain goods and services, and the like, are forbidden. However, investment incentives are not mentioned. The "extra-zone" Protocol confers foreign investors NT and MFN rights only at the post-establishment stage. At the same time, there is a ban on positive discrimination in favor of investors from non-Member States. Despite a declaration of principles regarding the need to establish a basic framework to avoid the distortion of investment flows, nothing in this protocol prevents Member States from granting investment incentives.

The core partners in MERCOSUR, Argentina and Brazil, are federal states. In the case of Brazil, sub-national governments have significant autonomy in fiscal matters, while in Argentina fiscal federalism is, in practice, substantially limited. No domestic discipline on incentives exists in Argentina. In Brazil, the federal government has failed to apply existing legislation which authorizes it to impose limits (Motta Veiga & Iglesias, 1997; Motta Veiga, 1999). In sum, there are few, if any, legal constraints for an investment race within the MERCOSUR, neither at regional nor at national levels.

On one hand, since the adoption of Convertibility in 1991 Argentina adopted a sort of "rules-based" competition, based, among other things, on the strict legal protection for property rights, predictability and the adoption of a "market and investor-friendly" policies. However, incentives-based competition was not absent. An automobile regime was established in 1991, including trade related investment incentives as well as trade-related PR for local producers. A regime for mining was adopted in 1993, including a 30-year guarantee of no tax increase for investors. The privatization program, in turn, had some specific features geared to attract foreign investors. FDI showed a strong response to these

To obtain the theoretical ceiling of permissible aid for a large-scale project, the maximum intensity authorized in the region concerned must be multiplied by the three coefficients obtained, provided the product of these coefficients is less than one. Most of the time this is likely to be the case, especially where capital-intensive projects are concerned. Here, the intensity of the aid authorized for large-scale projects will therefore be well below the allowable ceiling for the region in question (EC, 1998).

30.

The sectors which were included in the exemption lists are: real state at frontier zones, air transport, naval industry, nuclear facilities, uranium, insurance and fishing (Argentina); mining, hydroelectric energy, health assistance, radio, TV and telecommunications, rural real state, banking, insurance, construction, fluvial and coastal sailing (Brazil); real state at frontier zones, media; air, sea and terrestrial transport, electric energy, water services and telecommunications, mining, petroleum extraction, import and refining and mail service (Paraguay); electric energy, hydrocarbons, basic petrochemicals, nuclear energy, "strategic" minerals extraction, banking, railways, telecommunications and media (Uruguay). Brazil also made reservations regarding NT and MFN in relation with state purchases. Argentina and Brazil made reservations of the PR included in their respective automobile regimes.

incentives, but was also attracted by the macroeconomic stability, the enlargement of the domestic market and MERCOSUR.

On the other hand, in Brazil significant fiscal decentralization took place during the 1980's, which allowed sub-national governments to develop programs to stimulate new investments. These programs only became successful when macroeconomic adjustment created the conditions for a new cycle of productive investments and for the return of Brazil as a key host country for FDI. In this scenario a phase of intense policy competition between sub-national governments to attract new investments began to take place[31].

Real "bidding wars" among state governments have taken place, though most contracts are secret -lack of transparency being one of the most questioned aspects of this phenomenon. There is evidence also that policy competition has tended to extend to the fields of regulatory derogation's targeted at removing laws or norms which are considered too rigid by companies. Hypothetically, this could be the case of national environmental and labor standards unequally applied amongst regions and states. However, sub-national governments are by no means the only players in policy competition for investments. The Federal Government has also been active in this field, being the main example the automobile regime adopted in 1995, whose explicit motivation was the need to compete with the regime that was in force in Argentina since 1991, which was seen to be diverting investments programmed for the MERCOSUR. The Federal Government has also avoided any kind of control of policy competition at the sub-national level and it made no effort to enforce existing legislation in that area (Motta Veiga, 1999). In fact, when at the beginning of 1999 the Rio Grande do Sul government decided to reduce the incentives promised to Ford and General Motors due to fiscal restrictions, the federal government granted Ford with incentives for a plant in Bahia and announced that fiscal incentives would be available for all firms wishing to produce in the backward zones of the North, North-East and Middle-East of Brazil.

According to Laplane et al (2000), while federal incentives have mainly paid attention to the impact of investments on the trade account of the payments' balance, sub-national incentives were mostly concerned with "demonstration effects" (to attract further investments) and with employment generation. Objectives such as fostering R&D activities or other "spillovers-generating" activities have been mostly absent both at national as well as at sub-national levels.

