Multilateral Agreement on Investment (MAI): Policy Implications for Developing Countries

BY MARTIN KHOR

WORLDWIDE INTEREST and controversy on foreign investment policy has been sparked recently by the proposal of some developed countries to introduce a legally binding regime on foreign investment. This is taking place in the World Trade Organization (WTO) and the Organization of Economic Cooperation and Development (OECD).

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AT THE WORLD Trade Organization (WTO), some developed countries, led by the European Union (EU), are attempting to introduce a Multilateral Investment Agreement (MIA). At another level, a Multilateral Agreement on Investment (MAI) is being negotiated by the OECD member countries, which OECD later plans to open for other countries to join. The acronyms shift from MIA to MAI, but the two models are basically the same.

The MAI aims to protect and advance the rights of international investors vis-à-vis host governments and countries. The main elements are:

- The right of entry and establishment of foreign companies to enter and establish themselves in almost all sectors of a country, except security. This means that a government will lose its authority to determine which foreign investor it would allow or disallow from entering the country.
- The right to full equity ownership. This means that a government would not be allowed to require foreign companies to allow a portion of their equity to be locally owned, or form joint ventures with local firms or the state.
- National treatment. This means that a foreign company would have to be treated on equal or better terms than a local company, and that governments could not give more favourable treatment to local firms—for example, in granting contracts, allowing local banks to set up more branches, etc.

- Removal of the many regulations and conditions now imposed on foreign companies by host governments (e.g. movement of personnel, performance requirements, allowing foreign firms to take part in privatisation projects).
- Protection of foreign investors in regard to discrimination, intellectual property,expropriation, compensation, transfer of funds, and taxation, and full compensation if asked to close or taken over;
- Establish a dispute settlement system to make the agreement legally binding and enforceable.

The MAI is therefore very biased in favour of foreign investors' rights. Barriers would be removed to allow international companies to cross borders, set up projects or buy up local companies. Under MAI, they would face minimal or no regulations in host countries as to conditions for the establishment, ownership, and operation of business, as well as the repatriation of profits and capital. Moreover, the MAI would impose no obligations on the foreign investor to respect the sovereignty or social and development objectives of host countries.

But host governments would have many new and heavy obligations towards foreign investors. MAI would very significantly narrow, reduce and constrain the rights, authority, degree of freedom and policy options of host countries and governments in the following economic

BASIC DATA ON FOREIGN INVESTMENT AND TNCs

Global foreign investments amounted to US$349 billion in 1996, representing 10 per cent growth on top of the all-time peaks in 1994 and 1995. This rate exceeded annual global growth rates for gross national product (6.6 per cent) and international trade (4.5 per cent).

The scale of economic globalization is much greater, as measured by the activity levels of transnational corporations (TNCs).

- There are 44,000 TNCs in the world, with 280,000 subsidiaries
- Their annual turnover is $7,000 billion.
- In 1996 they invested $ 1,400 billion in countries where they were already active.

TNCs generate two-thirds of world trade.

- They controlled almost 33 per cent of world gross domestic product in 1995.
- Fifty-one of the world's largest economies are in fact TNCs.
- Almost every sector of the global economy is controlled by a handful of TNCs.

Sources: UNCTAD figures, MAI briefing paper by Corporate Europe Observatory - CEO (Amsterdam, Feb. 1998) areas: policy on foreign investment and investment in general; macro-economic management; policy and performance on trade, current and capital account and the balance of payments; development planning; policy on the balance of ownership of equity and assets between foreigners and locals and amongst various communities within the country; and growth and development policy at sector level (industry, agriculture, trade, finance and other services). Local firms would lose their present rights to receive more favourable treatment from their governments and to be protected from bigger foreign firms so as to survive and develop.

As the proposed MAI would cover almost all sectors (defense being an exception), the narrowing or loss of policy options in host countries would also apply to social sectors and services. This could have significant implications for social and cultural policy and practices.

