THE RELATIONSHIP BETWEEN TRADE AND FOREIGN DIRECT INVESTMENT AND THE IMPLICATIONS FOR THE WTO

by

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The Relationship between Trade and Foreign Direct Investment and the Implications for the WTO

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Abstract

This thesis challenges the conventional postulate of trade and foreign direct investment (FDI) as parallel and comparable international business modes. This thesis, based on the nature and function of FDI, argues that FDI is a neutral capital flow that underpins both international production and independent intra-firm trade, and therefore, FDI always supports trade in international production and distribution. Then, this thesis examines the impact of trade measures on FDI and FDI measures on trade respectively. It concludes that except for liberal trade and FDI measures, restrictive and incentive trade and FDI measures restrict or distort both trade and FDI and therefore reduce domestic and/or worldwide economic welfare. Therefore, governments should abandon restrictive and incentive trade and FDI measures, or endeavor to discipline these measures through multilateral arrangements. Lastly, this thesis argues for a Multilateral Agreement on Investment (MAI) under the WTO regime, and demonstrates that the proposed MAI is compatible with the WTO regime.
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CHAPTER ONE
INTRODUCTION

THE PURPOSE OF THE INTRODUCTION is to demonstrate the significance of the study of the relationship between trade and foreign direct investment (FDI) by indicating the strong linkage between trade and FDI from relevant trade and FDI figures and other empirical evidence.

I. DEFINITIONS

A. The Definition of “Trade”

“Trade” in this thesis refers to cross-border exchange of merchandise goods or trade in goods. Local or domestic sales of goods and services are not regarded as trade for the purpose of my study. Normally, trade should include trade in goods and trade in services. Since trade in goods is distinct from trade in services, this thesis will focus on trade in goods because of space and time constraints. Nevertheless, trade in services is becoming increasingly important in international trade. It accounted for almost 20% of total world trade in 1998, and its share of world trade is steadily growing. Another important development with respect to trade in services is that it has been formally recognized as a type of trade. Domestic service trade policies have been subject to discipline under the WTO regime known as the General Agreements on Trade in Services (GATS) since 1995. Trade in services likewise has a close relationship with cross-border investment.

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Policies regulating services may have dynamic effects on related FDI, and FDI may have impact on service trade. The GATS to some extent regulates service-related FDI for the first time in the WTO regime. Article 1:2 of the GATS defines “trade in services” as encompassing four modes of supply, including the supply “by a service supplier of one member, through commercial presence in the territory of any other member”. The term “commercial presence” is defined in Article XXVIII (d) as “any type of business or professional establishment, including through the constitution, acquisition or maintenance of a juridical person, or the creation or maintenance of a branch or a representative office, within the territory of a member for the purpose of supplying a service.” Since the establishment of a “commercial presence” in a foreign country normally involves a FDI commitment, the grant to foreign-service suppliers of the rights of entry, establishment and operation by the relevant clauses under the GATS can be interpreted as extending such rights to service-related FDI. Consequently, the national treatment and Most-Favored-Nation (MFN) principles and other basic rules under the GATS can be applicable to service-related investment. However, we should note that these rights for trade in services and impliedly, for service-related investment, are subject to the limitations and/or conditions on market access and national treatment that a member has specified in its Schedule of Specific Commitments.

B. The Definition of “Foreign Direct Investment”

According to the WTO, foreign direct investment (FDI) occurs when an investor based in one country (the home country) acquires an asset in another country (the host country) with the intent to manage that asset. This definition stresses that FDI is an asset.

The United Nations Conference on Trade and Development (UNCTAD) defines FDI as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity (the foreign direct investor or parent enterprise) of one country in an enterprise (foreign affiliate) resident in a country other than that of the foreign direct investor. This definition does not tell us what exactly an investment is.

The International Monetary Fund (IMF) defines FDI as capital in any of the following three forms:

1) Equity capital. This is the value of a foreign investor’s investment in shares of an enterprise in a foreign country. An equity capital stake of 10 per cent or more of the ordinary shares or voting power in an incorporated enterprise, or its equivalent in an unincorporated enterprise, is normally considered as a threshold for the control of assets. This category includes both mergers and acquisitions (M&As) and “Greenfield” investments (the creation of new facilities).

2) Reinvested earnings. Reinvested earnings are a transnational corporation’s (TNC) share of affiliate earnings not distributed as dividends or remitted to the TNC. Such retained profits by affiliates are assumed to be reinvested in the affiliates. Reinvested earnings can represent up to 60 per cent of total outward FDI from countries such as the United States and the United Kingdom.

3) Other

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3 See the WTO Annual Report 1996, p. 46.
capital. It refers to the short or long-term borrowing and lending of funds between TNCs and their affiliates. The IMF definition emphasizes FDI as capital.

In practice, many countries define FDI in both of two ways. For statistical purposes, FDI is defined as foreign capital that a foreign firm or individual intends to bring or actually brings into the host country for a long-term business operation. For legal purposes, FDI is treated broadly as the entire business operation undertaken by a foreign firm or individual in the host country.

Based on these authoritative definitions and the common FDI practice, I define FDI as assets that are controlled and managed by a foreign firm or individual in a host country for a long-term business operation. An asset is property or an item controlled by an economic entity as a result of a past transaction or event. Assets can be categorized into three basic types: current assets, fixed assets and intangible assets. Current assets are cash, accounts receivable, materials and inventories that in the ordinary course of operation are likely to be consumed or converted into cash within 12 months of the last financial year. Fixed assets include items such as buildings and machinery. Intangible assets include patents and goodwill, etc. An asset as FDI can be a foreign asset that is brought into the host country by the foreign firm or individual, or it can be an asset that is borrowed by the foreign firm or individual in the host country. However, host countries normally require a foreign firm or individual to bring in some assets from foreign source in order to qualify itself/himself as FDI. A long-term business operation must be a production facility, a trading entity, or a service presence.

7 Ibid.
Portfolio foreign investment, which takes the forms of foreign stocks, bonds and other financial instruments, is distinct from FDI in that there is no intention to manage the invested assets. Since portfolio investment does not serve the function of international production and distribution of goods, it does not have any link with trade. Therefore, it is not relevant to the thesis and will not be discussed or dealt with here.

C. The Definition of “Transnational Corporations”

Transnational corporations (TNCs) are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is a firm that controls assets used in international production, merchandise trade, or service trade. A foreign affiliate is an incorporated or unincorporated enterprise in a (host) country in which a firm resident in another (home) country has a stake that permits a lasting interest in the management of that enterprise.

II. RECENT TRADE AND FDI FIGURES

According to the latest world trade figures, the value of world merchandise trade in volume terms (that is, measured at constant prices and exchange rates) in 2000 reached nearly $6.2 trillion, an increase of 12.5% over the 1999 volume and the fastest rate of growth in more than a decade. The growth of world service trade was less dynamic than that of merchandise trade, due to the lacklustre performance of commercial service exports over the last two years.

8 See UNCTAD, Supra note 4.
9 Ibid.
There has been a dramatic increase in world FDI flows in recent years. Between 1990 and 2000 the US dollar value of world FDI inflows more than quintupled. Growth has been especially strong since 1997, with average annual growth in FDI inflows of more than 33% in 1998-2000. In 2000, FDI inflows, driven by the wave of M&As, reached a record total of more than US$1.1tn.\textsuperscript{11}

Comparing recent trade figures with FDI figures, we learn that, although the absolute amount of annual FDI inflows is about one-sixth of annual world merchandise trade, the annual growth rate of FDI is much greater than that of world trade. The WTO estimates that, over the period 1973-95, the estimated value of annual FDI outflows multiplied 12 times (from $25 billion to $315 billion), while the value of merchandise exports multiplied 8.5 times (from $575 billion to $4,900 billion).\textsuperscript{12} It is difficult to predict whether the absolute amount of FDI could exceed that of world trade in the near future.

### III. THE REASONS BEHIND FDI GROWTH

There are many reasons behind the surge of FDI in the past two decades. I summarize those reasons from related FDI and trade reports and papers addressing both macro- and micro- economic aspects.

From a macroeconomic perspective, there are four main reasons for this growth. First, continuing world economic growth in the past decade, notably, the continuing economic expansion in the US and the rapid recovery of Asian and Latin America countries from recent financial crises boosted TNCs confidence in their global strategy. Second, the substantive reduction of trade barriers in tariffs and non-tariff barriers through the

\textsuperscript{11} See World Investment Prospects, The Economist Intelligence Unit, February 12, 2001,
multilateral trade liberalization arrangements has significantly reduced transaction costs related to international production and sales, thus raising the efficiency of FDI. Regional free trade arrangements have stimulated intra-regional FDI flows. Third, paralleling trade liberalization efforts, most nations have liberalized their domestic FDI policy regimes towards a more investment- conducive and -friendly environment. These FDI liberalization efforts, which resulted from the recognition of the overall benefits of FDI, combined with active endeavors by nations to improve the physical infrastructure for investment, have considerably reduced investment and production costs as well as provided greater security for investment. Fourth, structural reforms and adjustments in many countries, characterized by privatization and deregulation, provided greater opportunities for foreign investors to buy or invest in formally restricted industries. Deregulation and improved competition policy enhanced FDI in the form of M&As in industries such as telecommunication, electricity and financial services.

From a microeconomic perspective, there are two main reasons for growth of FDI. First, intensified competition in domestic and overseas markets forced firms to internationalize their production and sales worldwide so as to seek and maintain competitive advantages. Following the liberalization of domestic trade and investment policies and the integration of world markets, international business undertakings have become imperatives rather than opportunities in consolidated corporate strategies. Accordingly, there is a shift from “Greenfield” FDI, which means setting up a new facility, to mergers and acquisitions (M&As) in TNCs global business strategy. It is estimated that between 1985 and 1994, http://www.eiu.com/latest/502720.asp, (visited April 6, 2001).

12 Supra note 3.
M&As accounted for between 50 and 60 per cent of all new FDI. As Dunning points out, the driving force behind the increasing use of M&A by TNCs as the primary mode for FDI is not to exploit existing ownership-specific advantages, but rather to protect or augment such advantages, so as to survive global-scale competition. Second, transport and technology advancements, e.g., cheaper and faster transport methods, information technology innovation, have greatly reduced transaction and coordination costs, thereby enhancing the efficiency of cross-border investment and trade. Far-reaching organizational change is taking place as a result of e-business and new technology, which are transforming the value chain for many industries. Vertical integration and ownership of physical assets are becoming less important; co-ordination of intangible assets is becoming crucial.

Among these reasons, trade liberalization endeavors made in the past 50 years, especially since the 1990s, along with investment liberalization efforts in the past two decades in many nations, are two fundamental reasons behind the FDI growth. Trade liberalization through tariff reduction and non-tariff barrier dismantle has dramatically reduced transaction costs and improved trade-related regulatory efficiency, making FDI-related transactions viable and profitable. FDI liberalization through deregulation, privatization and investment protection not only has considerably reduced FDI-related costs, but has also provided both opportunities for and confidence in FDI. The intensified competition among firms is only the secondary reason after trade and FDI liberalization because competition is the norm in business, and firms must respond and adjust to intensified

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14 Ibid.
competition by seeking competitive advantages wherever it is possible. Therefore, a liberalized world economy not only offers greater opportunities for international business, but also forces firms to compete with each other at the global level for competitive advantages. Many trade scholars have recognized the essential and fundamental role that trade liberalization has played in stimulating global FDI flows in the past two decades.

IV. THE ROLE OF FDI IN WORLD TRADE AND ECONOMY

Traditionally and typically, international trade was conducted through arm’s-length trade by trading firms located in different countries, which did not involve FDI. However, in recent years, there has been a significant change in this respect. Trade has been increasingly conducted by TNCs in the form of intra-firm trade at the global level. The WTO estimates that intra-firm trade conducted by TNCs at the global level accounts for about one third of annual world trade, and exports by TNCs to non-affiliates account for another third of world trade.\(^\text{16}\) Intra-firm trade has become an important international business mode for TNCs to distribute or allocate intermediate goods, materials and/or final goods around the world for production and/or distribution purposes. To establish an international production or distribution network, a firm must locate one or more production plants or trading entities in foreign countries. Such a move will inevitably involve FDI as a prerequisite. Instinctively, there should exist a close link between FDI,

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\(^{16}\) This estimate, cited from the WTO annual report (1996), is presented by the UNCTAD based on United States data.
international production and trade, and FDI flows and volumes may directly influence world trade and its patterns.

Along with the growth of trade and FDI and the significant role of FDI in world trade performance, domestic firms are becoming increasingly internationalized. According to UNCTAD World Investment Reports, by the early 1990s, there were 37,000 transnational corporations in the world, with over 170,000 foreign affiliates; however, by 1997, there were some 53,000 TNCs with about 450,000 foreign affiliates around the world.

As a result, TNCs are playing an important role in world economy as well as trade performance. According to UNCTAD,

In 1997, the value of international production was $3.5 trillion as measured by the accumulated stock of FDI, and $9.5 trillion as measured by the estimated global sales of foreign affiliates. Other indicators also point in the same direction: global exports by foreign affiliates are now some $2 trillion, their global assets $13 trillion, and the global value added by them more than $2 trillion. These figures are also impressive when related to the size of the global economy: the ratio of inward plus outward FDI stocks to global GDP is now 21 per cent; foreign affiliate exports are one-third of world exports; and GDP attributed to foreign affiliates accounts for 7 per cent of global GDP. Sales of foreign affiliates have grown faster than world exports of goods and services, and the ratio of the volume of world inward plus outward FDI stocks to world GDP has grown twice as fast.

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as the ratio of world imports and exports to world GDP, suggesting that the expansion of international production has deepened the interdependence of the world economy beyond that achieved by international trade alone.

(World Investment Report 1998)

Raymond Vernon estimates that in the United States, the parents and affiliates of TNCs account for two thirds of the country's industrial output and over four fifths of its exports.19

V. THE SIGNIFICANCE OF THE STUDY

The close link between trade and FDI suggests that there may be certain interaction between trade and FDI. The positive impact of trade liberalization on FDI suggests that trade barriers may adversely affect FDI growth, or FDI measures may restrict or distort trade. The WTO is aware of the link between trade and FDI and the dynamic effects of FDI on trade. It stresses that, besides overall economic growth, capital flows and trade policy are the major determinants of international trade flows.20 While the impact of trade policy changes on regional trade patterns is generally seen only over the medium term, changes in capital flows often have immediate repercussions for year-to-year trade developments.21

The study of the relationship between trade and FDI has attracted much attention from academics in fields such as trade and international business as well as trade bureaucrats at related international organizations such as the WTO and UNCTAD. In December 1996,

21 Ibid.
the WTO Singapore Ministerial Conference agreed to establish a working group on the relationship between trade and investment. The working group was given a four-item agenda that covers: (1) the implications of the relationship between trade and FDI for development and economic growth; (2) the economic relationship between trade and FDI; (3) existing international arrangements and initiatives on trade and investment; and (4) issues relevant to the design of future initiatives.22

Despite some progress in the study of the relationship between trade and FDI, there are still many illusions and misunderstandings. Many countries do not regard FDI as a trade issue, and thus reject any effort to include FDI rules in the world trading system.23 On the other hand, some trade bureaucrats and scholars worry that FDI may substitute for trade and hence reduce trade volume or trade flows, thereby weakening the world trading system. For instance, one focus of the 1996 WTO annual report on trade and investment was to try to convince people that investment is generally supportive or complementary to trade.24 Hanson also expressed the worry that, while eliminating barriers to FDI is a means of achieving global market integration, promoting FDI goes one step further by favoring one form of integration – expanded foreign control of productive assets, over others, such as increased trade in goods, more international licensing of technology, or larger cross-border flows of portfolio capital.25

24 Supra note 3.
As a result, many countries still maintain a significant amount of trade and FDI barriers, although they have recognized the positive contribution of trade and FDI to economic growth and development. They may not recognize that trade barriers impede not only trade but also FDI. They also may not realize that FDI barriers may have a negative impact on trade growth. Thus, the inadequate recognition of the relationship between trade and FDI and the related policy implications may have a negative effect not only on trade but also on the economic growth and development of all nations.

In addition, conventional studies are often conducted in an incomplete way that does not take into account other important aspects of the relationship between trade and FDI. For example, the WTO reports on trade and FDI so far has focused on the impact of FDI on trade, but overlooked the other side of the issue: the possible impact of trade on FDI. Besides, trade bureaucrats and academics have focused on the study of trade and FDI from a macroeconomic perspective but overlooked the study from a microeconomic perspective, i.e. from the perspective of the firm – which I think may be important to the understanding of the relationship between trade and FDI. Consequently, the WTO working group on trade and investment acknowledges that the relationship between trade and investment is complex and not susceptible to definitive conclusions.  

VI. THE STRUCTURE OF THE THESIS

The purpose of this thesis is to conduct an in-depth study of the economic relationship between trade and FDI, and the impact of trade policies on FDI and FDI policies on trade.

26 See WTO, Supra note 23.
so as to give a thrust to the incorporation of a set of multilateral investment rules in the WTO.