Strong criticisms have been raised regarding the outcome of incentive-based competition in Brazil. According to Motta Veiga & Iglesias (1997), for example, the subnational dispute to attract automobile industry investments has lost or misallocated funds for the economy as a whole and has become a stimulus to future idle capacity. Although no clear evidence exists, it seems that assemblers and their main suppliers made their investment decisions independently of any state subsidies. However the authors also state that the Brazilian new context has induced sub-national governments to modernize and organize themselves more flexibly with a view to enhancing local competitiveness. In this sense, state governments are "learning not only how to negotiate incentives but to help investors identify investment opportunities, target potential investors, co-ordinate and professionalize their actions, and improve their own learning skills". They also argue that the states most successful in competition for investments are those where the requirements for "good government" seem to be met.

Sub-national policy competition for investments had been relatively insignificant in Argentina during the early 1990s, though some provinces displayed "marketing" efforts to attract investors. This situation changed by 1996-1997, when the "fiscal war" among the Brazilian states began to raise concerns on the Argentinean side, even if Brazil did not operate against the regulations of MERCOSUR but moved into untapped areas (Campos, 1998). At that moment the Argentine federal government could only obtain minor commercial concessions in spite of its complaints, since the Brazilian government alleged that it had no power to cut the states capacity to offer incentives.

31.
The incentive packages of Brazilian sub-national governments typically include state and municipal fiscal and financial incentives and subsidized dedicated infrastructure. State participation in the capital of major ventures, via direct injections or by means of a development fund and subsidized training and qualification of labor force are also present in many packages.

Nonetheless, some Argentine provinces reacted more agressively. Buenos Aires, the most affluent Argentine province, announced a reduction in some provincial taxes for new investments, claiming that it was a response to Brazilian incentives (De la Guardia, 1997). In turn, even if the limited fiscal attributions of the Argentine provinces put relatively low ceilings to sub-national "fiscal wars", there is a significant anecdotal evidence showing an increase in the use of investment incentives in the late nineties. This tendency was reinforced after the real's devaluation in february 1999. In that year, the governor of Córdoba, the second richest Argentine province, announced that he was ready to make the best bid for an investment which the German MNC Volkswagen had decided to install within MERCOSUR (see Chudnovsky & López, 2000, for a description of the incentives granted to Volkswagen). Later on, by the end of 1999 a widespread concern existed because a number of Argentine firms had decided to relocate their plants in Brazil due to the presence of significant incentives. This led many politicians, including provincial governors, to propose retaliation measures against Brazil.

Regarding the perspectives of policy competition within MERCOSUR, there are three factors which could eventually lead to a decrease in its intensity. First, sooner or later budget constraints should lead governments to restrain the use of fiscal and financial incentives, specially if stricter fiscal disciplines are adopted within Argentina and Brazil both at national as well as specially at sub-national government levels. Second, a mandate was included in the new regional automobile regime recently signed by Argentina and Brazil regarding the need to undertake an analysis of the incidence of the different investment incentives which are in place in both countries. Third, a working group was recently established to analyze the investment incentives in place within MERCOSUR countries and evaluate feasible alternatives for harmonization. It can be expected that at least more transparency should be the result of these initiatives, which could eventually be the first step in order to design a framework to monitor and control policy competition for investments within MERCOSUR. This cautious optimism is reinforced since after serious controversies within the bloc in 1999, at present there is a more positive climate regarding the MERCOSUR perspectives. In this light, the decision to advance towards macroecomic convergence goals may also help to diminish the intensity of policy competition for investments within MERCOSUR.

In turn, recent studies about the impact of FDI on Argentina and Brazil have suggested the existence of some issues, which deserve attention and call for more activist FDI-related policies (Chudnovsky & López, 1997, 1998, 2000; Laplane & Sarti, 1997; Laplane et al, 2000). First, though in Argentina and Brazil exports by foreign firms have increased more than exports by domestic firms, the import coefficient of foreign firms also seems generally greater than their export coefficients. Besides, MNCs tend to have huge deficits in their trade relations with developed countries. The contribution of FDI to the growing merchandise trade deficit in both Argentina and Brazil, has thus became a critical issue. While this situation may change in the future, so far only those MNCs engaged in resource based investments are clearly net exporters[32].

Second, technological spillovers seem to be weak. MNCs do not devote significant resources to R&D activities, and have seldom created technological networks with suppliers, customers, competitors or research institutions. Third, in the 1990s MNCs affiliates appear to have destroyed more than created linkages with domestic suppliers, since trade liberalization allowed for a higher foreign content of local production, pari passu with the trend towards a greater reliance on "global suppliers" which is visible, for example, in the automobile industry. (see Motta Veiga, 1999 and Casaburi et al, 1999 for the negotiating implications).