RESPONSE TO MAI FROM ASIAN COUNTRIES

In March 1996, a workshop was organised by the OECD Secretariat in Hong Kong to explain the MAI to 12 selected "dynamic developing countries". Most of them were from theAsian region, including China, India, Malaysia, Indonesia, Korea, Singapore, and Hong Kong. Participants from some key Asian countries were cool and generally unfavourable to the proposed MAI. They raised several concerns and objections on the substance, procedures and institutional context of the proposed rules.

As explained by OECD officials, main goals of the MAI are to liberalise the terms of foreign investment, protect foreign investors' rights, and establish a legally binding dispute settlement system. They kept stressing that the MAI was aiming at "high standards" of investment liberalisation and investor protection—far higher than exist even in OECD countries.

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The most interesting feature is that MAI, though initiated by and negotiated amongst OECD countries, is actually intended to be of a global nature, open to all countries to join. Most non-OECD participants were critical of not having been invited to participate in the establishment of the MAI. The chairman of Malaysia's Industrial Development Authority, Mr. Zainal Abidin Sulong, said "whatever we say won't affect the process much." He explained that Asians are sensitive to how they are drawn into a process, and there is considerable discomfort when they are asked to accede to a treaty without being given an opportunity to get directly involved in its shaping. The process could even be seen as objectionable—the equivalent of "accede without representation." He concluded that "If this MAI is intended for global accession, then it has to be a global process, and all countries need to be more directly involved."

More generally, Mr. Zainal saw problems arising from the contrast in Western and Asian approaches to negotiations.

OECD took a top-down approach to the MAI, while the Asia-Pacific region preferred a bottom-up approach. The dynamic growth of the Asia-Pacific region is based on a highly pragmatic approach towards resolving problems and proceeding to the next stage. Regarding the OECD proposal, Mr. Zainal believed the Asia-Pacific region would want a more evolutionary and not a regulatory approach, and could be expected to have a negative response to MAI.

Another objectionable point was that the MAI is supposed to achieve a "high standard", and this had been cited as the reason for confining negotiations to OECD countries. The worrisome assumption seemed to be that if non-OECD member countries were involved, standards would have been compromised.

Mr. Zainal stressed that there were two sides to the issue of investment. Since the entry of foreign firms could also have an effect on domestic firms, there is a local concern regarding global liberalization and a domestic dimension to foreign investment. Both aspects had therefore to be considered. The issue, said Zainal, "is not investment liberalisation per se but the effective and mutually beneficial management of this liberalisation".

Participants from other Asian countries also raised similar concerns about the MAI process. In addition, they questioned whether the contents of the proposed MAI would be advantageous to developing countries. An Asian participant said that the MAI stressed the rights and interests of foreign investors, but had nothing to say on the rights of host countries and the obligation of investors to observe the laws of host countries. She insisted that the protection of a host country's interests and rights and observance of domestic laws should be a crucial part of an investment agreement.

She agreed with the general view that foreign investment plays a positive role. However, each country has a different situation, since countries are at different stages of development. Each country has the right to set up its own investment regime based on its own social and economic conditions. Although a lot had been said about the need for a MAI with "high standards", what was more important was a balanced, successful agreement, acceptable to most countries. She said, "If an agreement is of high standard but is not acceptable, then it would not be a good or successful one. The MAI should look at the rights of both sides. If only one aspect is stressed, things will go wrong."

MAI seems to lack balance. It would grant rights to investors without placing any obligations on them, but place obligations on host countries without giving them any rights.

Participants from two other ASEAN countries shared the view that MAI seemed one-sided. One of them said that an agreement usually involved a quid pro quo. On the one hand, MAI seemed to grant rights to investors without placing any obligations on them. On the other hand, host countries would have obligations but no rights. This shows the lack of balance between the interests of investors and host countries.

Not all non-OECD countries were so skeptical. Participants from Hong Kong and Argentina were strongly in favour of the OECD's MAI process, while participants from a few other countries appeared to prefer a wait-and-see approach.

NEED FOR NATIONAL REGULATIONS AND POLICIES ON FOREIGN INVESTMENTS

The major issue in regard to the MAI or the MIA is not whether foreign investment is good or bad, welcomed or unwelcomed. The real issue is whether national governments should retain the right and power to establish policy instruments, options and regulations covering investment, including foreign investment.