The structure of the thesis is as follows. In Chapter Two, I will observe the close economic relationship between trade and FDI from the perspective of international business. Then, I will conduct a literature review on the relationship between trade and FDI in order to identify a proper theory for the study of the relationship between trade and FDI. In Chapter Three, I will first examine the impact of trade policies on FDI and the impact of FDI policies on trade. Then, I will analyze the economic and/or welfare effects of relevant trade and FDI policies. Finally, I will discuss the proper role for government to attract and exploit FDI, basing on the implications from the relationship between trade and FDI. In the last chapter – Chapter Four, I will first discuss the necessity of incorporating FDI rules in the WTO regime. Then, I will make some suggestions on FDI rules in the WTO regime. Finally, I will conduct a preliminary check on the compatibility of the WTO regime with the proposed basic FDI rules.
CHAPTER TWO

THE RELATIONSHIP BETWEEN TRADE AND FDI

THE PURPOSE OF THIS CHAPTER is to examine the economic relationship between trade and FDI at the firm level from the international business perspective. I will demonstrate that trade and FDI are interlinked at the firm level in international production and distribution of goods. This will shed light on policy-making at both national and multilateral levels. Three main topics will be discussed in this chapter: (1) the relationship between trade and FDI at the firm level, (2) a literature review of the relationship between trade and FDI, and (3) a proper theory for the study of the relationship between trade and FDI.

I. THE RELATIONSHIP BETWEEN TRADE AND FDI AT THE FIRM LEVEL

Economics tells us that production and distribution of goods are basic economic activities in a market economy. The firm, rather than the state, is the agent to carry out these basic economic activities. Firms undertake production and distribution of goods in order to make a profit. To carry out a production of goods, a firm must invest money to purchase factors such as labor, equipment and machinery, materials and other necessities, and then utilize and coordinate these factors in an efficient and effective way. To undertake distribution of goods, a firm must invest to purchase operational factors such as labor, equipment, and other necessities. It must also invest to purchase goods from a producer
for redistribution, which takes place after the distribution of goods by a producer. These factors and goods that are purchased and/or used in production and distribution are called assets.

Economics also tell us that trade happens when a firm sells goods abroad. Trade, which is a mode for distribution of goods, is in fact the extension or expansion of domestic sales. FDI occurs when a domestic firm undertakes international production or cross-border service through a presence. FDI may also take place in international distribution of goods. FDI as an international capital flow can be regarded as a variation of domestic investment. Therefore, in order to understand better the relationship between trade and FDI in international business, it is necessary to start with the introduction of the basic link between investment and trade in domestic production and distribution process.

A. Trade as a Function in Domestic Production

Domestic production refers to a manufacturing activity that is undertaken by a firm in its home country. It does not involve FDI. From my viewpoint, a typical domestic production process encompasses four primary stages: acquisition, production, distribution, and income. It can be illustrated below with potential trade effects emphasized:
In this graph, we can see that acquisition involves the purchase of assets such as labor, machinery and equipment, raw material, and other inputs in domestic and/or international markets. When a producer purchases a production factor from international market, trade in imports occurs. Although acquisition occurs mainly in the first stage, it may also occur any time during an investment cycle so as to support production-related activities.

Production in the second stage is the core activity in the cycle, as factors are consumed or utilized to manufacture goods for sale. Distribution takes place in the third sequential stage after goods are manufactured. Goods/products are sold in domestic as well as international markets to realize income. When a producer sells a product into a foreign market, trade in exports occurs. Income is the money received from sales, which normally includes the recovered investment (costs/expenses) and a profit. At this point, investment finishes a complete cycle in a production. Normally a producer will use the recovered investment to acquire production factors to start a new production process, which I call a “simple reproduction process”, or an “expanded reproduction process” if the profits are also invested into the new production process. Current assets as investment may take different forms at different stage in a production process. Fixed assets and intangible assets as investment do not change their physical forms while transferring certain percentage of their value into the products by depreciation. Under the different forms of assets, there is a constant flow of value. This constant flow of value is defined as “capital flow”. In sum, investment as capital flow underpins production activity that is the basic economic activity in a market economy.
B. Trade as a Business Mode for Specialized Domestic Distribution

Specialized domestic distribution refers to the distribution entity or network that is set up by a firm in its home country. It also does not involve FDI. Distribution activities could involve both sale and purchase of goods. A domestic producer itself may establish an independent distribution firm to carry out distribution activities, or it may assign the distribution activities to a specialized trading firm and have the firm carry out such activities. A distribution operation can be illustrated below with potential trade effects emphasized:

![Diagram of a cycle for specialized domestic distribution]

We can see from this graph that a cycle for a specialized domestic distribution operation is simpler than that for a domestic production operation because it does not have a production stage. Other aspects are similar to a domestic production operation. Trade may take place in the acquisition stage by importing foreign goods and in the sales stage by exporting both domestic and international goods. The investment in a specialized domestic distribution entity or network constitutes a capital flow in a cycle which supports a distribution operation.

With respect to the relationship between trade and investment in both domestic production and specialized distribution operations, I draw the following conclusions: (1)
Production and specialized distribution are the two basic business modes in which trade can take place. (2) Trade in a production process acts as a function to support the production of goods. Trade under a specialized distribution operation is a business mode for a specialized trading firm to carry out distribution of goods. (3) Investment, which acts as a continual capital flow in cycle, has a neutral and dependent nature. It is not itself an independent business mode. It serves either a production or a specialized distribution operation. (4) Investment is the precondition of operation in production or specialized distribution. It underpins and sustains the operations of production and specialized distribution.

C. **Trade and FDI under International Production**

International production, which is an expansion or extension of a domestic production operation, refers to a production that takes place in a host country by a firm from another country (the home country). An international production cycle is identical to a typical domestic production cycle, which also includes four basic stages: acquisition, production, distribution and income. Therefore, I will use the basic domestic model to explain the relationship between trade and FDI under international production. However, there are two major changes in international production which needs to be taken into account. First, the character of investment is changed. Domestic investment is changed into FDI, and a domestic capital flow cycle turns into a FDI cycle. Second, the purpose and objective for international production are diversified. As a result, the pattern of international production is complicated. This complexity is due to the difference in
culture and legal tradition, and more importantly, the existence of various trade and FDI barriers.

Since international production can be a business mode in which FDI must take place and trade can happen, I will examine the relationship between trade and FDI in international production under three basic types, i.e. resource-seeking, market-seeking, and efficiency-seeking international production. This categorization is based on the classification method used by UNCTAD. More specifically, I will study the relationship between trade, FDI and international production in two aspects, i.e. the internal aspect and the external aspect. The internal aspect refers to the relationship between trade and FDI in a production process. The external aspect refers to the relationship between trade and production outside a production process.

1. TRADE AND FDI IN RESOURCE-SEEKING INTERNATIONAL PRODUCTION ("R-PRODUCTION")

R-production seeks natural resources endowed in different global locations that are essential for other production activities or for end-consumption after local initial or final processing. It was the primary form for early international production. A nation can prevent or restrict foreigners from accessing to its resources, but generally cannot create such advantages. Therefore, the decision on where to locate R-production is mainly dependent on what valuable resources a nation has to offer within its jurisdiction.

The relationship between trade, FDI and R-production can be identified as follows. In the internal aspect, FDI has a strong link with trade. In the acquisition stage, foreign capital

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27 See UNCTAD, Supra note 4. In the paper, UNCTAD categorized FDI into four types: Natural-resource-seeking FDI, Market-seeking FDI, Efficiency-seeking FDI, and Strategic-asset-seeking FDI.
may be used to purchase equipment, machinery, technology as well as consumer goods for production activities from the home or another country. In the distribution stage, products are normally exported to the home or other countries for further production or for final consumption. In the external aspect, R-production does not have a negative impact on trade. Normally, a R-production takes place in a host country because there are not enough natural resources to serve the local needs of the home and other countries. When there is an insufficient supply of relevant natural resources, the export of such resources to the host country before or after the R-production taking place is unlikely to happen. Therefore, there should be no such case in which a R-production would substitute for the export of the same natural resources to the host country.

2. TRADE AND FDI IN MARKET-SEEKING INTERNATIONAL PRODUCTION ("M-PRODUCTION")

An international-market-seeking domestic producer will locate its production in a foreign market if such a move can help it to sustain and expand the foreign market share. The motivation behind market-seeking production (M-production) can be that a localized production can reduce production, transportation and/or transaction costs. This reduction in costs makes a product more profitable or competitive. As well, a localized production can often better meet local standards and/or provide improved services to local customers. According to a poll conducted at the end of 1999 by UNCTAD and the International Chamber of Commerce (ICC) among 296 of the world’s largest or typical TNCs that had production facilities in Africa, some 81% of the 63 responding TNCs said they produced for the local market, while 24% said they produced for export to countries
outside Africa.\(^{28}\) This indicates that at least in Africa, the majority of international production is the market-seeking type.

The relationship between trade, FDI and M-production can be explained as follows. In the internal aspect, FDI has a direct yet weak positive link with trade. In the acquisition stage, foreign capital may be used to purchase plant equipment and/or production inputs such as raw materials and intermediate products from home or from other countries. However, the positive trade effect will be diminished once production related fixed assets have been imported into the host country for long-term use. Besides, the possible increase of local inputs for M-production would reduce reliance on imported inputs. In the distribution stage, since all products are sold locally in the host country, there will be no exports. In the external aspect, since the purpose of a M-production is to produce products for local markets in a host country, M-production normally reduces or even replaces exports to the host country. Therefore, M-production causes an overall negative impact on trade in both export and import from the standpoint of host country.

3. TRADE AND FDI IN EFFICIENCY-SEEKING INTERNATIONAL PRODUCTION ("E-PRODUCTION")

E-production takes place when a firm moves a part or the whole production to another country or to several countries in order to survive intense competition or to maximize profits for its overall operation. A firm often undertakes E-production in the form of value-added chain in which it can places different stages or components of a production

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in different nations where the cost for each stage is the least or the value added to the product is the largest. For example, a multinational firm may undertake an E-production with its segments or parts arranged as below: (1) to locate the labor-intensive segment of a production chain in a country where the labor cost is low yet the efficiency of production is relatively high; (2) to locate advanced or complicated component processing activity/ies in a country where the workers are well-trained and skilled; (3) to locate the general or final assembly plant in a place where the corporate tax and import duties are low and the productivity is relatively high; (4) to place R&D activities in a country with abundant highly-skilled personnel and adequate infrastructure; (5) to headquarter its central management activities in a country where the corporate tax is low and the infrastructure is sound. The business connection between these different segments or parts of an international production process will be cross-border transactions or trade. I illustrate a typical E-production with the graph below:

E-production Model:

In this diagram, I assume that an E-production consists of A, B, C, D four intermediate product (or component) plants and a general assembly plant. Normally, all component products of the four component plants are exported to the general plant for assembling the final products. The final products are distributed internationally through the
producer’s international distribution network. Comparing this model with a simple production model — no matter whether it is a domestic production model or a simple international model, E-production is the most complicated production process because segments of a production are located in several countries.

With respect to the relationship between trade, FDI and E-production, we can draw the following conclusions:

First, in the internal aspect, FDI strongly supports E-production and trade, and FDI contributes significantly to trade. On the other hand, E-production and related FDI are heavily reliant on intra-firm trade. The relationship between trade and FDI in E-production is the strongest among all kinds of production. In the acquisition stage, component plants may import production factors from foreign sources or from each other through intra-firm trade. The general assembly plant will import all components from component plants. The imports of the general plant in the acquisition stage are the exports of component plants in distribution stage. The general plant may even import some components from other sources if component plants do not supply all necessary components. In the distribution stage, the general plant will distribute all final products to international markets through the firm’s distribution network.

Second, in the external aspect, since the purpose of locating different segments of an E-production in different countries is to exploit the factor endowments and/or advantages of different countries, each segment plant does not reduce or replace exports to the host country where it locates. This is because the demand in each host country will be satisfied by exports to each host country, and these exports come from the E-production itself.

Therefore, I conclude that the link between trade, FDI and E-production is very strong.
FDI and trade strongly support each other. Moreover, FDI in E-production usually has a long-term contribution to trade once its production and distribution network is established.

Since E-production depends heavily on intra-firm trade, it requires a smooth and efficient international distribution system. E-production not only requires the firm to manage and coordinate intra-firm trade flows efficiently, but also calls for related countries to maintain an efficient free trading system.

There is a variation of this typical E-production model. Sometimes, an E-producer may seek external supply of components instead of undertake intra-firm trade type of supply if to do so is more efficient. Hanson studied the cases of GM and FORD production in Brazil. Interestingly, the two automobile giants adopted similar production strategies in Brazil. The purpose of both the GM and FORD productions in Brazil was to seek access to the broader MERCOSUR common market rather than the single Brazilian market.

Both relied heavily on outsourcing of components for their plants. In order to secure the component supply, the GM plant housed 20 suppliers, the most important of which were United States, French and Japanese. FORD plant had a similar design to GM's Blue Macaw plant, with suppliers of 17 parts housed under the same roof at the automobile assembly facility. GM outsourced all components except power trains, body welding, body panels, paint, and final assembly. Also like GM, Ford's components primarily came from foreign suppliers, who worked with Ford in other regions.

Under this E-production variation, trade effects may still be the same as that under a typical E-production. However, since the firm does not need to establish some or all component plants, except for FDI in general assembly plant, there is much less or even
no FDI taking place in other countries. Therefore, if arm’s-length trade is more efficient than intra-firm trade through FDI in component production, a firm may choose the former rather than the latter. This means that arm’s-length trade may substitute for FDI.

D. FDI Effects in Independent Intra-firm Trade

Basically, international trade can be undertaken in one of the two basic modes: arm’s-length trade and intra-firm trade. Under arm’s-length trade, two firms in different countries conduct international exchange of goods through contractual arrangements. Under intra-firm trade, a firm conducts international exchange of goods through two or more affiliates located in different countries. There are two kinds of intra-firm trade: intra-firm trade that is conducted within an international production process, and intra-firm trade that is undertaken by a producer or a specialized trading firm through establishing a trading entity in another country. The difference between them is that the former is a production function in an international production process, while the latter is an independent international business mode. The former is affiliated with an international production while the latter requires the establishment of an independent trading entity in a host country. Therefore, the former per se does not generate FDI, while the latter directly requires FDI. I call the latter form of intra-firm trade “independent intra-firm trade”.

A producer may choose to establish a specialized trading entity in a foreign country to conduct production-related procurement and/or sales activities. Similarly, a specialized trading firm may choose to establish a trading affiliate in a foreign country to conduct

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29 See Hanson, Supra note 25.
purchase and/or sales activities. The basic economic rationale for independent intra-firm trade is cost- and/or time-efficiency.

The relationship between trade and FDI in independent intra-firm trade can be summarized as follows. First, in the internal aspect, independent intra-firm trade depends on FDI. To establish an independent intra-firm trade operation in a foreign country, a firm must invest capital as a prerequisite in order to provide operating funds and to purchase operation necessities. Without FDI, independent intra-firm trade cannot take place. On the other hand, intra-firm trade as an international business mode obviously generates FDI. Therefore, trade and FDI are mutually supportive of each other under independent intra-firm trade. Second, in the external aspect, independent intra-firm trade does not have any substitution effect on FDI.

Independent intra-firm trade has become an important mode for international business. As one WTO member commented, many firms in this country have engaged in outward FDI across a range of products because they need to establish channels (i.e., trading firms) for the distribution of exports. It is also common for retailing firms (e.g., Walmart) to use intra-firm trade to supply goods for their worldwide retailing chains.

E. The Relationship between Trade and FDI at the Firm Level: An Overview

From the discussion above, we learn that there exists a close relationship between trade and FDI at the firm level. The relationship can be summarized as follows:

First, international production and independent intra-firm trade are the two basic modes that require FDI to accompany them. In other words, FDI is a prerequisite for international production and independent intra-firm trade to take place. Second, FDI as
capital flow strongly supports trade in international production and independent intra-firm trade. FDI in R-production can contribute to trade in both imports in the acquisition stage and exports in the distribution stage. FDI in M-production may still make a contribution to trade in imports in the acquisition stage. FDI in E-production strongly supports trade in both the acquisition and distribution stage of each segment plant as well as of the general assembly plant. FDI under independent intra-firm trade mode strongly supports intra-firm trade flows. Third, trade supports and promotes FDI. In each type of international production, trade serves the function of supporting production, and therefore indirectly supports FDI by contributing to an added value for capital flow in international production. Independent intra-firm trade generates FDI in international distribution. The further expansion of intra-firm trade will likely generate more FDI in international distribution. Fourth, FDI is a neutral capital flow that underpins both international production and independent intra-firm trade. It is not an independent business mode or purpose. Therefore, it cannot substitute for trade. However, international production as an international business mode can substitute for trade. This is evidenced by M-production in which trade in both imports and exports from the host country standpoint usually are reduced or even replaced.

F. The Relationship between Trade and FDI at National Level

FDI may have an impact on trade at national level, even though a nation is not involved in trade and FDI activities. The impact of FDI on national trade can be found in two situations. First, FDI has an impact on both home and host country's balance of trade. For example, FDI is often used to purchase imports for operation, or FDI itself is in the form of

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30 See WTO, Supra note 22.
of imports such as machinery and equipment. As a result, the aggregate amount of imports at the national level may contribute to the imbalance of trade of the host country. Such an impact, however, may be alleviated to some extent by exports of the foreign investor. Second, FDI may have an indirect negative impact on trade. An UNCTAD study points out that FDI, which increases the supply of foreign exchange, may lead to an appreciation of the currency of host country, thus discouraging overall exports of the host country. If FDI is invested primarily in tradable goods, the additional generation or saving of foreign exchange will appreciate the exchange rate further, which is particularly the case when the investment projects involved raise productivity, thus entailing a long-run discouraging effect on host country's trade performance. Nevertheless, the study points out that FDI has less of an impact on the exchange rate than other purely financial types of foreign capital inflows, since a significant share of FDI takes the form of imported capital goods.