Last but not least, the implications of investment incentives for competition policy have yet to be assessed. In the EU, the competition policy directorate decides whether a proposed incentive may or may not be granted under agreed disciplines. In turn, the need of linking international investment and competition policy issues has been stressed specially by developing countries, which argue that any MFI should be complemented

32. Currently the authors are undertaking a research project on the trade patterns of MNCs affiliates in MERCOSUR countries d on the role played by incentives to attract FDI flows under the "Mercosur Economic Research Network" financed by the International Development Research Centre of Canada.

with an international agreement on international restrictive business practices (see Tavares, 1999, for arguments in favor of cross-border competition policy rules).

MERCOSUR State Members have signed a Protocol for the Defense Competition in 1996 but congressional approval is pending to be enforceable. This protocol provides mechanisms to curb business anti-competitive practices, calls for the convergence of domestic competition laws and provides an agenda for surveying public policies that distort competition conditions and affect trade among member countries. The Protocol calls upon member countries to undertake, within a two year period, preparations to set common standards and mechanisms aids susceptible to limit, restrict, falsify or distort competition and affect trade between the parties (Tavares and Tineo, 1998). The recent enactment of a new Defense of Competition Law (Nbr 25156) in Argentina which tends to alineate Argentinean competition policy regime with that in place in Brazil since 1994, may help harmonization in this area.

Moreover, a technical committee on public policies that distort competitiveness has been operating since 1995, with the goal of identifying government measures affecting competition and decide whether they are compatible with the customs union. Few advances have been made by this committee until now, but the Argentine government is very interested in revitalizing its operation. Nonetheless, as is obvious the committee has not yet been very effective in disciplining competition for investments. However, both the Protocol for the Defense Competition and the technical committee could be the basis on which regional disciplines on investment incentives might be built. The task of introducing these disciplines should, thus, be closely related to the defense of competition and antitrust mechanisms, both at the national as well as at the regional level, following the experience of the European Union.

Developed countries, which are interested in an MFI, are not interest in limiting policy competition, but in higher protection standards and rights for their domestic firms investing abroad.

V. CONCLUDING REMARKS AND POLICY SUGGESTIONS

Despite the arguments against activist FDI-related policies and investment incentives, in the real world most countries have both. These policies and instruments may be implemented at national and/or at sub/supra-national government levels, may be more or less overtly imposed, may be more or less discretionary, may imply few or significant public resources, etc., but the fact is that they exist, and that most countries are reluctant to give them up. Developed countries, which are interested in an MFI, are not interested in limiting policy competition, but in higher protection standards and rights for their domestic firms investing abroad. In fact, incentives-based competition for investments has been growing in recent years, and, contrarily to what one might presume, the developed countries are the main players. At the same time, many developed countries do have specific restrictions for FDI -which they were unlikely to abandon even with the MAI-, and target, through different provisions, preferred FDI operations (i.e. in order to promote backward regions, to develop high-tech sectors, to create jobs, etc.).

In this scenario, without multilateral or regional disciplines, a country wishing to receive higher flows of FDI -or even to preserve the existing operations of MNCs- seems to be almost obliged to engage in some kind of incentives-based competition, specially when it comes to investments in high-tech sectors, or in the automobile industry, for example. Beyond this context other arguments may justify the employment of incentives and PR, and, in general, of FDI-related activist policies:

i) FDI inflows may not always reach the socially desirable volume or composition;

ii) host countries may fail to reap from MNCs potential spillovers;

iii) there could be discrepancies between FDI and host country development objectives.

This is not to say that these kinds of policies are always correct -in the sense that their social benefits surpass their costs-, especially when they give place to "bidding wars". Incentives, in turn, may open the door to rent seeking and bribery, especially when they are of a discretionary nature. Furthermore, FDI-related activist and selective policies may foster domestic entrepreneurship, but may also contribute, for example, to technological backwardness of host countries.

These objections must be taken seriously but the case in favor of incentives and FDI-related activist policies still holds. In any case, these objections call for a better design, monitoring and enforcement of those policies and for a cautious approach which should emphasize the need of reaping more externalities and of attracting specific types of FDI, more than to restrict the entry of MNCs or impose severe restrictions to their operations. More broadly, policy competition for FDI may have some positive externalities, especially when competition is rules-based. Countries have learned that investments are mostly attracted to countries with macroeconomic stability, high rates of economic growth, well-functioning legal systems, etc.. Besides, a key element to attract FDI is the magnitude and quality of what has been termed "created assets" (human resources, technological and communication infrastructure, etc.), which are more prone to attract "high-quality" investments. If governments are impelled to compete on the basis of the quality of their institutions and their human resources, their infrastructure, etc., significant externalities will arise.

All this does not mean, however, that competition at large should be unleashed. In the case of regional agreements, the need of harmonization of FDI-related policies is evident. Even if full harmonization would surely prove impossible, any attempt in that direction may contribute to:
i) avoiding the diversion of regional investment flows;
ii) limiting the amount of resources devoted to bidding wars;
iii) increasing the spillovers to be reaped from MNCs.