Most countries presently accept the importance of foreign investment and are trying their best to attract foreign investors. However, there is evidence that foreign investment can have both positive and negative effects. A major objective of development policy is to maximise the positive aspects while minimising the negative, so that, on balance there is a significant benefit. Experience shows that, for foreign investment to play a positive role in economic and social development, governments must have the right and power to regulate its entry as well as the terms and conditions of its operation. The key problem is that the proposed MAI would remove these government rights and powers. By doing so, the negative aspects of unregulated and uncontrolled foreign investment inflow could overwhelm the positive aspects.

Most developing countries now have policies that regulate the entry of foreign firms, and include various conditions and restrictions governing foreign investment in general and on a sector-by-sector basis. Few countries (if any) have adopted a policy granting total right of entry. In some countries, foreign companies are not allowed to operate in certain sectors, for instance, banking, insurance or telecommunications. In sectors where they are allowed, foreign companies have to apply for permission to establish themselves, and if approval is given it often comes with some conditions.

Of course the mix of conditions varies from country to country. They may include equity restrictions; for example, a foreign company cannot own more than a certain percentage of the equity of the company it would like to set up. There may be ownership restrictions; for instance, foreigners are not allowed to own land or to buy houses below a certain price.

Many developing countries also have policies that favour the growth of local companies. Tax breaks may be available for local companies, but not to foreign firms. Local banks may be given greater scope of business than foreign banks. Local firms may be given preference in the allocation of government business or contracts.

Generally, governments base such policies and conditions on national sovereignty, holding that a country should control at least a significant part of its

MALAYSIA: DOMESTIC SOCIAL OBJECTIVES AND FOREIGN INVESTMENT POLICY

Malaysia has combined liberalisation and regulation in a policy mix that can be fine-tuned according to the country's economic condition and development needs. Flexible policies were especially needed to redress social imbalances among ethnic communities in the country. Without such policies, it is doubtful the country could have attained the social stability that underlay its high economic growth.

In 1970, 13 years after independence, the foreign share of equity was still 70 per cent; the share of the majority Malay community, with 55 per cent of the population, was 1 per cent; and the share of non-Malay citizens was 22 per cent. Then a new development policy was introduced, requiring foreign companies to enter Malaysia on a joint-venture basis. Terms were set that 50 per cent of equity went to locals, and of that 30 per cent to the Malay community.

As a result of differential shares of growth going to different communities, the shares of equity have changed dramatically. The foreign share is now around 35 per cent, the Malay share has grown from one per cent to 20 to 30 per cent, and the share of non-Malay citizens is about 25 per cent. Such an outcome would not have been possible if there had been such constraints as are now being proposed in MIA and MAI.

own economy. Or the policies are justified in the interest of national development, considering that local firms need special treatment at least for a time until they can compete with more powerful and better endowed foreign companies.

Moreover, most developing countries would argue that during the colonial era, their economies were shaped to the advantage of foreign companies and financial institutions, usually belonging to the colonising country. Local people and enterprises were therefore at a disadvantage, and currently require considerable time and special treatment before they can compete on more balanced or favourable terms with bigger foreign companies. This has been the central rationale for developing countries' policies in applying restrictions or imposing conditions on foreign investments.

The MAI proposes to liberalise foreign investment flows in a comprehensive manner and would therefore have serious consequences. Governments in developing countries would find that the space for adopting their own independent policies regarding investments and foreign companies will be very severely restricted. No longer will each govern-

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ment have the freedom to choose its own particular mixture of policies and conditions on foreign investments. The major policies would be already determined by the multilateral set of investment rules, and the choice available would be very much constrained to more minor aspects.

PROTECTING BALANCE OF PAYMENTS, PROMOTING DOMESTIC DEVELOPMENT

One of the most important effects of the MAI would be that governments will find it much more difficult to control the balance of payments (BOP), and especially to take measures to get out of balance of payments deficit problems. A critical disadvantage or danger of foreign investment is its tendency to lead to a net outflow of foreign exchange and thus have a negative effect on the balance of payments. This is why government policies to regulate foreign investment are important. In southeast Asia, countries like Malaysia, Thailand, Indonesia and the Philippines are now facing large deficits in the BOP current account. On further analysis, it is found that the large inflows of foreign investment have contributed significantly to the deficit.