II. THE RELATIONSHIP BETWEEN TRADE AND FDI: LITERATURE REVIEW

Scholars generally have realized that the study of the relationship between trade and FDI should be undertaken from the international business perspective. Conventionally, international business is defined as any cross-border business activity that is carried out by firms. All kinds of international business are categorized into four basic types: trade in

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31 See UNCTAD, Supra note 4.  
32 Ibid.
goods, trade in services, FDI, and portfolio investment. Or more precisely, conventional wisdom regards trade and FDI as two basic forms for firms to undertake international business. The literature on the relationship between trade and FDI has been based on such a concept. The literature has flourished since the early 1990s when global FDI flows had become a major phenomenon after continuing trade liberalization. Introduced here are some of the major studies since the 1990s.

A. The WTO studies

1. THE WTO 1996 ANNUAL REPORT

The report was the first ever comprehensive and landmark study on the relationship between trade and FDI. The report in fact dealt with only one aspect of the relationship between trade and FDI, i.e., whether trade and FDI are substitutes (negatively correlated) or complements (positively correlated). More specifically, the report only observed one aspect of the ‘correlation issue’, i.e., the impact of FDI on trade from both home and host country sides. It did not touch the other aspect of the issue – the impact of trade on FDI. The report, based mainly on inadequate empirical evidence or studies, concludes that FDI is positive for both home and host countries exports, except that the complementarity is apparently stronger in the host country case than in the home country case. With respect to FDI’s impact on home and host countries imports, the report maintains that existing evidence suggests a positive but weak relationship between FDI and both home and host countries imports.

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2. LATER WTO STUDIES

Since its first meeting in June 1997, the WTO working group began shifting its focus from the 'correlation' issue to FDI's implications for development and economic growth, thus bringing a much wider range of investment issues into consideration.

The 1998 Report of the Working Group to the General Council mainly addressed issues such as the positive and negative effects of FDI on host countries, especially developing countries, and the policy implications. It also addressed issues such as the effects of FDI policies on FDI, and the relationship between FDI and competition policy. The WTO Working Group commented for the first time that the conventional analysis of the relationship between FDI and trade in terms of whether FDI and trade were complements or substitutes has become less relevant in a globalizing economy in which trade and investment are determined simultaneously by decisions of multinational enterprise regarding the location of their production facilities. The report for the first time reflects the awareness of the effects of FDI on trade balances, yet stresses that empirical evidence shows that FDI has no negative effects on trade balances. The report also acknowledged that an initial complementary relationship between outward FDI and exports could eventually turn into a net substitutive relationship. The report reaffirmed that most empirical studies have concluded that there is a complementary relationship between home country exports and FDI, and that there is an overall positive correlation between host country exports and inward FDI. The report also noted that there was an increasing overlap of the determinants of investment and trade as firms determine simultaneously where to invest and from where to export.

34 See WTO, Supra note 3.
35 See WTO, Supra note 22.
The 1999 Report of the Working Group focused on the role of FDI in the Asian financial crisis, FDI’s role in development and economic growth, the effects of trade and investment policies on FDI, the role of government in economic development, FDI and host country’s technology development, and FDI and competition policy, etc. On the economic relationship between trade and investment, the report focused on the issue of investment incentives. It also cited a recent OECD study which shows that FDI tended to be complementary to trade, in which intra-firm trade was a central contributor. The OECD study found that countries that were both substantial outward and inward investors stood to gain in trade terms from both outward and inward FDI. The report acknowledged that the findings of this OECD study were somewhat different from the WTO conclusion that in some instances there was substitution between trade and FDI.

The 2000 Report of the Working Group mainly discussed the relationship between FDI and the transfer of technology to host countries. It also raised certain issues that should be the subject of further examination by the Working Group. These issues are: the implications of the relationship between trade and FDI for development and economic growth, the movement of labor, the advantage of bilateral investment treaties, the positive role of performance requirements in ensuring a level playing field between foreign and domestic investors and in enhancing the benefits of FDI for the host country, the costs and benefits of multilateral investment rules, investment incentives, and foreign investors’ obligations. The report acknowledged that the relationship between trade and FDI was complex and not susceptible to definitive conclusions. On the economic

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37 See WTO, Supra note 23.
relationship between trade and investment, the principal subject in the report was the issue of investment incentives.

**B. The OECD Studies**

The OECD published the first complete and seminal study on the relationship between trade and FDI in October 1999 as a working paper for the OECD Directorate for Science, Technology and Industry (STI Working Paper Series). Some important findings from this work are: 38

1) The relationship between trade and FDI, which is a feature of globalization, is complex and cannot be inferred from a purely theoretical analysis.

2) Empirical work shows that, until the mid-1980s, international trade generated direct investment. After this period, the cause-and-effect relationship seems to have been reversed, with direct investment heavily influencing trade.

3) In particular, the evidence indicates that foreign investment abroad stimulates the growth of exports from originating countries (investing countries) and, consequently, that this investment is complementary to trade. An analysis of 14 countries demonstrated that each dollar of outward FDI produces about two dollars’ worth of additional exports.

4) Conversely, in host countries, short-term foreign investment most often tends to increase imports, whereas an increase in exports appears only in the longer term. However, in the short term, host countries enjoy many benefits from foreign investment (technology transfers, job creation, local subcontracting, etc.).

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5) Empirical results show that the nature and extent of the relationship (complementarity or substitution) can differ from one country to another. For example, American outward investment has a more pronounced complementary effect than outward investment from European countries (e.g. France, United Kingdom). American investment abroad also has a greater bilateral trade effect for both imports and exports.

6) Unlike the situation in France, the impact of inward FDI on US exports is not significant. This can be explained by the difference in the size of the respective domestic markets. Foreign companies invest in the United States mainly because of the large US domestic market. But this lesser complementarity is also observed for imports: whereas each dollar of inward investment is associated with an additional USD 1.40 of imports in France, it is associated with only 60 cents in the United States.

7) Unlike the predominant situation in most other countries, inward investment in the United Kingdom has a complementary effect on trade. However, given the weakness of certain statistical results, this relationship needs to be confirmed with more detailed data.

This empirical work showed the main and positive influence of FDI on international trade particularly after the mid-1980s. It also showed that FDI abroad stimulates the growth of exports from countries of origin and consequently this investment is complementary to trade.
C. Canadian Studies

W. Hejazi and A. E. Safarian challenged the common view that increases in outward FDI substitutes for domestic exports and that increases in inward FDI results in lower imports.\(^{39}\) Their study has established that international trade and FDI are complements in the Canadian context. By using a gravity model to measure the link between outward Canadian FDI and Canadian exports on a bilateral basis to 35 countries over the period 1970-96, they concluded that inward FDI increases imports into Canada, and Canadian outward FDI stimulates domestic exports. Furthermore, the impact on exports is larger than the impact on imports. This finding indicates that on a net basis, the higher level of openness of Canada to FDI has improved its trade balance. Notably, Hejazi and Safarian are the first to explore the impact of outward FDI on the home country (Canada) exports. They also conducted an analysis at the industry and inter-industry levels. They found that even if the relationship between trade and FDI at the industry level were substitutes, it might be complements at inter-industry level when taking into account the inter-industry links and interactions.

The gravity model appeals to transaction costs as the source of comparative advantage. This model has been used to explain bilateral trade flows among large groups of countries and over long periods of time.\(^{40}\) Hejazi and Safarian have found that FDI fits well into the gravity model. They argued that the presence of FDI would indicate that links or networks in the foreign country have been established, and hence the costs associated


\(^{40}\) Cited in W. Hejazi and A. E. Safarian, Ibid.
with exporting should be lower. As a result, exports should be higher. Therefore, trade and FDI are complementary.

D. Other Studies

Magnus Blomström and Ari Kokko argue that foreign firms generally contribute more to host country's trade performance than local firms, because they have better knowledge of and better access to foreign markets through the existing international marketing and distribution networks of their parent companies. Moreover, TNCs are often larger than local firms and may be able to afford the high fixed costs for the development of transport, communications, and financial services that are needed to support export activities. They also argue that foreign investors might enhance the export prospects of local firms by directly or indirectly providing information about foreign markets and/or distribution channels for exporting goods.

At both national and international levels, FDI growth may have positive impact on future trade performance. Industry Canada predicts that the increased economic integration among the three NAFTA countries following intra-regional FDI flows will likely lead to further specialization by firms and countries in the region, and Canada is expected to increase its specialization in resources, resource-intensive manufacturing and financial service industries.

Basing on classical trade theory, further specialization at industry

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42 Ibid.
43 Ibid.
and national levels will increase the dependence on trade in the region, thus sustaining and further expanding trade.

Dunning noted that in the mid-1950s, most United States FDI in the United Kingdom replaced imports from the United States.\(^4^5\) This means that the US production in the UK is mainly the M-production type at that time. In 1953, about 38.6 per cent of the output of United States manufacturing affiliates were exported. The great majority of these exports went either to the rest of Europe or to Commonwealth countries, while the US affiliates accounted for 12 per cent of all UK manufacturing exports.\(^4^6\) In 1994, the US manufacturing affiliates in the UK exported 27.6 per cent of their output, and accounted for 33.8 per cent of all UK manufacturing exports.\(^4^7\) These figures, taken from a 40-year time span, reveal the following implications. Firstly, the majority of the outputs of the US affiliates were for local sales. This observation is in accordance with the trade effect in a market-seeking production. Secondly, the US affiliates had increased their local sales and reduced their exports accordingly, which means that more productions had become local market-seeking type although trade barriers presumably had become much less significant. This suggests that even in a much freer trading environment, M-production still plays an important role in international production. Lastly, the percentage of the US affiliates’ contribution to the UK’s export performance has risen significantly. This indicates that foreign productions can contribute more to host country’s export performance in the long run, and/or foreign producers can play a better role than domestic producers in host country’s exports. These data also correspond to my observation that the link between trade and FDI in M-production is very weak, albeit

\(^4^5\) See Dunning, *Supra note 13.*

\(^4^6\) *Ibid.*
established. Dunning’s data also corroborate Fontage’s view that for host countries, foreign production in the short term most often tends to increase imports, but in the long term, will increase exports.

E. An Overview of the Literature

As we can see, most studies on the relationship between trade and FDI undertaken by trade theorists and international business academics have focused on the issue of ‘substitutability or complementarity’ between trade and FDI. Most studies are empirical studies. Results from these studies are mixed: some studies conclude that trade and FDI are generally supportive of each other, some conclude that they are substitutes for each other, and some maintain that the result is inconclusive.

Based on my observation and understanding of international business and the relationship between trade and FDI, I have found that these studies have the following major shortcomings:

1) The conventional approach of treating trade and FDI as two parallel and comparable business modes is inappropriate.

As I have observed, FDI is capital or capital flow that underpins both international production and independent intra-firm trade. Although FDI takes place concurrently with international production and independent intra-firm trade, it is not a parallel business practice with either international production or independent intra-firm trade. Rather, it is a neutral capital flow underpinning international production and independent intra-firm

\[47\] See Dunning, *Supra note 13*, p. 7-8.
trade. Similarly, FDI and arm’s-length trade are not parallel or comparable business modes either. Therefore, trade and FDI should not be compared together. In contrast, arm’s-length trade, international production and independent intra-firm trade are three international business modes that can be compared and chosen. All three modes serve a common business purpose in a foreign market, i.e. to meet the demand of a product there, or to serve the demand in countries other than the host country. Firms should choose the most efficient mode among them to carry out that purpose. For instance, if a firm decides to undertake M-production in a host country, it normally will not export the same product to the country by either arm’s-length trade or independent intra-firm trade. The reverse is likewise true. Therefore, it is international production, arm’s-length trade and independent intra-firm trade that could substitute for each other. Trade and FDI cannot substitute for each other. Rather, considering their nature and function in international production and distribution activities, they are always supportive of each other.

The mistake of treating trade and FDI as two parallel and comparable modes can be found in most conventional studies. For example, the UNCTAD paper categorizes FDI into natural-resource-seeking, market-seeking, efficiency-seeking, and strategic-asset-seeking types. On another occasion, UNCTAD categorizes FDI into two types: Greenfield and M&A FDIs. Dunning categorizes FDI into market-seeking, efficiency-seeking and strategic-asset seeking types. FDI is also classified as “vertical” and “horizontal” FDIs. The WTO Working Group on Trade and FDI has accepted the misconception that trade and FDI are parallel and comparable business modes in its

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48 See UNCTAD, Supra note 4.
50 See Dunning, Supra note 13, p. 22.
annual reports when it discusses the relationship between trade and FDI. As a result, conventional studies have attributed all those negative impacts of international production on trade to FDI. Following this misconception, the issue of “substitutability or complementarity” eventually must be judged by the value of trade that is replaced or created. Since the purpose of international production is not always clear or is mixed sometimes, it is natural that these studies could not reach a definite and identical conclusion. In conclusion, it is the conceptual problem with FDI that has led these studies to inconclusive or even contradictory results.

Hejazi and Safarian have noted the conceptual problem involved when comparing exports to FDI stock or FDI flow. They noted that the analogue to exports should be foreign production or foreign sales. Nonetheless, their study was still trapped in the old concept, due to the lack of an adequate recognition of the nature and function of trade and FDI in international production and independent intra-firm trade.

2) The literature has focused too much on the issue of ‘substitutability or complementarity’, but overlooked other more important issues in the relationship between trade and FDI.

Conventional studies so far have focused on whether trade and FDI are substitutes or complements. In fact, the relationship between trade and FDI is much broader than the issue of “substitutability or complementarity”. From my viewpoint, some other important issues are: (1) the nature and function of trade and FDI in international production; (2) the interaction between trade and FDI in independent intra-firm trade; (3) the relationship

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51 See WTO, Supra note 22.
52 See Hejazi and Safarian, Supra note 39.
between arm’s-length trade, independent intra-firm trade and international production, and the role of FDI in them; (4) issues at industrial or national level, including the impact of FDI on the balance of trade, the implications for trade from the impact on the balance of payments and foreign exchange rates by FDI; and (5) the interaction between FDI stock or flow and trade at national and global levels. On the other hand, there is a tendency that the conventional study of the relationship between trade and FDI is departing from the logic subject. For example, since the 1998 report, the WTO has shifted its focus of discussion from the relationship between trade and FDI to issues such as FDI and development, FDI and technology transfer, and FDI and competition policy, regardless of whether such FDI issues are related to trade. This change was probably due to the conviction that the “substitutability or complementarity” issue was no longer important in the era of globalization, or due to the dilemma that the study of the relationship between trade and FDI had entered into a dead end without a conclusion. However, any solution to the “substitutability or complementarity” issue should not have diverted our attention away from the study of the relationship between trade and FDI.

3) There is no adequate study of the relationship between trade and FDI at a theoretical level. Most studies so far have been empirical studies that were based on one fundamental misconception: FDI is a business mode that is comparable to trade. A few studies such as the one conducted by Hejazi and Safarian used traditional trade theory to test the link between trade and FDI. Unfortunately, even the limited theoretical studies were focused
on the “substitutability or complementarity” issue. They overlooked other important aspects of the relationship between trade and FDI. Moreover, no one has undertaken a comprehensive study on the relationship between trade and FDI at the firm level from the international production and distribution perspective. The inadequacy of the theoretical literature calls for us to develop a sound international business theory under which the relationship between trade and FDI can be properly addressed.

III. A THEORY FOR THE STUDY OF THE RELATIONSHIP BETWEEN TRADE AND FDI

Although my perspective on FDI in international production and independent intra-firm trade can explain the linkage between trade and FDI, it cannot explain some basic issues such as why a firm engages in international business and why it chooses one international business mode over another. Therefore, it is necessary to explore an international business theory that can explain not only the relationship between trade and FDI but also the reasons behind FDI in international production and distribution.

In this section, I will firstly introduce some relevant theories and examine their applicability to both trade and FDI. Then, I will identify a theory that is most suitable for the study of the relationship between trade and FDI.

I will examine related theories under four categories: trade theories, the combined theories for trade and FDI, the Internalization Theory, and the Eclectic Paradigm.
A. Trade Theories

Two trade theories that I will discuss are the Theory of Comparative Advantage and the Factor Endowment Theory.

The theory of comparative advantage, which constitutes the basis of conventional international trade theory, is the foundational concept of the world trading system. The theory argues that a country still will be benefit from trading with another country even if it does not have absolute advantage over another with respect to any product, because international trade based on specialization is still mutually advantageous and can make both countries better off.

The Factor Endowment Theory (the Heckscher-Ohlin Theorem) addressed the question of the basis of cost differentials in the production of trading nations. It posited that each country allocates its production according to the relative proportions of all its production factor endowments—land, labor, and capital on a basic level, and management and technological skills, specialized production facilities and established distribution networks on a more complex level. Thus, the range of products made or grown for export would depend on the availability of different factors in each country. A country would be expected to produce goods that require large amounts of the factors it holds in relative abundance and to export them in exchange for goods produced by other countries with relative abundance in their factors.

Although conventional trade theories can explain well the reasons and rationales for trade, they are inadequate to explain the new trends in trade or to address issues related to FDI. Vernon points out that since traditional trade theories were modeled on a world composed of separate nation-states with each presenting its national firms with its own
national supply of the factors of production, it cannot address the issues in a more integrated world where TNCs draw resources from any country irrespective its location.\textsuperscript{54}

Specifically, trade theories have three major shortcomings in regard to the study of the relationship between trade and FDI: Firstly, trade theories focus on the reasons and rationales for trade rather than for FDI or international production. Thus, they cannot explain the issues pertaining to FDI or international production. Secondly, trade theories presume that countries are trade actors. In reality, individuals and firms, rather than nations, undertake international business activities, including trade. Another related shortcoming is that trade theories established the concept of comparative advantage from a macroeconomic perspective. Therefore, such a view of comparative advantage may not be identical to the view from a firm. Thirdly, trade theories were based on a perfect market condition in which producers had perfect knowledge of international markets and opportunities, and in which each country had full mobility of labor and production factors and full employment. In reality, all these restrictions exist, and market imperfection is the norm. These restrictions affect a firm’s ability to make rational and efficient business decisions, including international production and distribution decisions.