At multilateral level without any brakes on competition, developing countries might lose the battle for investments. Developing countries should, thus, make efforts to increase transparency and limit locational incentives at world level, and should also try to constrain the use of other instruments which, in a disguised fashion, are employed to retain investments by developed countries -such as rules of origin or antidumping regulations. A "grand bargain" has thus been suggested (Moran, 1998). Although it could be demonstrated that not only developing countries' but also global welfare would be enhanced by creating a "slightly sloped" playing field in favor of developing countries, the latter would perhaps be better served if a "level" playing field were achieved. In that scenario, developed countries would be forced to abandon or seriously restrict disguised protectionist practices and to limit the use of locational incentives. This if of course only a suggestion that needs to be justified and examined in detail. However, it highlights the fact that at the multilateral level the issue of incentives cannot be treated separately from the other dimensions involved in international trade and investments negotiations.

Developing countries should, thus, make efforts to increase transparency and limit locational incentives at world level.

In balance, since there are many unresolved questions regarding the effects of incentives and PR, the outcomes of policy competition for FDI and the conditions for success of FDI-related policies, a broad research agenda on these issues is left open. Nonetheless, beyond the need for further research on many key areas, in the light of the previous discussions on incentives and FDI-related policies three main policy suggestions arise:
i) Within MERCOSUR, there is a need to establish investment-related disciplines at regional level, to limit the competition for investments, and to re-direct it towards socially desirable objectives. For example, by itself, incentives-based and even rules-based competition will reinforce rather than reduce regional inequalities. In this sense, the adoption of rules similar to those in force in the EU should be of great help to limit "bidding wars" and to orient aids towards those areas with structural problems. Disciplines on investment incentives should

be closely connected with those regarding competition policy. New regional initiatives should also take into account the flaws of the EU disciplines to consider the interests of the less developed regions within the Union. Schemes, similar to EU's structural funds could also help in fostering development in backward regions. At the same time there should be common rules if sectoral regimes are implemented, and existing sectoral policies should be unified, as it has occured in the case of the automobile industry. Last but not least, disclosure of information and transparency could help to limit incentives-based competition, as well as reducing the possibilities of bribery and corruption among government officials.

ii) A more activist approach towards FDI is needed to enhance the benefits which MERCOSUR countries reap from MNCs. Argentina and, to a lesser extent, Brazil, do not seem to meet the pre-requisite for the success of a selective approach towards FDI (as employed in some Asian countries). However, the evidence shows that many countries have implemented successful pro-active strategies including the targeting of priority sectors and the fostering of "spillovers-generating" activities, such as R&D, labor training, domestic linkages, etc. Domestic social or absorptive capability is a key factor to reap benefits from FDI. This includes different policy fields, such as education and training of human resources, institution-building, the creation or development of markets such as capital markets, fostering of domestic entrepreneurship, the enhancement of transport, communications and science and technology infrastructure, etc. Without significant improvements in these areas it will prove increasingly difficult not only to reap spillovers, but also to receive "high-quality" FDI inflows.

iii) Strengthening of the participation of MERCOSUR in regional and multilateral fora where investment issues are discussed. The Free Trade Agreement of the Americas (FTAA) has a Working Group on Investment in operation. The Group is tackling, first, a stocktaking of the existing BITs and national regimes on FDI in Latin American countries and, second, recommendations on the different issues which could be addressed by an eventual agreement on investment in the FTAA.

The issues at stake in multilateral negotiations on investments far exceed that of incentives and PR. For example, both Argentina and Brazil firms have made significant investments abroad, which could benefit from strengthening the guarantees brought about by a multilateral negotiation covering many different issues. Finally, even accepting the idea that a "grand bargain" may arise if an eventual MFI is negotiated at the WTO, MERCOSUR countries should try, as far as possible, and as part of the group of developing countries, to preserve margins for implementing policies which may contribute to align FDI with host-country development objectives and which could foster increasing "high-quality" FDI inflows.

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The Latin American Trade Network (LATN) began its activities in April 1998, with the support of the International Development Research Centre (IDRC) from Canada.

LATN is a network gathering scholars, academic institutions and international organizations. Its main objectives are:

- To analyze the ongoing changes in international trade relations in response to the expansion of the trade agenda, the diversification of the negotiation fora and the growth of new coalitions
- To support the process of agenda-building and policy formulation in Latin American countries in light of the new trends of the international trade system
- To promote professional development and research capabilities in Latin American countries
- To strengthen institutional links and cooperation among the participating institutions with the aim of sustaining the long-term goals of the network

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