Take the case of Malaysia. The BOP current account deficit has risen from M$7.4 billion in 1993 to M$17.8 billion in 1995, reaching 9 per cent of the GNP and causing great concern in the country. The main reason for this rising deficit was the increase in foreign investment:

- First, there was a jump in imports of capital goods and intermediate goods by foreign investors, and this had a negative effect on the merchandise trade balance.

  According to the Deputy Finance Minister: "The rise in the trade deficit (in 1995) is mainly due to an increase in the import of capital goods brought in by foreign investors. If not for foreign investments in 1995, Malaysia would have recorded a large excess in the trade account." He said foreign investment rose 26 per cent in 1995 to M$20 billion, and imports of capital goods through these investments accounted for M$18.5 billion.
- Second, there was a steep and fast increase in the repatriation of profits and dividends by foreign investors. As the stock of foreign direct investment rises, the stream of "investment income" flowing out also increases rapidly. In Malaysia, the weakness of the BOP is the large deficit in the services account. In 1995, the deficit was as high as M$18.8 billion, or 9.4 per cent of GNP, compared to M$9.7 billion in 1990. Of this, M$13.4 billion was gross investment income of foreign companies, at about seven per cent of GDP value. According to Malaysia's top economic planner,"outflows for investment income payments, particularly repatriation of profits and dividends for foreign-owned companies, is the single major contributor" to the services account deficit.

To counter the impact of profit outflow, one option is to persuade a foreign company to re-invest its profits in the country. But further reinvestment by foreign firms leads to a higher stock of foreign capital and thus a higher future stream of profits and dividends, which eventually may be repatriated. The dilemma is that present effects of profit outflow are reduced, but even higher streams of profit potentially arise in future. The problem is thus not solved but postponed, and to a potentially higher level.

The more permanent solution is to ensure that foreign investment in the country does not cause large foreign exchange outflows in net terms. Ways of doing this are to welcome foreign firms that export a large part of their products, or give firms permission to enter only on condition that they do not create high foreign exchange losses. Such loss can be avoided, for example, by exporting enough of their products, and by limiting their imports through the use of local inputs.

Some foreign companies enter a country in order to exploit its market, rather than to export from it. This displaces products or services previously provided by local firms, and tends to generate foreign exchange loss and BOP problems. Countries with a large market like China or India will face this problem more, because foreign companies are attracted to producing for the large population and local market there.

To strengthen the BOP, governments need to retain the authority and option to regulate foreign investment, reduce imports of goods and services, and promote exports of local firms and services. These options are already being severely curtailed by the new Uruguay Round rules in the WTO and that the MAI would make the situation worse.

In the past and at present, governments have adopted so-called "performance requirements" under which firms must use specified local inputs, or a percentage of the output value must be locally sourced (local content policy); restrict imported inputs of a firm to only a certain percentage of its export earnings (balancing of foreign exchange policy); restrict a commodity or product from being exported, for instance, by imposing a ban or limiting exports to a certain percentage. All three of these policy measures have been made illegal by the trade-related investment measures (TRIMS) agreement of the Uruguay Round, on the ground that they discriminate against foreign products or foreign trade. Of course, the removal of these policy measures would make it more difficult to resolve balance of payments deficits. Developing countries have five years from January 1995 to implement this rule, though in coming negotiations it may be possible to reconsider the fairness of such prohibitions.

The MAI would make the situation worse. Governments now control the quantity and quality of foreign investment and can limit the percentage of foreign equity, preferring joint ventures so that a share of the profits is retained by locals. Some countries limit the outflow of profits. These measures would be outlawed. Inability to regulate entry will increase the foreign share of equity. Removal of joint-venture arrangements would further raise foreign equity. Together these would raise the foreign share of profits in the economy. Given international trends, corporate tax is being progressively reduced. If foreign profit outflow is too high and can threaten the BOP or reserves and financial stability, the option of limiting profit repatriation would not be available.