B. The Combined Theories for Trade and FDI

The combined theories for trade and FDI refer to theories that address both trade and FDI issues within their framework on a common theoretical basis. Here I will examine Raymond Vernon’s Product Cycle Theory and the General Equilibrium Theory.

\textsuperscript{53} See Hejazi and Safarian, Supra note 39.
\textsuperscript{54} See Vernon, Supra note 19.
The Product Cycle Theory explains the fundamental motivations for trade and international production from the perspective of the life span of a technology-based product. This theory examines the potential trade and international production possibilities of a product in four discrete stages in its life cycle. In the first stage, known as the innovation stage, a new product is manufactured and sold primarily in the domestic market. Any overseas sales are generally achieved through exports to other markets, often those of industrial countries. But why would the firm produce it at home (in the United States) rather than foreign markets? Vernon said that the answer lays in external economies of industry location. The new product was “unstandardized” and the producer needed to be close to the market to save on communication costs. In the second stage, known as the product growth stage, sales tend to increase. As sales increase, so does competition as other firms enter the arena. The product becomes increasingly standardized. The firm begins some production abroad to strengthen service in foreign markets and to meet competition from rivals. As the product enters the third stage, known as maturity, exports from the home country decrease because of increased production in overseas locations. Higher sales levels in foreign markets as well as lower costs are crucial to maximize profits as competition increases. Consequently, production will be shifted from foreign industrial markets to less costly developing countries to take advantage of cheaper production factors, especially low labor costs. At this point, the firm may even decide to discontinue all domestic production and export the product from developing countries to the home country and to other markets. In the final stage of the product life cycle, which is the stage of product decline, the product enters the period of decline because new competitors have achieved levels of production high enough to

See Vernon, Supra note 19.
effect scale economies in the production that are equivalent to those of the original manufacturer.

Vernon and his colleagues later somewhat deviated from the product cycle theory by introducing another important concept: the concept of the ‘copy-cat pattern of behavior’, which emphasizes the dynamic aspect of firms’ strategies. The ‘Copy-Cat’ theory argues that firms often observe the moves and countermoves of rivals before deciding to create and operate an affiliate in a foreign country. Firms adopt such a strategy in order to reduce the risks created by rivals. The theory is used to explain the seeming tendency of TNCs to engage in a follow-the-leader strategy by setting up their new affiliates in any given country in what appeared to be a copy-cat pattern of behavior. Such a copycat propensity is stronger in a market where oligopoly exists with a fairly limited number of players than in a market where there exists competition among a large number of participants.

Vernon’s product life cycle theory touched the issue of trade and FDI in international production from the perspective of technology evolution and market competition. This theory explained why and when firms would choose between trade and international production. His Copy-Cat theory explains some motives behind FDI in international production from the perspective of market competition. However, his theories, which are based on the superiority of the US firms in technology, have the following shortcomings: First, some products that have a rapid time span do not show an obvious four-stage characteristic. Nevertheless, international production and trade still take place. Second, independent intra-firm trade or international service is less reliant on technology than international production. Nevertheless, FDI still occurs in the former. Therefore, the
technology postulate cannot effectively apply to FDI in international distribution and service. Third, the theories cannot explain some recent trends in international production. In the era of globalization, firms often undertake innovation (R&D) activities in foreign countries and then introduce the new product simultaneously in several markets in the world. These business behaviors are anti-anecdotes to the product life cycle argument. Likewise, some productions with less technology are taking place in North America by firms from other countries, such as the recent textile production by a Chinese firm in Quebec. Such a production may take place because the firms have advantages other than technology or because they can exploit the advantages from regional trade arrangements that usually discriminate against foreign products. Fourth, in analyzing the firm’s locational decisions, the theory emphasized the locus and timing of innovation, on ease of communication and scale economies, and the threat of trade protection as determinants of production, but overlooked relative factor costs and transport issues in locational decisions. In other words, these theories mainly considered the role of technology and competition in the firm’s international business decisions but ignored the influence of other important factors. The theories did not find a deep common reason or rationale to decipher all international business practices undertaken by firms.

The General Equilibrium Theories of Multinationals introduced trade and factor costs to explain firms’ choice between trade and FDI in international business. The basic assumption is that to produce a good, a firm must incur fixed costs such as R&D, marketing, and management costs, and non-fixed costs such as trade and factor costs. The

56 See Vernon, Supra note 19.
58 See Hanson, Supra note 25.
theory predicts that firms will penetrate foreign markets through FDI when trade costs are
low, firm-level scale economies are high (i.e. the fixed costs associated with head-
quarters activities are high), and plant-level scale economies are low (i.e. the costs of
having plants both at home and abroad are low). Conversely, firms will penetrate foreign
markets through exports when trade costs are low and plant level scale economies are
high.\textsuperscript{59} The theory further posits that a firm will penetrate foreign markets through
vertical FDI when factor-cost differences between countries are large, and through
horizontal FDI when countries are similar in terms of market size and factor cost.\textsuperscript{60}
Vertical FDI means the firm arranges each distinct segment or stage of a production in
different world locations. The firm could do so by locating its headquarters in a capital-
abundant (low-capital cost, high-wage) country and production in a labor-abundant (high-
capital cost, low-wage) country. Horizontal FDI means the firm undertakes similar
production activities simultaneously in many countries. Activities at its headquarters,
however, remain concentrated in one country only.

The basics of the general equilibrium theories suggest that the low cost of trade is the
common denominator for both trade and FDI. The shortcomings of the theories are as
follows. Firstly, although this argument may be true in many cases, it cannot explain
tariff-jumping international production that is based on high trade costs, nor can it explain
trade in times when trade costs were very high due to trade and technology barriers.
Secondly, the theories tend to treat trade and FDI as two comparable and incompatible
modes. As I have discussed, the approach of treating trade and FDI as two comparable
international business modes is inappropriate. The relationship between trade and FDI is

\textsuperscript{59} Ibid.
\textsuperscript{60} Ibid.
not what the theories supposed as "either FDI or trade". They can be compatible with each other. For instance, under the mode of independent intra-firm trade, trade and FDI happen concurrently. Thirdly, the theories focus on the external costs that influence the firm’s trade and FDI decisions but overlook the costs or risks associated with arm’s-length trade. Thus, it cannot explain why firms choose to internalize international business relations by FDI rather than engage in arm’s-length trade, such as licensing, franchising, subcontracting or other non-equity arrangements, given the low factor costs in foreign countries. Therefore, the theories are also inadequate to explain the relationship between trade and FDI.

C. The Internalization Theory

The theory of internalization, which was first developed by Peter J. Buckley and Mark Casson in 1976, is regarded as the modern theory of the TNC. Basing on the existence of imperfect markets, the theory articulates that a firm threatened by inefficient market conditions for a product or service has a clear option: namely, to internalize transnational business activities within the firm. By doing so, the firm can reduce the transaction and coordinating costs and/or risks that are associated with using external agents. Inefficient market conditions include high and unstable transaction costs, insecure supply of inputs, inadequate protection of intellectual properties, difficulty in execution and enforcement of contracts, etc. External international business activities are various cross-border transactions and exchanges in the form of arm’s-length trade, including trade under contractual arrangements, licensing, franchising, and contract manufacturing, etc.

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The theory can explain why a firm will choose international production or independent intra-firm trade over arms'-length trade. Thus, it can explain one important aspect of the rationale for FDI: The existence of inefficient market conditions. However, it does not address other important factors that shape a firm's FDI decision, such as the locational or ownership advantages. Therefore, the theory is also inadequate for the study of FDI and the relationship between trade and FDI.

D. Dunning's Eclectic Paradigm for International Production

Dunning's eclectic paradigm explains the motives and the determinants for firms from one country to undertake international production through FDI in another country. The paradigm asserts that the participation of firms from one country in the value-adding activities in another country is determined by:

1) the extent and characteristics of the competitive or ownership (O) specific advantages of the investing (or potentially investing) firms, relative to those headquartered in the recipient or host country;

2) the locational (L) attractions of the recipient country, relative to those of other countries – including the investing country – especially in respect of the activities necessary to optimize the economic rent on the O-specific advantages of the investing firms;

3) the extent to which it is in the best interests of the foreign firm to internalize (I) the market for its O-specific tangible and intangible assets, rather than choose another organizational mode, e.g. licensing, management contract, franchising, etc., by which

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62 See Dunning, Supra note 13.
63 Ibid.
these assets, or the rights to their use, are transferred; or indeed, by which their value may be protected or augmented.

The paradigm further asserts that the structure of the OLI advantages facing a particular firm will vary according to a number of contextual variables, such as the nature of the value added activities of the firm, its country of origin, and a range of firm-specific characteristics, such as age, size, strategic focus, and its relation to its competitors or potential competitors. Finally, the determinants of FDI will depend on its raison d'etre. Is it, for example, primarily intended to supply products for sale in local or adjacent markets; or is it seeking a secure supply of natural resources or intermediate products for domestic or international production, or to take advantage of lower factor costs? Or is its purpose to rationalize or restructure its portfolio of existing foreign assets, or to augment the firm's global competitive advantages – so-called strategic-assets-seeking FDI? Dunning observed that in the 1950s, the great majority of inbound United States investment was of a market-seeking kind, mainly due to high trade barriers. In the mid-1990s, United States TNCs increasingly adopt an efficiency-seeking or rationalized strategy towards their European manufacturing operations. Since early 1980s, especially in recent years, M&A has become the major foreign entry mode for TNCS. This movement is called strategic-asset seeking FDI. The motivation for M&As is not to exploit existing O-specific advantages, but rather to protect or augment such advantages.

Another significant trend is the rise of R&D activities undertaking in foreign locations. Dunning documented that over the period 1969-1972, only 6.5 percent of the R&D expenditures by United States TNCs were undertaken outside the United States; however,

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64 Ibid.
65 Ibid.
in 1994, the proportion was 13.2 per cent. This indicates that FDI in R&D has increased significantly. Despite this focus, Dunning was able to break away from an economist’s country-level analysis of FDI as a capital flow and instead have FDI as a firm-level managerial decision.

Dunning’s theory, which was based on rich and consistent empirical evidence, is so far the most influential international production theory. The structure of OLI advantages of the theory, which addresses all important aspects that shape a firm’s international production decision, explains effectively the reasons and rationales for international production.

With respect to the study of the relationship between trade and FDI, the theory has some shortcomings, albeit not fatal. Firstly, the theory focuses on international production, and does not address FDI in international distribution. Secondly, reflecting the mistake most international business studies have made, the theory confuses FDI with international production. Dunning in his literature often interchanges FDI with international production. He fails to recognize that FDI may also link with trade. The shortcoming is due to the inadequate recognition of the nature and function of FDI. Thirdly, the theory confuses international business with international production and fails to recognize that arm’s-length trade and independent intra-firm trade are the other two important international business modes.

E. A New Eclectic Paradigm for FDI

The imperfection of these trade, FDI and international business theories calls for a new FDI theory under which we can explain the relationship between trade and FDI.
Dunning's Eclectic Paradigm has established a powerful theoretical foundation for a proper FDI theory. If we apply the core of Dunning's Eclectic Paradigm -- the OLI advantages hypothesis to FDI in independent intra-firm trade, we can see that it still holds very well, because these advantages are general advantages of a firm or a country rather than of international production. To develop a proper FDI theory, what I need to do is to introduce into the Paradigm the FDI perspective (the perspective of FDI in international production and distribution discussed in Section 1). The main contribution of my FDI perspective is the separation of FDI from international production, and the integration of independent intra-firm trade into FDI theory. The new FDI theory, which is the combined wisdom of Dunning's Paradigm and my FDI perspective, can be called the "New Eclectic Paradigm". Under the new Paradigm, we can explain properly the reasons for FDI as well as the relationship between trade and FDI.
CHAPTER THREE
INVESTMENT-RELATED TRADE MEASURES AND TRADE-RELATED INVESTMENT MEASURES

THE PURPOSE OF THIS CHAPTER is to address optimal trade and FDI policies by analyzing the dynamic impacts of trade policy on FDI and FDI policy on trade. The neoclassical market theory and the new Eclectic Paradigm will be deployed to evaluate the efficacy of current Investment-Related Trade Measures (IRTMs) and Trade-Related Investment Measures (TRIMs). The discussion of the close relationship between trade and FDI in Chapter Two will shed light on the analysis of related policy efficacy. Some qualifications will be considered in proposing government non-interventionist policy.

I. IRTMS AND TRIMS: THEIR IMPACT ON FDI AND TRADE

The analysis of the impact of IRTMs and TRIMs on FDI and trade will be based on the IRTMs and TRIMs of host countries, with some discussion basing on IRTMs and TRIMs in home countries and international agreements. An important policy background of both IRTMs and TRIMs is that the vast majority of these measures are directed towards increasing exports or decreasing imports. Host countries seldom adopt a trade or FDI policy that would encourage imports or discourage exports, because they believe such a policy would be inconsistent with their endeavor in enhancing domestic economic growth and development.
Based on the understanding that FDI is a continual process of capital flow, in this section, I will define FDI measures in a broad sense to include measures on the entry, establishment, operation, termination, and repatriation of foreign capital. The discussion of IRTMs and TRIMs will be based on this broad definition.

Another characteristic of this section is that the examination of IRTMs and TRIMs will be conducted in both a broad and narrow sense. In a broad sense, IRTMs refer to all trade measures, and TRIMs refer to all FDI measures. In a narrow sense, only those trade measures that have a direct impact on specific FDI activities are IRTMs. Similarly, only those FDI measures that directly change trade patterns and volumes are TRIMs.

When examining IRTMs and TRIMs in a narrow sense, a three-step procedure will be involved. First, those IRTMs and TRIMs employed by host and home countries will be identified. Second, the impact of each IRTM on FDI and each TRIM on trade will be evaluated. Lastly, those measures that require correction or adjustment at the domestic level and those measures need to be addressed at the multilateral level will be identified.

A. IRTMs

IRTMs are a diverse array of trade policy instruments that influence the volume, sectoral composition and geographic distribution of FDI. Some trade measures are specifically designed to influence FDI, while other trade measures are not designed to influence FDI directly but nevertheless can have an impact on FDI.

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1. **IRTMS IN A BROAD SENSE**

All trade measures can be categorized into three types by their nature: restrictive IRTMs, liberal IRTMs, and incentive IRTMs. The impact of trade measures on FDI will be discussed under the three types.

Each restrictive IRTM in the form of either tariff or non-tariff trade barrier constitutes a cost to trade. Firms engaging in international production and distribution are sensitive to trade costs. Except for M-production, both international production and independent intra-firm trade are closely linked with trade. Therefore, restrictive IRTMs will discourage firms from undertaking international production (except for M-production) and independent intra-firm trade. Consequently, although FDI in M-production (so-called "tariff-jumping FDI") may still happen to a certain degree, generally speaking FDI in international production and distribution will be impeded or constrained.

Conversely, liberal trade measures in the form of tariff reduction and non-tariff barrier dismantling reduce trade costs, hence encouraging FDI in international production and trade. Incentive trade measures in the form of various kinds of export subsidies to some extent compensate for burdensome trade costs relating to high tariffs and non-tariff trade barriers, or lower the overall local production costs if trade costs are not an issue. Both liberal and incentive IRTMs raise the economic benefits from international production and trade, thus encouraging firms to undertake international production and trade. As a result, FDI flows will increase.

To conclude, in a broad sense, every trade measure is an IRTM. Restrictive trade measures generally impede FDI, while liberal and incentive trade measures encourage FDI.
2. **IRTMS IN A NARROW SENSE**

The analysis of IRTMs in a narrow sense will draw heavily from the recent study of IRTMs by UNCTAD, the first comprehensive study ever conducted on IRTMs. The UNCTAD study categorizes IRTMs into four types: market access restrictions, market access development preferences, export promotion devices and export restrictions. However, this thesis will reclassify those IRTMs identified by UNCTAD into three basic types: restrictive IRTMs, liberal IRTMs, and incentive IRTMs. The rationale for such a classification is that, as indicated above for IRTMs in a broad sense, each group of IRTMs has a distinctive nature and an identical impact on FDI.

(a) **Restrictive IRTMs**

Restrictive IRTMs are those trade policies that restrict or otherwise disadvantage trade, and therefore exert an impact on FDI. Most restrictive IRTMs are import restrictions, while a few of them are export restrictions. This is because the design of restrictive trade policy is designed mainly to protect domestic products or industries from competition from imported foreign products.

(1) **Tariff and Quantitative Restrictions on Imports**

This kind of trade measure restricts and hence discourages imports. As a result, E-production that is heavily reliant on foreign inputs will less likely take place. Accordingly, FDI for E-production will be less likely to occur. Independent intra-firm trade will be taken at a relatively low level because imports to the country concerned are constrained. If other countries adopt similar import restrictions to exports from the
country concerned reciprocally, which are often the case, exports from the country concerned will also be constrained. In such a case, FDI in independent intra-firm trade will take place at a relatively low level. Nevertheless, M-production, which is less dependent on foreign inputs, will likely take place. That can explain why “tariff-jumping M-production” was so popular while E-production seldom took place in the past when tariff and quantitative restrictions were high. It should be noted that tariff-jumping M-production generally does not contribute to further trade flow because of the high trade costs. However, successive negotiating rounds of tariff and quantitative restriction reductions have weakened the role of import restrictions in import-substitution strategies, although the effect in a few industries may still be significant.

(2) Sectoral Trade Restraints
Countries use this kind of measures to constrain certain imports that are deemed to constitute a threat to similar domestic industries. The United States used “voluntary export restraints” in the early 1980s to constrain Japanese auto imports. The European Community (EC) also used similar restraints called “national restrictions” to limit Japanese auto imports into EC members. Both these two cases led to a second stage effect: The development of Japanese FDI in auto production in the US and EC respectively. This kind of IRTMs can have a three-fold impact on FDI: keeping FDI in the countries whose trade position is enhanced (retention); drawing FDI from other countries to the advantaged country(ies) (attraction); and effectively excluding non-capital-exporting countries from potential participation in affected sectoral transactions.68

67 Ibid.
68 Ibid.
(3) Anti-dumping Measures

Generally speaking, anti-dumping measures are designed to prevent international price discrimination, international predatory pricing and intermittent dumping. The problem with anti-dumping measures is that, while domestic enterprises may price at or close to marginal cost without being penalized by government regulations, foreign firms may fall into victim to the imposition of anti-dumping duties for similar pricing methods. If such discrimination against imports is significant enough, anti-dumping measures can affect FDI in following ways: Firstly, these measures may force a foreign firm to move M-production (tariff-jumping production) into the protected market to avoid the anti-dumping threat. As a result, FDI associated with M-production will take place. For example, both Japanese and Korean firms had been subject to frequent dumping allegations and “voluntary” export-constraint pressure, and consequently, these firms responded by moving production units to their export markets in the United States and the European Union. Secondly, these measures may discourage foreign as well as domestic firms from undertaking international E-production, because a lower-cost product from E-production is more likely to face anti-dumping duties. Consequently, FDI in E-production will be less likely to occur. Lastly, due to the anti-dumping threat, firms may have less incentive to undertake intra-firm trade in both E-production and independent intra-firm trade, thus impeding related FDI flows.

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69 See Michael J. Trebilcock and Robert Howse, THE REGULATION OF INTERNATIONAL TRADE, 2ND EDITION, ROUTLEDGE, London and New York, p.188.
70 See UNCTAD, Supra note 66.
(4) Export Restrictions

Export restrictions are often imposed for national security or other foreign policy purposes to prevent militarily sensitive products from reaching potential adversaries or to deny goods and services otherwise beneficial to political opponents.\footnote{See UNCTAD, Supra note 66.} When internationally agreed trade controls are not achievable or effective and extraterritorial enforcement is impractical, firms may choose to evade national export controls by undertaking international production and/or independent intra-firm trade if international practice is a viable business.\footnote{Ibid.} In such a case, export controls encourage FDI outflow. Meanwhile, potential foreign firms may hesitate to place such a sensitive E-production in the country with export controls. They are more likely to locate such an E-production in other countries. Such a move changes the location of FDI in E-production.

(b) Liberal IRTMs

Liberal IRTMs are favorable trading conditions in the form of reduced trade barriers and/or facilitated customs clearance procedures. There are two types of liberal IRTMs: Export Processing Zones (EPZs) and International Preferential Arrangements (IPA). EPZs as liberal IRTMs generally apply to domestic as well as foreign firms in a host country. IPAs are international liberal IRTMs that apply to specific countries or regions, which include international preferential trade arrangements (IPTAs) and regional free trade agreements (RFTAs). IPTAs and RFTAs provide further trade concessions to some specific countries or members, thus constituting discrimination against non-recipients or
non-member states. Nevertheless, they are permitted under Article XXIV “Customs Unions and Free-Trade Areas” of the GATT.

(1) Export Processing Zones (EPZs)
An EPZ is a geographic area designated by a country to attract foreign and domestic business operations. The attractions usually are very liberal trade rules that are not available for firms in the rest of the country, which may include facilitated or improved custom services, reduced import duties and/or duty-free import of production factors. Many countries have used EPZs to promote export-oriented business activities. For example, there were some 200 EPZs around the world in early 1989. By 1996, the figure had climbed to at least 840.

EPZs have mainly induced E-production, with some M-production and independent intra-firm trade. Consequently, EPZs generate a broad range of FDI. EPZs built and operated by foreign firms are a typical E-production in EPZs. For example, Japan’s Sumitomo Corporation has developed fourteen EPZs in countries throughout Asia in order to take advantage of host countries’ liberal trade rules to facilitate its international production and intra-firm trade among these EPZs and to maximize the benefits from such a multinational network.

(2) Preferential Arrangements for Developing Countries
Under certain conditions, developed countries grant special trade preferences to designated developing countries. These special treatments nevertheless are permissible

\(^{74}\) Ibid.  
\(^{75}\) Ibid.
under the multilateral trading system. Some of them are: the Generalized System of
Preferences (GSP) under the WTO regime, the United States Caribbean Basin Initiative
(CBI), and the Lome Convention Arrangements supervised by the European Union (EU).
The basic feature of these preferential arrangements is the grant of duty-free access for
specified products from designated developing countries to developed country markets.
Some of these arrangements, e.g. the CBI, deploy rules of origin in order to preclude
products of non-designated countries from enjoying the benefits through trans-shipment,
while others such as the Lome Arrangements do not have rules of origin for that purpose.
The FDI-related impact is obvious. Since these trade preferences create a significant
advantage for certain products from designated countries over products from non-
designated countries, E-production will more likely go to those designated countries.
Thus, there will be an increase of related FDI flowing to these developing countries,
which is often at the expense of non-designated countries. Such an effect is reinforced in
the CBI case where the rules of origin are strictly enforced.

(3) Regional Free Trade Agreements (RFTAs)
RFTAs generally are a more liberalized trading system than the WTO regime, because
they allow goods and firms within the regions to enjoy more liberalized trade conditions
than goods and firms from outside the region. These RFTAs are considered to be
conducive to free trade and free international production. However, not all scholars think
so. Trebilcock and Howse argue that regional trading blocs always entail some degree of
trade diversion as well as trade expansion and thus carry the potential for distorting

76 Ibid.
global trade and reducing global economic welfare.\textsuperscript{77} Although RFTAs may cause some negative effects and may not be optimal, they are still better than the trade conditions under the WTO regime. Therefore, I prefer to treat them as liberal IRTMs. Some major RFTAs are EU, NAFTA and MERCOSUR.

The establishment and proliferation of RFTAs exert a significant impact on FDI in independent intra-firm trade and international production. Firstly, the establishment of RFTAs propels intra-regional FDI flows. As UNCTAD noted, the announcement of the EC 1992 reform programme prompted firms from EC member countries such as France and Germany to expand intra-EC FDI flows, positioning themselves to take advantage of the new market integration opportunities.\textsuperscript{78} Secondly, RFTAs attract firms from non-member countries to establish production facilities in these regions in order to gain a “level playing field” with competitors within the regions, or to take advantage of an integrated market. Thus, production-related FDI increases. Thirdly, rules of origin, which are an important instrument deployed by RFTAs to determine whether a product reaches the level of regional content for enjoying the regional trade benefits, reinforce FDI in M-production in the regions. Again, this gain for member states of FDI in M-production sometimes is the loss of FDI in E-production for other countries. For example, AT&T shifted production of telecommunication equipment from Asia to Mexico due to a requirement that at least nine of ten printed circuit boards (the key component of office switching equipment) be packed within NAFTA to qualify for its trade benefits.\textsuperscript{79} Canon reportedly invested over $100 million in a new United States copier facility, rather than

\textsuperscript{77} See Trebilcock and Howse, Supra note 69, p. 519.
\textsuperscript{78} See UNCTAD, Supra note 66.
\textsuperscript{79} Ibid.
building the plant in lower-cost China or Malaysia, because a special NAFTA rule of origin for copying machines required the equivalent of 80 per cent local value added.\textsuperscript{80}

The effect following FDI diversion may not be totally negative. Arguably, TNCs divert FDI to these free trade regions because such a move reduces production and/or distribution costs, or expands sales. There should be higher efficiency for firms to produce in the regions than in other non-member countries. Moreover, such a tendency may drive those non-member countries to liberalize their stringent trade and FDI regime in order to attract or maintain FDI.

(c) Incentive IRTMs

Incentive IRTMs are various kinds of benefits granted to specific foreign firms or products. They are different from liberal IRTMs, not only because they constitute discrimination against domestic firms and other foreign firms or products, but also because they represent strong government interference in the market.

\textit{(1) Preferential Import Duties}

Governments often use import duties reduction or exemption for production inputs and capital goods to attract foreign firms to set up production facilities in their countries. The availability of such benefits is an important consideration in TNCs' international production decisions. Hanson noted that when GM and FORD finally settled their investment locations in Brazil in the late 1990s, the exemption from import duties for

\textsuperscript{80} Ibid.
plant machinery was among the three major benefits the local governments in Brazil had assured for both companies.\textsuperscript{81}

Therefore, preferential import duties can play an important role in attracting FDI in international production.

\textit{(2) Export Financing Programs (EFPs)}

EFPs are various financial supports and benefits offered by governments to promote exports or export-oriented activities. EFPs generally apply to foreign investors and domestic firms alike because they target the export activities rather than specific firms. Basically, there are two kinds of such programs: export credits and export tax rebates. Export credits are offered in various forms such as preferential interest rates, cash-down payments, repayment periods, concessional financing levels, and most recently, minimum premium rates for country and sovereign risk.\textsuperscript{82} Although export tax rebates on direct (income) taxes are proscribed as illegal export subsidies and are prohibited, export tax rebates on indirect (sales or value-added) taxes are permissible. A recent ruling issued by the Appellate Body of the WTO in February 2000 on the complaint brought by the EC against the US on tax treatment for ‘Foreign Sales Corporations’ indicates the controversies surrounding the export tax rebate issue. FSCs are foreign corporations responsible for certain sales-related activities in connection with the sale or lease of goods produced in the US for export outside the US. The FCS measure essentially exempts a portion of an FSC’s export-related foreign-source income from US income tax. The Appellate Body ruled that the FSC measure creates a “subsidy” because it creates a

\textsuperscript{81} See Hanson, \textit{Supra note} 25.

\textsuperscript{82} \textit{Ibid.}
“benefit” by means of a “financial contribution”, in that government revenue is foregone that is “otherwise due”. This “subsidy” constitutes a prohibited export subsidies under the SCM Agreement and the Agreement on Agriculture because it is contingent upon export performance.83

The impact of incentive IRTMs on FDI can be identified as follows: First, various export credits and tax rebates increase the possibility of E-production in the country that offers such programs, because the profitability of such operation is improved. Second, export-related tax benefits may not only promote trade performance but also influence FDI outflow. In the FCS tax treatment case, the tax exemption incentive induced many US firms to establish a FCS in a convenient foreign country to manage intra-firm exports from the US. As a result, FDI outflow for intra-firm trade purpose increased dramatically. Therefore, we can conclude that domestic trade-related tax policy can exert a significant influence on FDI outflow.

Trade measures discussed above are the important IRTMs. Apart from that, the UNCTAD paper treated measures such as national regulatory standards, co-production requirements and foreign exchange restrictions as IRTMs. In my view, these are either production or monetary measures rather than trade measures. Therefore, they will not be discussed under IRTMs in this section.

B. TRIMs

TRIMs are government FDI measures that affect trade patterns, volumes or flows.

Many countries introduce TRIMs to manipulate FDI activities in a way to benefit the trade performance of their countries. TRIMs can be categorized into two groupings: restrictive TRIMs and incentive TRIMs. Restrictive TRIMs are FDI measures that not only restrict or discourage FDI, but also exert an impact on trade. Incentive TRIMs are various tax holidays, grants, and subsidies that are offered specific to foreign investors but nevertheless have an impact on trade.

1. TRIMS IN A BROAD SENSE

TRIMs in a broad sense include all FDI measures, including restrictive and incentive measures. There is no exact figure on how many kinds of FDI measures have been adopted around the world. However, a recent survey conducted by the Canadian Chamber of Commerce (CCC) gives us a rough idea about the size of restrictive FDI measures existing in the world. The survey, which was conducted among 71 CCC members that had an international presence and represented a variety of industry sectors and company sizes, has identified a total of 106 kinds of FDI barriers. Among them, the major types of FDI barriers are: restrictions on industry entry, monopolies in an industry, ownership constraints, limitations on the forms of establishment, preferences for non-equity (e.g. licensing, franchising, management contracts, collaborative agreements) versus equity participation, preferences for “Greenfield” investment versus direct acquisition of domestic enterprise, restrictions on the geographic location of affiliates, limitations on the number of foreign firms (e.g. open or hidden quotas on number of licenses to foreign firms), limitations on land ownership, and local employment requirements. Most of these

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FDI barriers are restrictive in nature, while some cannot be characterized as restrictive FDI measure because they are incentives in nature or do not specifically target FDI. Incentive FDI measures are also prevalent around the world. According to a recent UNCTAD survey of tax incentive regimes in over 45 countries from all regions of the world, nearly all countries offer incentives that target specific sectors. The UNCTAD study on Tax Incentives and Foreign Direct Investment identified the following fiscal incentives: tax holidays or tax rate reductions; accelerated depreciation allowances; allowances for investment in training, research and development or similar types of activities; and export incentives.

As discussed in Chapter Two, FDI supports trade in both international production and independent intra-firm trade. With respect to the policy of a host country, any FDI measure that is restrictive or disincentive in nature will discourage FDI inflows. As a second stage effect, trade that is dependent on or closely linked with FDI will decline. In contrast, any FDI measure that is liberal or incentive in nature will encourage FDI inflows. As a result, trade that is dependent on or closely linked with FDI will expand.

2. TRIMS IN A NARROW SENSE

There is no definite scope for TRIMs in a narrow sense. Nevertheless, TRIMs are very commonly used by nations. According to a USTR study that was based on a survey of fifty-one countries, of the thirty-one “middle income and less-developed” countries, twenty-three had local content requirements and sixteen had export performance.

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86 Ibid.
requirements. Eleven of the countries had TRIMs specifically geared toward the automotive industry. Among the twenty developed countries, six had local content requirements, and three had export requirements.\textsuperscript{87} Moran and Pearson has defined TRIMs as including export requirements, local content requirements, requirements on the use of local labor, limits on foreign ownership of equity, counter trade requirements, and foreign exchange balancing requirements.\textsuperscript{88} Edwards and Lester listed the following as TRIMs: export performance requirements, product-mandating requirements, trade-balancing requirements, local content requirements, manufacturing requirements and limitations, local equity requirements, licensing requirements, technology transfer requirements, and TRIMs for regional development purpose.\textsuperscript{89}

In my view, requirements on the use of local labor are FDI measures related to trade in services rather than to trade in goods. Licensing requirements and technology transfer requirements are not FDI measures, nor do they have an obvious impact on trade. Therefore, these measures will not be discussed in this section. Since TRIMs for regional development purpose are similar to those TRIMs applying nationwide, they do not warrant independent study.

(a) TRIMs in The WTO

The WTO TRIMs Agreement applies only to measures that affect trade in goods. An illustrative list of TRIMS recognized as being inconsistent with GATT articles is appended to the agreement. The Agreement prohibits the following TRIMs: (i) measures


\textsuperscript{88} Ibid.

\textsuperscript{89} Ibid.
which require particular levels of local procurement by an enterprise ("local content requirements"), (ii) measures which limit the amount of an enterprise's imports to its exports ("trade-balancing requirements"), (iii) measures which limit an enterprise's imports based on general or foreign exchange control grounds ("quantitative restrictions on imports"), and (iv) measures that restrict the exportation of products ("quantitative restrictions on exports").

The WTO TRIMs agreement bans local content requirements and trade-balancing requirements, based on the reasoning that they are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994. According to the Agreement, local content requirements are measures that require the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production. Trade-balancing requirements are measures which mandate that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

A local content requirement is a TRIM because it requires a foreign investor to purchase more local inputs or products than the amount without the requirement. Other things being equal, this will result in a decrease in imports into the country applying the TRIM. Obviously, local content requirements directly restrict imports.

89 Ibid.

Trade-balancing requirements comprise another type of TRIM because they limit the volume or value of products an enterprise can purchase from foreign sources to its export level. The purpose of such policy is to balance trade. Under such a policy, enterprises often must refrain from purchasing abroad or must boost their exports. Subsequently, trade is distorted.

The WTO TRIMs agreement also prohibits quantitative restrictions on imports and exports, based on the reasoning that they are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994.

Quantitative restrictions on imports or exports become TRIMs when a government restricts a foreign investor’s ability in purchasing products from foreign sources, or requires a foreign investor to export certain amount of local products. The most common motive behind these policies, besides the trade-balancing motive, is to protect domestic industry, or to balance payments. Although the purpose here is somewhat different from trade-balancing purpose, the practice is similar. These measures have an apparent trade-restricting or distorting effect.

It should be noted that the applicable scope of the TRIMs agreement extends beyond trade-related FDI measures, because the agreement does not limit its applicability to FDI. Thus, arguably, it also applies to domestic investment.

Nevertheless, the TRIMs Agreement provides some substantial exceptions for WTO members. First, Article 4 specifically notes that developing countries may deviate from the TRIMs Agreement when experiencing balance-of-payments difficulties, in accordance with Article XVIII of the GATT. Second, Article 5 allows countries
substantial transition periods before fully complying with the Agreement. The length of this period depends on a country's status as developed (two years), developing (five years), or least developed (seven years). Besides, the Agreement confines TRIMs that should be disciplined only to those inconsistent with existing GATT articles. Thus, other trade-distorting TRIMs that arguably violate the intent and spirit of the GATT are still permitted. Therefore, the Agreement is ineffective and incomplete in many ways.

(b) Other TRIMs

(1) Restrictive TRIMs

Remittance restrictions are restrictions on foreign capital outflows in terms of the repatriation of profits and other capital withdrawals. Therefore, they are FDI measures. The impact on trade flows of these FDI measures is unclear. For example, it is difficult to predict ex ante how a restriction on the remittance of profits may affect trade flows. If profits cannot be remitted, they may be used either to purchase more local goods (which leads to a decline in imports), or to purchase foreign goods as inputs for the manufacturing process (which leads to an increase in imports). However, the general effect on FDI from the restriction is no doubt negative, which means that firms will undertake less FDI than without such restriction. Thus, FDI-related trade is also reduced.