Measures to reduce imports and use of foreign services and to increase use of local products, services and facilities are important for reducing BOP deficits and developing the economy. The enhanced disciplines in the WTO already make this more difficult, and the proposed MAI would make it still more difficult.

Under the Services Agreement (GATS) in the WTO, policies discriminating in favour of local services, facilities or enterprises are not to be allowed. Under MAI, such "national treatment" measures benefitting domestic investors would have to be extended also to foreign investors. MAI would include all sectors and activities that are not specifically excluded. Any "affirmative action" measures that promote local industries or services through subsidies, preferential tax treatment, specified conditions for investment, or even support for Research & Development could be seen as "discriminatory" against foreigners and thus prohibited.

EFFECTS OF FOREIGN INVESTMENT AND CONDITIONS FOR ITS USE

In considering the implications of a MAI, it is important to examine the effects (positive and negative) of foreign investment on developing countries, and the conditions for the successful use of such investments. The question should then be asked whether these conditions for success will be promoted or disallowed under a MAI.

A leading Malaysian economist, Dr Ghazali Atan, has done a study on the effects of foreign direct investment (FDI) on trade, balance of payments and growth in developing countries. The study empirically examines various facets (effects on savings, financial inflows and outflows, trade and growth), which he then builds into a model with equations on each aspect and an equation to capture the total or combined effects. Its main findings are summarized in the table below:

FDI EFFECTS ON INFLOW/OUTFLOW OF FUNDS AND BALANCE OF PAYMENTS

Category of effect:	Positive	Negative
Financial flows	Inflow of foreign capital	Outflow of profit, royalties, and revenues/incomes
Trade flows	Increased export earnings	Increased import of capital goods
	Savings from reduced imports	Increased import of intermediate and consumer goods

The study showed that successful growth in developing countries is premised essentially on raising the domestic savings rate to a high level and productively investing the savings. This is more important than the role of foreign capital (including FDI) which can help supplement domestic savings but also has its downside. There are three types of foreign capital inflow: aid, debt and FDI. FDI has many advantages (bringing in productive capital, foreign expertise, brand names, market linkages, aiding in industrialisation, exports, employment).

However, the impacts, disadvantages or costs of FDI also need to be managed to ensure a net positive outcome. For example, FDI has a negative effect on domestic savings, as it gives room for the recipient country to increase its consumption. Also, FDI affects the flow of foreign exchange through two accounts:

- **Financial.** FDI brings in capital, but also leads to a stream of outflows of profit and other investment income. This outflow increases through time as the stock of foreign capital rises. Thus, FDI has a tendency to lead to "decapitalisation". Comparing aid, debt and FDI, the study finds that because of the much higher rate of return of FDI compared to the interest paid on aid or debt, the "decapitalisation" effect of FDI is greater than for aid or debt. The study documents this finding by empirical studies of several cases.
- **Trade.** FDI has a positive effect through higher export earnings and savings on imports (for products locally produced. But it has a negative effect through higher imports of the intermediate and capital goods on which it relies heavily, and sometimes by raising imports of consumption goods.

To maximize positive and minimize negative effects and ensure successful use of FDI, the study recommended that countries should observe the following eight preconditions:

- Availability of foreign capital should not be allowed to detract from domestic savings efforts.
- The factor payment cost must be minimised and prudently managed.
- Joint ventures should be encouraged or required so that part of the returns accrue to locals and the local economy.
- Get foreign firms to list themselves on local stock exchanges.
- To enhance positive trade effects, concentrate FDI in the tradable sector, especially in export-based activities.
- Local content of output should be raised over time to improve trade effects.
- Obey Moffat's rule that growth of domestic investment should exceed FDI growth.
- To avoid reliance on foreign capital, increase the savings rate and maintain sound economic and political conditions.