(2) Incentive TRIMs

Recently, there has been a transition with regard to TRIMs among countries from the use of restrictive performance requirements to incentive FDI measures. Countries have realized that performance requirements, once seen as essential, have proved detrimental

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91 See Edwards and Lester, Supra note 85.
in the end.\textsuperscript{92} As a comprehensive study of investment in ASEAN countries noted, regulations specifying a minimum level of local content, a minimum proportion for export and a minimum amount of technology transfer have been largely replaced by incentives to those firms that produce goods with a certain local content ratio or export a specific proportion of their output, or transfer advanced technology.\textsuperscript{93} Broadly speaking, incentive TRIMs refer to FDI measures that encourage foreign firms to purchase local production factors, fixed assets and other goods for their local production and intra-firm trade, and FDI measures that encourage foreign firms to export locally made products. They are often in the forms of tax rebates, corporate income tax exemptions, import duty reductions or exemptions, preferential financial terms, and direct purchase or exporting funding. Hanson notes that, in 1998-1999, 103 countries granted special tax concessions to those foreign corporations that had set up production or administrative facilities within their borders. Incentive TRIMs raise the economic benefits of FDI related to intra-firm trade and local production in the host country, thus boosting host country's exports and reducing its imports. Therefore, incentive TRIMs have an obvious trade-distorting effect.

(c) The Combined Use of Incentive and Restrictive TRIMs

Another common government practice is to combine the use of incentive and restrictive TRIMs for one purpose rather than to use them separately.


\textsuperscript{93} See Edwards and Lester, \textit{Supra note 85}. 
For example, the Brazilian auto regime, which was established in 1995, provides that a foreign automaker can receive tariff reductions of up to 90% on imported capital goods, between 40% and 80% on imported raw materials, parts, and components, and 50% on imported assembled automobiles.\textsuperscript{94} If a foreign automaker wants the benefits, it must meet the following requirements: (I) a local content requirement of 60% in its vehicles manufactured in Brazil; (II) a one-to-one ratio of imported to domestic capital goods and imported to domestic raw materials; (III) a producer may not permit its imports of raw materials and assembled automobiles to exceed its net exports; (IV) its imports of auto parts may not exceed two-thirds of net exports.\textsuperscript{95} The Brazilian auto regime prompted Japan, the US and the EU to formally complain against Brazil to the WTO Dispute Settlement Body in 1996 and 1997. Instead of requesting the formation of a dispute panel, all of them sought to solve the issue through consultation. Before the Brazilian auto regime, Argentina in early 1990s had already implemented similar measures that combined tax and tariff incentives with local content requirements. Attracted by these measures, foreign automakers one after another invested in Argentina, thus helping Argentina develop a trade surplus in the automobile industry with Brazil.\textsuperscript{96} These programs have mixed effects on businesses. For those automakers that were attracted by these measures and invested in the countries, they should have benefited from the combined TRIMs by saving overall production costs. For those foreign suppliers who would otherwise have gained from local productions, the increase of local procurements was a significant loss for them because it substituted for their exports that

\textsuperscript{95} Ibid.
\textsuperscript{96} Ibid.
would otherwise have occurred. Although the combined TRIMs are beneficial to both those automakers and local economy, they entailed losses for foreign suppliers and more importantly, distorted trade. Such combined TRIMs arguably violate the TRIMs Agreement. In another case, i.e. Indonesia – Certain Measures Affecting the Automobile Industry, a WTO panel ruled that the custom duty benefits in favor of imported parts and components used in certain car assembled in Indonesia violated Article I (the Most-Favored-Nation principle) of GATT. Therefore, even if the combined TRIMs actually reduce the overall cost of production, they nevertheless constitute discrimination against foreign products and thus violate the GATT and the TRIMS agreement.

(d) TRIMs in Chinese Law

There are three basic laws that regulate FDI in China. They are: (I) the Wholly Foreign-owned Enterprise Law ("Foreign Enterprise Law"), (II) the Sino-Foreign Co-operative Enterprise Law ("Co-operative Law"), and (III) the Joint Venture Law. Recently, the Standing Committee of the People's Congress amended the Foreign Enterprise Law and the Co-operative Law on October 31, 2000, and amended the Joint Venture Law ("JV Law") on March 15, 2001. One major change to the three basic laws was the repeal of the local purchase preference requirement that had been in place for about 20 years. There is no remittance restriction on the repatriation of profits, other revenue and liquidated assets.

TRIMs existing in Chinese law are enumerated below under two categories: restrictive TRIMs and incentive TRIMs.

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(1) Restrictive TRIMs

Although the Chinese government has endeavored to reduce restrictive TRIMs, there are still some restrictions on imports by foreign investors. For example, the implementation provisions of both the JV Law (Article 55) and the Foreign Enterprise Law (Article 45) stipulate that if foreign investors import equipment and machinery, components and parts, raw materials and fuel, they may need to apply for import permits from the competent authority.98 Article 27 of the implementation provision of the Foreign Enterprise Law stipulates that the registered foreign capital in the form of intangible goods such as patents and know-how must not exceed 20% of the total registered capital.99 These restrictive TRIMs to some extent discourage FDI inflows into China.

(2) Incentive TRIMs

There are many incentive TRIMs existing in FDI-related Chinese laws. For example, both Article 17 of the Foreign Enterprise Law and Article 8 of the JV Law provide that a foreign investor can apply for a corporate income tax refund in the amount that the investor has paid for the profits that are retained and reinvested in China.100 There are other incentives for trade-related FDI. For example, Article 61 of the implementation provision of JV Law provides that the foreign investment that is used for importing equipment and machinery, components and parts and other materials according to the approved contract, can enjoy the reduction or exemption of import duties.101

99 Ibid.
100 Ibid.
101 Ibid.
According to the same article, a JV can also enjoy import duty reduction or exemption if the JV exports the product that uses these imported materials.  

According to the Notification issued on January 14, 2000 by the Department of Finance and the State Revenue Bureau, foreign investors can use the annually increased amount of payable corporate income tax to offset up to 40% of the total purchase value of domestic-made equipment.

The numerous incentive TRIMs provided to foreign investors by the Chinese government are mainly in the form of reduction or exemption of import duties and tax refunds or rebates. These incentive TRIMs are designed to encourage foreign investors to purchase or export local products, or to introduce advanced technology.

From the discussion above, I conclude that measures regarding to local content requirements, trade-balancing requirements, quantitative restrictions on imports, remittance restrictions, and various incentive TRIMs are those major TRIMs in use that directly restrict or distort trade.

II. THE ECONOMIC ANALYSIS OF IRTMS AND TRIMS

Governments use IRTMs and TRIMs to influence firms’ international business decisions and behaviors in a way they deem appropriate for economic development. The intended objective of IRTMs is to use trade measures to attract FDI or to channel FDI into specific industry or region. The deliberate purpose of TRIMs is to use FDI measures to attract FDI or direct FDI in a way that is beneficial to host country’s domestic industries and

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102 Ibid.
trade performance. Therefore, there is a policy convergence between IRTMs and TRIMs. The policy target for both IRTMs and TRIMs is FDI. The objective of these policies is to exploit the maximum benefits from FDI for economic development and growth while avoiding possible negative effects of FDI on national economy such as balance-of-payments and balance-of-trade. The central question here is: are those IRTMs and TRIMs enumerated above the most effective and efficient ways to attract and utilize FDI for economic development and growth? Since firms are the target of as well as the respondent to these IRTMs and TRIMs, before we undertake an economic analysis of the central question, we need to know first what are the factors that firms take into account in making their FDI decisions.

A. **Locational Factors in Firms’ FDI Decision**

There are a number of empirical studies on the factors that influence firms’ locational decisions. Between November 1999 and January 2000, the UNCTAD and the International Chamber of Commerce (ICC) conducted a joint survey among 296 of the world’s largest TNCs. The joint survey indicated that economic growth, the size of local markets, and the profitability of FDI, were the most enticing factors and were mentioned most frequently as influencing corporate investment decisions in a positive way. On the negative side, the prevalence of extortion and bribery and difficult access to global markets were by far the most discouraging factors cited, followed by the overall political and economic outlook, access to capital and high administrative costs of doing

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103 *ibid.*
104 See UNCTAD, *Supra note 28.*
business.\textsuperscript{105} ICC Secretary-General Maria Livanos commented, "The inescapable conclusion is that foreign direct investment, coupled with the grass-roots development of a viable private sector, are key to economic and social progress in Africa. Good governance, a transparent and predictable regulatory framework, the rule of law and a stable society all contribute to a hospitable investment climate."\textsuperscript{106} Although the joint survey focused on the determinants of FDI in African countries, it is also applicable to developing countries in other regions, because the issues and problems pertaining to FDI and economic development among them are similar in many ways.

The report of the WTO working group on trade and investment concluded that the fundamental factors explaining decisions of multinational enterprises to invest in developing countries were availability of natural resources, market size, and the existence of a suitable platform for exports. The strength of local institutions, the quality of local infrastructure and of the work force and the degree of macro-economic stability also played a role.\textsuperscript{107} One WTO member concluded from its experience that the maintenance of a high level of competition, a stable political and macroeconomic climate, open trade and investment policies, adequate transport and communications infrastructure and the maintenance of a predictable and effective institutional environment were important conditions for attracting foreign investment and enhancing its benefits.\textsuperscript{108} Hanson’s empirical research suggests that FDI is sensitive to both host-country tax polices and economic conditions, including the educational level of the labor force,

\textsuperscript{105} \textit{Ibid.}  
\textsuperscript{106} \textit{Ibid.}  
\textsuperscript{107} See WTO, Supra note 90.  
\textsuperscript{108} See WTO, Supra note 22.
overall market size, and the size of the local industrial base. He quoted Intel executives as saying that they chose Costa Rica based on the country’s long history of stability, open trade and investment regime, relatively high-quality primary and secondary educational systems, and recent success in attracting other multinational firms in electronics.

Dunning stresses that the locational attractions of countries are increasingly viewed by mobile investors in terms of the ability of those host countries to provide the kinds of human and physical infrastructure and other kind of support facilities necessary for their O-specific advantages to be productively employed. Incentives, i.e., policies to promote FDI, would encourage multinational production by raising the advantages of multinationality, i.e., lower production costs.

From the empirical studies above, we know that market size, the quality of work force (labor), the adequacy of infrastructure, the stability of the political and economic environment, the efficiency of governmental institutions, and the openness of trade and investment policies are the most frequently cited locational factors that influence firms’ FDI decisions. This conclusion has the following implications for governments: First, the openness of trade and investment policies is one fundamental factor that influences firms’ FDI locational decisions. Therefore, restrictive IRTMs and TRIMs, which are the antithesis of open trade and FDI policies, no matter whether in the form of tariffs and non-tariff barriers or local content requirements or balance-of-payments requirements, are obviously among the negative factors in firms’ FDI decisions. Second, none of these fundamental factors are related to incentive IRTMs and TRIMs, which means that firms

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109 See Hanson, Supra note 25.
110 Ibid.
are concerned much more about the general market conditions and the basic human and physical infrastructure than specific FDI incentives. Or in other words, incentive IRTMs and TRIMs are less crucial or influential factors in firms' locational decisions. Oman's study confirms the observation above. He noted that the evidence is consistent with the view that a FDI decision normally involves a two-stage (or multi-stage) process. Investors first draw up a short list of acceptable locations on the basis of the economic and political "fundamentals", largely irrespective of the availability of fiscal and financial incentives from potential host governments. And only later, after the short list is drawn up on the basis of the investment "fundamentals", do investors consider — and often seek out — investment incentives, sometimes playing one government off another at this stage of their location decision. Therefore, with respect to the effects of incentives on corporations' real investment-location decisions, firms attach much greater overall importance to the "fundamentals". Only when these "fundamentals" are similar, firms will consider or seek FDI incentives. This is particularly true in locational decisions for major new investment projects, in which FDI incentives sometimes can play a decisive role if the difference in "fundamentals" among potential locations is minimal.

B. The Economic Analysis of IRTMs and TRIMs

The neo-classical theory of free trade and the modern theory of the firm suggest that in a world where government action does not influence the allocation of productive resources apart from background rules of property rights and contracting, markets themselves should generate optimal levels of FDI. Therefore, government intervention by its nature
distorts the allocation of productive resources, inasmuch as disincentives reduce the level of FDI below the market optimum, or incentives increase the level above that optimum.\textsuperscript{112} From an economic welfare perspective, the free international movement of goods and factors of production raises world economic welfare as well as national economic welfare by leading to a more efficient global allocation of resources.

1. \textit{RESTRICTIVE IRTMS AND TRIMS}

Tariffs and quantitative restrictions on imports have an overall negative impact on FDI. As a second stage effect, the costs of products are likely to be higher than without these trade barriers, thus making consumers of affected products worse off. Even in the case of tariff-jumping M-production, consumers in the protected market are still worse off than under conditions of liberal trade, because the investing foreign firm is able to price up to the tariff or other trade barriers (e.g. VERs), thereby still charging consumers higher prices than would be the case without trade restrictions.\textsuperscript{113}

Sectoral trade restraints and anti-dumping practices aim at protecting domestic industries or products. Under the threat of or following the consequence of such policy enforcement, exports to the country concerned are likely fall. At the same time, the price of the affected products will rise, and consumers will pay more for the products and the like domestic products. As discussed above, M-production will likely take place in the country concerned under the threat of both types of TRIMs. However, since M-production is compelled to happen in the country concerned, economic efficiency is


\textsuperscript{112} See Trebilcock and Howse, \textit{Supra note 69}, p. 338.
compromised. Consumers may incur relatively higher product prices in this situation than in the normal case. Moreover, since domestic firms are aware of the threat of these measures, their interest in undertaking E-production overseas will diminish. Thus the economic development of other countries that otherwise would benefit from this E-production is negatively affected.

Export restrictions may encourage the FDI outflow for M-production of affected products. The economic effect is uncertain because, although the production costs may increase, the consumers in the targeted market can access the product. Moreover, the host country may realize other benefits such as employment and technology spillovers.

Restrictive TRIMs such as local content requirements, trade-balancing requirements, balance-of-payments requirements, deprive enterprises of the flexibility needed to adapt to changing economic circumstances. Restrictive TRIMs disrupt foreign direct investors’ decisions on where and how to invest, to procure inputs, and to distribute products, thus altering the cost structure of the affected firms. As a result, Restrictive TRIMs not only injure producers of goods in the investor’s home country or in a third country, but also raise the costs or lower the quality of related products in host country. Thus, both production efficiency and product-related consumer welfare are compromised. Moreover, restrictive TRIMs may create unfair competition among investors in domestic markets and international markets when some foreign firms are subject to these requirements while other foreign firms and domestic firms are not, or when FDI made at different times are subject to different requirements.

In short, restrictive TRIMs distort international trade flows and reduce economic welfare in the host and other countries alike. Hence, they should be abandoned by governments or

\[113\] *Ibid.*
be disciplined in the WTO regime. To sum up, except for export restrictions and remittance restrictions where the overall negative effect is not clear, restrictive IRTMs and TRIMs raise the costs of production and thus make consumers worldwide worse off.

2. **LIBERAL IRTMS**

Liberal IRTMs such as preferential international trade arrangements, regional free trade agreements, EPZs, and preferential import duties reduce tariffs and/or non-tariff trade barriers. Although preferential international trade arrangements and regional free trade agreements discriminate against non-recipients or non-member states, which are allowed under the WTO, they reduce production and trade costs. Therefore, they increase the FDI in E-production. In addition, consumers under these frameworks benefit from lower product prices than consumers in other regions. EPZs entail unilateral trade liberalization that has similar positive results for consumers in the country that adopts such policy. Since these IRTMs improve economic efficiency and contribute to world economic welfare, they should be encouraged.

3. **INCENTIVE IRTMS AND TRIMs**

The direct effect of incentive IRTMs is the distortion of capital and resources allocation, and that of incentive TRIMs is the distortion of trade. In essence, both incentive IRTMs and incentive TRIMs have an overall negative effect on domestic and worldwide welfare. Oman has undertaken an insightful analysis of the negative effects of incentive IRTMs
and TRIMs on FDI and the economic welfare of host and other countries. The following are the main findings from his study:114

1) With respect to the effect of FDI incentives on global FDI flows, the study concludes that there is little evidence that increasing global competition for FDI over the last two decades has contributed in any significant way to the major growth of global FDI that has occurred over the same period. Rather, any relationship of cause and effect between the two phenomena appears more to work in the opposite direction: as the global supply of FDI has risen significantly, governments have intensified competition with one another to attract "their share" of that growth. Several factors have stimulated the growth of FDI, including Europe's Single Market and Maastricht Accords and other regional phenomena, e.g., NAFTA, as well as worldwide economic policy liberalization and market deregulation and the globalization of corporate activity and competition.

2) Incentive FDI measures may exert significant distortionary effects on a domestic economy. Firstly, incentives tend to discriminate against smaller firms, against local firms (de facto, though rarely on a de jure basis) and against firms in sectors or types of activity that are not targeted, thus leading to unfair competition among market players and reducing the efficiency of resource allocation. The cost for attracting FDI in some sectors is significantly high. For example, data on the direct financial and/or fiscal 'cost-per-job' of incentives received by investors in the automobile industry reveal similar orders of magnitude of that cost in OECD and in developing and emerging economies (a cost that often exceeds $100 000). Secondly, costly FDI incentives can be counterproductive if the "fundamentals" of a potential investment

114 See Oman, Supra note 111.
site fails to meet serious long-term real investors’ basic requirements, because the incentives — in addition to the distortions they inevitably introduce — will tend to attract the "wrong kind" of investment, e.g. a production that is not to the best interests of the host country in its social and economic development, or a production that is not the most efficient one. Thirdly, incentive FDI measures also tend to render the broader policy-making process more vulnerable to rent-seeking behavior, perhaps including corruption, which can be very costly — and can even spread and become quite destructive for the economy, for democracy and the development of a modern state, and thus for the very process of development. Fourthly, FDI incentives tend more to compete with than to augment the use of public resources to increase local productivity-enhancing human-capital formation and the supply of modern infrastructure. Fifth, undiscerning use of investment incentives and other discretionary policies by governments to attract FDI can have a negative effect on FDI inflows, in part because the incentive programmes and policies tend to be seen by investors as unsustainable. Lastly, while governments often “justify” providing investment incentives with the argument that they are needed to steer corporate investment to poorer areas within their economy, in practice incentives are often of limited effectiveness in this regard (though there are exceptions) and they sometimes actually reinforce inequalities instead.

In regard to the effects of FDI incentives in international arena, the competition for FDI by nations, dubbed as “a global bidding war for FDI”, often leads to a beggar-thy-neighbor effect, because one country’s gain of FDI often is the loss of another country that cannot or does not offer these programs. Moreover, if the bidding war for FDI among
nations intensifies, it will increase the welfare gap among nations, because developed or large countries often have a deep pocket and attract away the FDI that should have gone to developing or small countries. Even worse, the bidding war for FDI among nations intensifies government intervention in the market. Therefore, there is a need for cooperation among governments to ensure that the competition for FDI does not harm each other’s interests or disrupt the function of international markets.

C. IRTMs and TRIMs: An Overview

Governments have vigorously used restrictive, liberal and incentive IRTMs and TRIMs to manipulate FDI for achieving developmental goals. Except for export restrictions where the negative effect is uncertain, all restrictive IRTMs and TRIMs impede trade and FDI flows and raise the costs of production and trade, thus making consumers worldwide worse off. Therefore, governments should abandon all restrictive IRTMs and TRIMs. Since liberal IRTMs generally aim at liberalizing restrictive trade and investment measures, they create an efficient economic environment for FDI operation for intra-firm trade and international production. Besides, since these liberal measures do not involve any direct government intervention in the allocation of resources, they have the least market distorting effect. Therefore, they should be a choice for government policy making. Incentive IRTMs and TRIMs not only distort trade but also reduce economic efficiency. Hence, governments should not employ these incentive policies.

It should be noted that most of the restrictive IRTMs and TRIMs discussed above have been either disciplined or prohibited by the WTO. Although some of these measures such as tariffs and quantitative restrictions and local content requirements have lost their
significance in government policy options, some measures such as anti-dumping measures still adversely affect world trade and FDI flows. Another important development in IRTMs and TRIMs is that governments have shifted the policy focus from restrictive IRTMs and TRIMs toward liberal and incentive IRTMs and TRIMs. This is because restrictive IRTMs and TRIMs have been strictly disciplined by the WTO, and more importantly, countries have realized that these measures do more harm than good for economic development. While some of the incentive IRTMs and TRIMs in the form of direct subsidies, preferential financial terms, and rebates on direct (income) taxes have been prohibited by the WTO Subsidies Agreement, other incentive IRTMs and TRIMs in the form of tariff and tax reductions or exemptions are still prevalent. In fact, incentive TRIMs in the form of tariff and tax reductions and exemptions, which are offered to specific foreign investors, discriminate against domestic and other foreign investors, and entail similar trade- and market-distorting effect as those direct subsidies that are disciplined by the WTO do.

Porter observed that subsidies delay adjustment and innovation rather than promoting it, because most forms of subsidy limit flexibility and dampen innovation by attaching explicit or implicit strings to them, for example the limits on locations or layoffs.¹¹⁵ Ongoing subsidies dull incentives and create an attitude of dependence, since attention is focussed on renewing subsidies rather than creating true competitive advantage.¹¹⁶ He further argued that government’s intrusive industrial policy seldom succeeded because it

¹¹⁶ Ibid.
was based on a highly simplified and questionable view of competition in which scale and spending were decisive.\footnote{Ibid.}

The general conclusion from the economic analysis of IRTMs and TRIMs is that except for liberal IRTMs and TRIMs, restrictive and incentive IRTMs and TRIMs are inefficient and counter-productive. Therefore, from the neoclassical market theory and consumers welfare perspectives, there is no justification for governments to manipulate restrictive or incentive IRTMs and TRIMs to achieve specific economic goals.

Given that incentive IRTMs and TRIMs are inefficient and market distorting, then, why do host-country governments continue to offer TNCs preferential treatments? Hanson provides us two answers.\footnote{See Hanson, Supra note 25.} First, governments feel compelled to offer concessions to TNCs, given that multinationals subject their locational decisions to bidding by potential host-country governments. Second, the promotion of FDI serves the interests of host-country politicians, in the sense that attracting multi-nationals may benefit specific constituencies, from whom politicians derive support, or may fit into political strategies of empire-building. He argues that whatever the explanation, countries are likely to be better served by being cautious about promoting FDI, until we see strong empirical evidence that the social rate of return on FDI exceeds the private rate of return.

With respect to the solution to the bidding war for FDI among countries, he suggests that the appropriate response is to seek international cooperation among governments to prevent multinationals from extracting all gains associated with their presence in host economies, rather than to validate auctions of this type.
III. THE PROPER GOVERNMENT ROLE FOR ATTRACTING AND EXPLOITING FDI

FDI brings foreign technology and other foreign resources into host countries, and thus raising the productivity of domestic factor and eventually, contributing to national welfare. As discussed above, governments should abandon all restrictive and incentive IRTMs and TRIMs and continue to liberalize all restrictive IRTMs and TRIMs. Nevertheless, this does not mean that governments should have no place in making trade and FDI policies for economic development. Thus, we need to ask: what should governments do to attract and exploit FDI for economic development in this new economic reality? Should they give up their traditional policy tools?

A. The Proper Role for Government

Porter argues that government should not become involved in the competitive process – its role is to improve the environment for productivity, for example, by improving the quality and efficiency of business inputs and infrastructure and creating policies and a regulatory context that stimulate upgrading and innovation. "Government's proper role is as a pusher and challenger. There is a vital role for pressure even adversity in the process of creating national competitive advantage. These are drives that government, by providing too much assistance, undermines ... Sound government policy seeks to provide the tools necessary to compete, through active efforts to bolster factor creation, while ensuring a certain discomfort and strong competitive pressure. Government's proper role is to encourage or even push firms to raise their aspirations and move to a higher level of
competitive prowess even though this may be an unsettling and even unpleasant process.\(^{119}\)

Safarian stresses that the key to policy is to improve the country-specific capabilities which attract and retain the increasingly mobile firm-specific intangible assets embodied in commercial knowledge.\(^{120}\) This is a policy approach which accepts the gains, or the inevitability, of integration driven by technological change, and attempts to make the most of it from a national viewpoint.\(^{121}\) He stresses that governments must follow growth-oriented policies which facilitate market development over time rather than distort resource use permanently. Countries in different circumstances will need to vary the timing and composition of policies. And more consistent, intergovernmental rules are needed if the sometimes-conflicting objectives of firms and governments are to be reconciled.

Daniels and Morck argue that governments should focus on framework policy.\(^{122}\) That is to say, the state should focus on providing the legal and institutional environment in which markets and firms are able to thrive. They stress that the nature and quality of the corporate governance system obtained in a given country is a core feature of an effective framework for competition.\(^{123}\)

From the discussion above, I conclude that the proper government role in attracting, retaining and exploiting FDI should be to provide the human, legal and physical

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\(^{119}\) See Porter, *Supra note 115*, p. 681.
\(^{120}\) See Safarian, *Supra note 57*.
\(^{121}\) *Ibid*.
\(^{123}\) *Ibid*.
 infrastructure in which firms can thrive, rather than to provide direct incentives or in other ways to involve themselves in firms' specific business decisions.

B. Qualifications to Non-interventionist FDI Policy

As discussed above, there is no role for government to use incentive IRTMs and TRIMs to intervene in the market allocation of resources. However, there may be some qualifications to this non-interventionist argument. Hanson argues that if there exists market failure that is specific to multinational production, e.g. multinationals are unlikely to choose the optimal level of production (from the host country's perspective) without a subsidy or other inducement, or if there is clear and direct evidence of substantial positive spillovers associated with multinational production, governments may use incentives to attract or influence FDI.\(^{124}\)

Safarian also agrees that there should be some qualifications to non-interventionist argument so as to reflect a divergence of private and social costs and benefits because, for example, the market lacks fair competition or knowledge of available choices.\(^{125}\)

Based on Giammarino's arguments,\(^{126}\) I conclude that governments should intervene in the following areas in order to attract or retain FDI:

1) The quality of infrastructure. The greater production factor mobility in the
globalization era implies that FDI will flow to the environment that offers the highest overall return. This return includes pecuniary components such as low costs for operation and nonpecuniary components such as high quality of life. A task for

\(^{124}\) See Hanson, Supra note 25.

\(^{125}\) See Safarian, Supra note 57.

government is to invest in infrastructure in order to maintain the efficiency of capital and labor markets and high quality of life. The market alone might not fulfil this task.

2) Public goods. It has been well established that certain investment in programs such as national defense, flood control, R&D, and even mosquito abatement benefits many individuals and firms besides the initial investor. It is difficult if not impossible to restrict the consumption of these public goods to paying customers only. Since the social value of such an investment exceeds the private profits and investors have less interest in it, there is a case for government subsidies or investment.

3) Environmental protection. Environmental standards exert a direct influence on investment decisions. Imposing higher domestic standards not only place domestic firms at a disadvantage in global competition, but also may lead to the flight of capital and/or the loss of FDI. If a relatively high standard is the politically right choice, there should be some way of compensation for firms to offset the extra costs through measures such as a compensatory tax rate, etc.

4) The maintenance of a competitive and open market is essential to promoting economic development and increasing investment. Governments need to intervene with necessary constraints on the practices of domestic and foreign firms alike if the market lacks fair competition. Or governments need to relax ownership restrictions, lift barriers to accessing products and capital markets for FDI.
CHAPTER FOUR

THE IMPLICATIONS FOR THE WTO

THE PURPOSE OF THIS CHAPTER is to draw some implications for the WTO regime from the discussions in previous chapters. Three main topics will be discussed in this chapter: (1) the necessity of integrating FDI rules into the WTO. (2) A proposal for basic FDI rules in the WTO. (3) The compatibility of the WTO regime with the proposed FDI rules.

I. THE NECESSITY OF INTEGRATING INVESTMENT RULES INTO THE WTO

A. FDI Has Become An Underpinning of World Trade.

As discussed in Chapter One, trade patterns have significantly changed in the past twenty years, with trade increasingly dependent on intra-firm trade. From the observation in Chapter Two, we know that FDI as capital flow directly supports international production and independent intra-firm trade. Without FDI, international production and independent intra-firm trade cannot take place. FDI in international production and independent intra-firm trade strongly supports and contributes to trade. Without FDI, trade would have occurred much less. In other words, FDI has become an important underpinning for modern world trade.
B. It Is Imperative to Recognize the Contribution of FDI to Trade and Economic Development in the World Trading System.

As we know, after 50 more years of development, the WTO has become the predominant multilateral system for regulating international economic relations. Trade liberalization through the GATT has brought about a profound change in the world economy. The magnitude of FDI flows in the movement of production factors not only has shaped trade relations among nations, but also has also substantially changed the fundamentals of international economic relations. A recent study by UNCTAD defines the movement of production factors as the “deep” integration of world economy, compared with the “shallow” integration under the condition of arm’s-length trade. Three points can explain the profound change of the world economy.

First, the aggregated huge stock of FDI and the magnified intra-firm trade flows have entailed the mass movement of production factors such as capital, raw materials or intermediate products, labor, and technology. This fundamental change, which is driven by TNCs seeking international production and distribution efficiency, has promoted the rational allocation and efficient use of world resources, thus benefiting consumers worldwide and promoting economic development in every nation.

The second point is that the diversified FDI flows suggest that more and more countries rely on FDI to sustain their economic growth. Or in other words, more and more nations have a substantial stake in the free movement of capital and the security of capital. Safarian notes that the percentage of the US FDI outflows in the total developed country outflows dropped dramatically from 66 per cent in 1961-1970 to only 16 per cent in the

127 See UNCTAD, Supra note 4.
period of 1981-1990, while FDI outflows from other countries have increased.\textsuperscript{128}

Dunning notes that the US share in the total inbound FDI stock in the UK fell from around four fifths in the early 1950s to 41.4 per cent in 1994, while the share of other European countries and Japan grew sharply from under 10 per cent to 30.9 per cent and from 0 per cent to 4.5 per cent respectively.\textsuperscript{129}

Third, FDI flows have shown a strong two-way development as more countries have become both home and host countries to FDI. For example, the USA is not only the largest home country for outward FDI flows but also the largest host country in absolute terms.\textsuperscript{130} Another spectacular example is Canada, where the stock of FDI inflows and that of FDI outflows are nearly equal. The recent Canadian data show that the stock of FDI rose to $301.4 billion at the end of year 2000, while Canadian direct investment abroad (CDIA) reached $291.5 billion.\textsuperscript{131} Safarian concludes that the change in Canada with regard to FDI from a one-way phenomenon into a two-way one began in the 1970’s, at the time when the ratio of outward to inward FDI had been constant at about 20 per cent for many years.\textsuperscript{132} In Canada, the inflow of FDI in 1999 represented 31.8 percent of Canada’s total business investment in non-residential structures and in machinery and equipment, up from 8.8 percent in 1989.\textsuperscript{133} The two-way phenomenon of FDI flows and the ensuing cross-border business activities conducted by TNCs further reflect the deep connection of national markets. Consequently, FDI plays an increasingly important role in host countries’ capital formation and economic development. Such close relationships

\textsuperscript{128} See Safarian, \textit{Supra note 57}.
\textsuperscript{129} See Dunning, \textit{Supra note 13}.
\textsuperscript{130} \textit{Ibid}.
\textsuperscript{132} See Safarian, \textit{Supra note 57}.
\textsuperscript{133} \textit{Ibid}.
make domestic markets increasingly integrated and interdependent. As a consequence, the domestic economic policy of a home country not only affects its own domestic economy, but also has effects on the host country's economy through the investments of TNCs from the home country.

Although the world economy has fundamentally changed, the basic concepts directing international economic relations have not changed greatly. The conventional trade concepts of comparative advantage and free trade, which constitute the theoretical foundation of the world trading system, still dominate and direct international economic relations. However, many scholars have begun to question the adequacy of these trade theories in explaining the new trends in trade and in dealing with issues regarding economic development in the globalized world economy. Porter argues that merely using the resources available or assembling more resources based on the theory of comparative advantage is not enough for prosperity.\(^\text{134}\) He argues that the failure to understand the distinction between comparative advantage and the new competitive advantage of nations is the root cause of problems in economic development.\(^\text{135}\) Braga supplements Porter’s point by asserting that many developing countries have not gained a fair share of the benefits from the trading system because old concepts, i.e. free trade, comparative advantage and interrelated concepts, do not capture the driving forces for economic development in today’s global economy.\(^\text{136}\) He argues that developed countries have

\(^{134}\) See Porter, *Supra* note 115, Introduction, xii.

\(^{135}\) Ibid.

gained more than developing countries from the world trading system mainly because their firms have adopted effective outward-oriented international business strategies that stress key abilities such as technology creation and outward FDI so as to exploit resources and markets world-wide. He suggests that developing countries should encourage and support their enterprises to emulate such business strategies in the global economy. Dunning notes that Japan has offered its corporations a supportive infrastructure and competitive ethos well suited to the needs of global investors, which has led to the dramatic success, at least for Japanese automobile and consumer electronics industries, in global markets.

Therefore, in the new era where FDI plays an important role in economic growth and development of many nations and contributes significantly to world trade, beyond the conventional wisdom of trade theories, we need to recognize the importance of FDI in the world trading system, and to incorporate FDI theories as a theoretical foundation into the world trading system.

C. Many IRTMs and TRIMs Impede or Distort Free Trade and Free Capital Flows.

Since FDI and trade are closely linked with each other, trade and FDI policies no longer affect only trade or FDI respectively. Trade policies may affect FDI, and FDI policies may also influence trade. As I have observed, restrictive trade measures deter or reduce FDI in international production and independent intra-firm trade, and thus impede further trade flows related to FDI. Similarly, restrictive FDI measures discourage FDI, thus

137 Ibid.
138 See Dunning, Supra note 13.
constraining trade volume pertaining to international production and independent intra-firm trade. Incentive trade and FDI measures not only distort trade but also engender unfair policy competition among nations. Empirical evidence supports this conclusion. The Canadian Chamber of Commerce (CCC) survey reveals that, of those respondents, a considerable number of investments (42%) were changed or altered because of a specific FDI barrier, with 21% being cancelled, and with another 16% being suspended.\footnote{See the CCC Survey, Supra note 82.}

All these restrictive and incentive IRTMs and TRIMs impede or distort world trade and reduce welfare of all nations.

The implications for the WTO regime from these policy consequences are two-fold. Firstly, in order to expand trade and the economic growth of all nations, the WTO members should make further efforts to eliminate restrictive and incentive trade measures that are disciplined by the WTO regime, especially tariffs, anti-dumping measures, and various trade incentives. Secondly, the WTO members should endeavor to establish a set of FDI rules under the WTO regime to discipline or coordinate prominent TRIMs. Since the WTO regime has prohibited or disciplined most restrictive and incentive trade measures which may impose a negative impact on FDI, I will not spend much space to discuss about IRTMs. Rather, I will focus on the discussion of FDI rules (i.e. rules on TRIMs) into the WTO regime.