The author of the study, Dr. Ghazali, advises that "countries using FDI without regard to the above conditions would do so at their own peril. Any moves designed to prevent host countries from instituting such policies, however they are couched, are moves designed to keep developing countries at the bottom of the global economic ladder…With the correct policies, FDI can be of great help to host countries. Without the correct policies, however, the use of FDI can lead to severe problems especially with regard to the long-term viability of the recipient's balance of payments."

ALTERNATIVE BALANCED APPROACH

The approach taken by the MIA-MAI proponents—greatly expanding the rights of international investors while greatly reducing those of host governments—contrasts with some earlier attempts within the UN system to set up an international framework on foreign investments. The most well known was the draft UN Code of Conduct on Transnational Corporations, which was negotiated for a decade from 1982 to the early 1990s. It attempted to balance the rights and obligations of foreign investors and host countries and had sections on each "Activities of TNCs", and "Treatment of TNCs". The draft stated that TNCs have a right to fair and equitable treatment. It also recognized the right of states "to regulate the entry and establishment of transnational corporations, including determining the role that such corporations may play in economic and social development and prohibiting or limiting the extent of their presence in specific sectors." Unfortunately, in the early 1990s the Code process was abandoned, mainly because some developed countries did not favour the obligations the Code would place on TNCs.

At the same time, developed countries initiated negotiations on Trade Related Investment Measures (TRIMS) in the GATT "Uruguay Round" of trade negotiations. The TRIMS proposal initially contained a first part on foreign investment policy *per se*, including the right of entry and establishment of foreign companies and granting of national treatment to them. This part was dropped when many developing countries objected, stating that governments have the sovereign right and the necessity on development grounds to regulate the entry and terms of operation of foreign investments. Another objection by developing countries, that GATT was not the competent body to deal with the issue, was also accepted.

However, a second part of the TRIMS proposal, covering such investment measures as local content policy which directly affect trade, was retained as the present TRIMS agreement in the WTO. Developed countries are now trying to bring back the rejected first part in WTO through the phrase "trade and investment" (no longer "trade-related investment measures"). Their main aim is to start negotiations towards a MIA and thus regain what was eliminated from the Uruguay Round covering the issues of investors' rights, investment policy per se and the investment regime as a whole. The response from developing countries is that these issues not only were dropped from the earlier TRIMS proposal and not meant to be brought into the WTO framework, but also fall outside the competence or legitimacy of the WTO.

CONCLUSIONS

There is an important role for foreign investments in developing countries, and objections to the MAI treaty do not arise out of any bias against foreign investment per se. Rather, the experience of countries that have made successful use of foreign investment underscores the importance of host governments having decision-making power and policy options over the entry, terms of equity and operations of foreign investors.

An international regime that would reduce or take away those rights and give total freedom and rights to foreign investors may lead to the disappearance of many local enterprises, higher unemployment, greater outflow of financial resources, and therefore to balance of payments problems. It may also worsen social imbalances within society, thereby causing social instability which will offset economic prospects (see Malaysia box above).

The MAI and the MIA are not the only models for establishing relations between foreign companies and host governments. Another approach was earlier attempted in the draft UN Code of Conduct for Transnational Corporations, in which the rights and obligations of foreign companies and the rights and obligations of the host governments were spelled out. Efforts to establish this Code of Conduct were ended in 1992, but the draft is still useful as an example of an alternative approach.

Striking a proper and fair balance is important for foreign investors and the host countries which have different goals and interests:

- Investors from foreign countries want to come to developing countries to pursue their aims of getting higher return on capital than in their home country, combining their capital with the cheap labour of the host country to reduce the cost of production, and utilizing the raw materials of developing countries near their source.
- Host developing countries, on the other hand, are interested in strengthening their services and infrastructure to help in industrialization and development, producing exportable goods, and achieving continuous technological development in their industrial production and services.

These two sets of objectives are not incompatible. The interests of foreign investors and host governments, although different, may be harmonized. But it is critical that any FDI meet both sets of objectives.

From the point of view of a developing country, the government must have the right and power to determine the entry and conditions of foreign companies, so that the country's development objectives can be fulfilled. The MAI would cause a great imbalance in the relation between the host country and the foreign investor. Thus in its present form, it would be unwise for developing countries to enter into such an agreement. ■