D. The Investment-related Rules in the WTO Are Inadequate.

In fact, some investment-related rules have been established in the WTO regime. Some investment-related principal concepts have been incorporated into the preambles of Agreement Establishing the World Trade Organization and the General Agreement on
Tariffs and Trade (GATT). Both agreements in their preambles call for parties to take
into account the full use of the resources of the world and the expansion of the production
and exchange of goods when they conduct their relations in the field of trade and
economic endeavor.\textsuperscript{140} We can see that the expansion of the production of goods (which
should be understood as including international production) and the expansion of the
exchange of goods (which should include independent intra-firm trade) are basic
objectives of the world trading system. The two agreements in their preambles further
state that, in order to contribute to that objective, all parties are committed to substantially
reduce tariffs and other barriers to trade and to eliminate discriminatory treatment in
international trade relations through multilateral arrangements.\textsuperscript{141} Since international
expansion of the production and exchange of goods in the mode of independent intra-firm
trade are based on FDI, arguably, the two agreements in fact link FDI with trade, and
recognize the negative effects of restrictive trade measures on international production
and distribution of goods.

The WTO TRIMs Agreement in its preamble expresses the desire to promote the
expansion and progressive liberalization of world trade and the desire to facilitate
investment across international frontiers so as to increase the economic growth for all
trading partners, while ensuring free competition.\textsuperscript{142} It is the first time that the WTO has
recognized trade and FDI as two primary means to achieving economic growth.

Moreover, the preamble stresses the importance of maintaining free market competition
in economic growth – which suggests that the WTO members should refrain from using

\textsuperscript{140} See the WTO, Agreement Establishing the World Trade Organization and General Agreement On
Tariffs And Trade, \url{http://www.wto.org/english/docs_e/legal_e/final_e.htm}, (visited August 8, 2001).
\textsuperscript{141} Ibid.
\textsuperscript{142} See WTO, \textit{Supra note 88}. 
market-distorting trade and FDI measures to achieve economic growth. More importantly, the preamble explicitly recognizes that certain investment measures can cause trade-restrictive and distorting effects.\textsuperscript{143} Arguably, the applicable scope of the TRIMs Agreement can be so wide as to encompass all restrictive and incentive TRIMs, because every restrictive or incentive TRIM can produce some "trade-restrictive or distorting effect". Thus, the statement in the preamble leaves it open for including more TRIMs into the TRIMs Agreement. Nevertheless, the related WTO agreements do not explicitly recognize the contribution of FDI to world trade and the contribution of trade to FDI, nor do they fully recognize the importance of free capital movement or capital liberalization in economic growth.

Although the TRIMs agreement proscribes certain FDI measures that restrict or distort trade, i.e. local content requirements, trade-balancing requirements, and balance of payments requirements, many other FDI measures that impede or distort trade, mainly incentive TRIMs, are left undisciplined. The Agreement on Subsidies and Countervailing Measures (ASCM) has prohibited certain IRTMs in the form of subsidies. Nevertheless, many IRTMs that distort or impede FDI, which are mainly in the form of incentives, have not been disciplined in the WTO. Other discriminatory and restrictive FDI measures and the issue of FDI protection are even not on the agenda of the WTO.

As one WTO member has commented, FDI-related provisions in the WTO agreements such as the TRIMs Agreement, the GATS and the ASCM are limited in scope and lack coherence, therefore, members should strengthen FDI rules in the WTO to ensure that the benefits of trade liberalization will not be eroded by distortive investment measures.\textsuperscript{144}

\textsuperscript{143} Ibid.
\textsuperscript{144} See WTO, Supra note 23.
E. Why Are Nations Not Committed to A Multilateral Agreement on Investment (MAI) in the WTO?

Despite the lack of effectiveness of the WTO in dealing with TRIMs, many countries are not committed to negotiating an MAI in the WTO system. The main reasons given are: they cannot see any direct or additional benefits from an MAI; they insist that FDI is not a trade issue; and finally, they consider autonomous FDI liberalization and bilateral FDI treaties enough to promote and protect FDI.145

For some countries, this reluctance may be due to the lack an adequate recognition of the importance of FDI in world trade and domestic economic development. If it is only a recognition problem, it can be solved once these countries realize the positive link between trade and FDI and the negative impacts of TRIMs on trade and economic development. However, some countries reject an MAI simply for the sake of domestic “policy flexibility”. In such a case, it is difficult to persuade these countries to commit to an MAI, because most often, the real motive behind the ostensible reason is to serve either domestic political interests or the interests of special groups at the expense of consumers and economic development. As one WTO member notes, any international agreement necessarily involves a loss of a measure of policy flexibility, but this would be compensated by a gain in terms of greater predictability and stability of rules.146 Besides, an MAI in the WTO would have the scope and flexibility desired by its Members. The GATS is such an example regarding a particular kind of FDI which fully takes into

145 Ibid.
146 Ibid.
account the specific situation of each country and the differences in level of development between Members.\textsuperscript{147}

Countries favoring autonomous liberalization and bilateral treaties over an MAI argue that, in the current context of closer global economic integration in which the importance of FDI to development is generally recognized, countries are likely to make every effort through legislation or best practices to compete successfully for FDI.\textsuperscript{148} They also argue that the recent increase in FDI flows have occurred in the absence of a multilateral framework.\textsuperscript{149} This argument is unconvincing in many ways. Firstly, the functions of autonomous liberalization and bilateral treaties are different from the function of an MAI, and they cannot fully replace each other. The approach of autonomous liberalization stresses the controlling and maneuvering power of the host government while bilateral investment treaties concentrate on the protection of investment.\textsuperscript{150} Although both to some extent promote and protect FDI, they are by no means satisfactory. They do not target many FDI barriers and distorting measures. As well, they cannot deal with many problems such as transparency, government competition, and discrimination.\textsuperscript{151} An MAI should have the scope to deal with these problems and issues. Secondly, although developing countries have begun to liberalize their investment regimes, this liberalization has been only partial.\textsuperscript{152} Furthermore, without an underlying standstill or rollback obligation of a multilateral investment agreement, this modest liberalization can be easily

\textsuperscript{147} Ibid.
\textsuperscript{148} Ibid.
\textsuperscript{149} Ibid.
\textsuperscript{150} Ibid.
\textsuperscript{151} Ibid.
reversed. An MAI in the WTO, therefore, would at a minimum lock in the current levels of liberalization. Thirdly, possible gaps and conflicts among existing international investment instruments may restrict market contestability, distort investment flows, reduce economic efficiency, and thus frustrate the objective of such instruments.

Although there is a large degree of commonality between existing instruments in terms of basic principles, specific rights and obligations vary. Therefore, there may be potential for conflicts arising from investment agreements that are designed to address the priorities and concerns of the parties involved without proper regard to the potential negative impacts on third parties. Lastly, arguably, an MAI in the WTO will generate more FDI flows and thus produce more benefits to host countries. An MAI can play a special role in promoting FDI flow and world welfare which autonomous or bilateral liberalization cannot substitute for.

Many developed countries are not fully committed to an MAI in the WTO, mainly due to the political pressure from anti-free trade or anti-globalization movements in these countries. The anti-free trade movement mainly targets the free movement of goods and capital – the most tangible manifestation of globalization. It was the main reason for the failure of the MAI negotiations in the OECD. The extensive and substantial reservations to the MAI draft made by each member state were obviously the result of a strong anti-free trade or anti-globalization sentiment arising from the civil society in those developed countries. These reservations had rendered an MAI less than compelling.

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153 Ibid.
154 Ibid.
155 See WTO, Supra note 23.
156 Ibid.
However, most of the criticisms presently directed against free trade in general, and the WTO in particular, are either false, incoherent, or fatuous.\textsuperscript{158} The same is true with respect to the anti-free-capital sentiment. Although most motives behind the anti-free trade or anti-globalization movement are either trade protectionism or unjustifiable concerns, they nevertheless constitute a major obstacle for developed countries to commit to a MAI in the WTO.

\textbf{F. The Benefits of An MAI in the WTO}

The benefits of an MAI in the WTO are multiple. Firstly, an MAI will enhance the transparency and predictability for FDI and thus contribute to an efficient allocation of resources worldwide.\textsuperscript{159} Secondly, an MAI will ensure more secure and stable FDI flows to the country with the comparative advantages, and provide sustainable and strong support to world trade. Thirdly, an MAI will prevent unnecessary competition among nations for FDI, thus ensuring that a country's ability to attract FDI will not be negated by distorting practices of other countries, such as incentives and performance requirements.\textsuperscript{160} As well, by eliminating investment-distorting measures, an MAI in the WTO will generate a net gain in world welfare.\textsuperscript{161} Finally, the establishment of an MAI in the WTO would resolve the systemic problem of the inconsistency between the coverage of FDI in services in the GATS and the lack of coverage of FDI in manufacturing.\textsuperscript{162}

\textsuperscript{159} See WTO, \textit{Supra note} 23.
\textsuperscript{160} \textit{Ibid.}
\textsuperscript{161} See Burt, \textit{Supra note} 152.
\textsuperscript{162} A comment made by one WTO member at Working Group discussions. See WTO, \textit{Supra note} 23.
Besides, the existence of an MAI does not necessarily mean that countries should behave identically, since there will be ample room for individual countries to enhance their ability to attract FDI, for example by improving the quality of their infrastructure and human resources.\textsuperscript{163}

II. A PROPOSAL FOR AN MAI IN THE WTO REGIME

A. What FDI Rules Are Needed in the WTO?

After resolving the "necessity" issue, we then need to ask: what FDI rules should be incorporated into the WTO regime?

In my view, three basic categories of FDI rules are needed in the WTO regime: (1) General provisions, (2) Basic principles, and (3) Specific rules.

Firstly, I will propose general provisions for FDI in the WTO, basing on the previous discussions of the relationship between trade and FDI and the impact of IRTMs and TRIMs. Secondly, I will define the basic principles for FDI rules in the WTO, basing on the identification of the major restrictive and incentive FDI measures that are in use around the world. Thirdly, I will propose some specific FDI rules in the WTO, basing on the prevalence and the negative consequence of FDI measures.

For the second and third purposes, the survey of the Canadian Chamber of Commerce (CCC) on FDI barriers and the discussion of TRIMs in Chapter 3 will be deployed.

Existing FDI rules in the WTO and NAFTA will also be taken into account.

\textsuperscript{163} See WTO, Supra note 90.
The reason for me to use Chapter 11 "Investment" of NAFTA as a background model is two-fold. Firstly, NAFTA is a free trade agreement that encompasses both trade and FDI rules. Secondly, NAFTA is a model of cooperation in trade and investment policy-making among developed countries (the US and Canada) and a developing country (Mexico). The issues of whether NAFTA is successful or not and whether trade and FDI rules in NAFTA are compatible with each other or not are critical for both developed and developing countries to gain confidence in negotiating a set of multilateral FDI rules in the WTO.

From an economic perspective, NAFTA is a success. Since its implementation on January 1, 1994, NAFTA has significantly increased intra-regional trade as well as capital flows among its Parties, i.e. Canada, Mexico, and United States. For example, in 1997, intra-NAFTA trade accounted for 49 percent of all trade of NAFTA Parties, an increase of almost 11 percent a year on average since 1990. At the same time, NAFTA trade to third countries was only growing at 7 percent. Since January 1, 1994, United States total trade (imports and exports combined) with Canada and Mexico had increased from an annual average of $269 billion in 1991 to 1993 to an annual average of $384 billion in 1994 to 1996. Mexico as a developing country has benefited substantially from NAFTA. Despite the serious economic downturn that it endured in late 1994 and early 1995 during the peso crisis, Mexico has seen substantial growth in its trade with its NAFTA partners and a blossoming of foreign direct investment. From 1994 to 1996, Mexico received $25 billion of foreign direct investment in plants and equipment, which

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165 Ibid.
166 Ibid.
was the second largest amount of direct investment of that type to a developing country ever recorded.\textsuperscript{168} Seven billion dollars in investment was projected for 1997, increased from only $4.3 billion in 1993 before NAFTA was created.\textsuperscript{169} The positive impact of NAFTA on trade and FDI convinces me that NAFTA could be a good model for incorporating FDI rules in the WTO.

1. \textit{GENERAL PROVISIONS}

Firstly, the Agreement Establishing the WTO should recognize in its preamble that FDI as capital flow is an underpinning of world trade by supporting trade in international production and independent intra-firm trade in goods and services. It should also recognize that the expansion of trade would contribute to FDI flow in international distribution of goods and services.

Secondly, the Agreement Establishing the WTO in its preamble should recognize the important contribution of free capital movement to economic growth and development of all nations.

Thirdly, the WTO regime should also acknowledge that restrictive and incentive IRTMs can have restrictive or distorting effects on FDI, while restrictive and incentive TRIMs can have restrictive or distorting effects on trade.

\textsuperscript{167} \textit{Ibid.} \\
\textsuperscript{168} \textit{Ibid.} \\
\textsuperscript{169} \textit{Ibid.}
2. BASIC PRINCIPLES

The basic principles are important in the WTO regime because they are used to guide government behavior and to determine whether government measures violate the multilateral rules.

In regard to restrictive and incentive IRTMs, since they are trade measures, the basic principles in the current WTO regime are applicable to them. The fundamental principles that run throughout all the WTO agreements are: non-discrimination ("most-favoured-nation" treatment and "national" treatment), freer trade, predictable policies, encouragement of competition, and special provisions for less developed countries.\(^{170}\)

Based on the recent survey by the Canadian Chamber of Commerce\(^{171}\) and the restrictive and incentive TRIMs discussed in Chapter 3, I have identified major restrictive and incentive FDI measures as follows:

(1) Discriminatory Measures. Restrictions on industry entry, ownership constraints, limitations on the forms of establishment, restrictions on the geographic location of affiliates, limitations on the number of foreign firms, and limitations on land ownership are forms of discrimination against FDI. Local content requirements discriminate against foreign products. Local employment requirements discriminate against foreign labor. It should be noted that the offering of incentives to domestic firms except for foreign investors also constitutes discrimination against FDI. Therefore, these FDI measures are discriminatory in nature.

(2) Market Intervention. Preferences for non-equity versus equity participation, and preferences for “Greenfield” FDI versus direct acquisition of domestic enterprises in

essence are government intervention in the free movement of capital in the market. These preferences are implemented in the form of various incentives. Therefore, they can be defined as the issue of “Free Capital Movement”.

(3) Fair Competition. The existence of monopolies in industries is an issue pertaining to a nation’s competition policy. It is a matter of fair market competition. Therefore, this kind of barrier can be defined as a “Fair Competition” issue.

(4) Business Restrictions. Remittance restrictions are designed to address the negative impacts of FDI on balance-of-payments rather than to discriminate against FDI. We can call balance of trade and balance of payments requirements as “restrictions on business practice”. Like market intervention measures, they in essence are a matter of “free capital movement”.

(5) Compensation for Expropriation. Measures related to appropriation or nationalization usually apply equally to domestic and foreign investors. Foreign investors generally regard this kind of measure as an issue of fair and adequate compensation rather than an issue of discrimination. This special category of measures is regarded as the issue of “Fair and Prompt Compensation”.

Based on the major TRIMs above, I have identified the basic principles for FDI rules as below: (1) Non-discrimination, (2) Free Capital Movement, (3) Free Competition, and (4) Fair and Prompt Compensation for Expropriation.

In addition, in the light of the accelerating pace of regulatory changes in many countries, regulatory transparency is of growing importance to the promotion of FDI.\(^{172}\) Therefore, the “Transparency Principle”, which is a general requirement for all WTO members with

\(^{171}\) See the CCC Survey, 82.

\(^{172}\) One comment in WTO Working Group discussions. \textit{Supra note 23}. 
respect to trade measures, should also apply to FDI regulations. In fact, transparency obligations have been applied to investment-related provisions in the GATS and the TRIMs Agreement.\footnote{Ibid.}

It is noteworthy that these proposed basic principles are identical to those embodied in Chapter 11 “Investment” of NAFTA.\footnote{Ibid.} Article 1102 and 1103 of Chapter 11 clearly provides that the Non-discrimination principle (both National Treatment and Most-Favored-Nation Treatment principles) must apply to FDI as well as investors of another party. Besides, Article 1105 of Chapter 11 incorporates a principle of Minimum Standards of Treatment to ensure that the treatment of FDI by each party should be in accordance with international law, including fair and equitable treatment and full protection and security. This principle acts as a baseline for FDI treatment in order to prevent a party from rolling back the treatment of FDI below international standards.

Apart from these general principles, Chapter 11 also underlies the following principles:

(1) Free Capital Movement. Article 1109 stipulates that each party shall permit all transfers relating to an investment of an investor of another Party in the territory of the Party to be made freely and without delay. Such transfers encompass all payments, assets, proceeds, and properties that are related to FDI. (2) Fair and Prompt Compensation for Expropriation. Article 1110 stresses again the principle of Non-discrimination in case of expropriation. The spirit of this Article is that compensation for expropriation must be “equivalent to fair market value of the expropriated investment”, must be paid “without delay and be fully realizable”, and must be “freely transferable”. Thus, Article 1110 underlines the principle of “Fair and Prompt Compensation for Expropriation”.

\footnote{Ibid.}
Therefore, the principles of Non-discrimination, Free Capital Movement, Free Competition, Fair and Prompt Compensation for Expropriation, and Transparency should be the basic principles for FDI rules in the WTO regime.

3. SPECIFIC RULES

In Chapter 3, I have identified the major restrictive TRIMs in the narrow sense as local content requirements, trade-balancing requirements, balance-of-payments requirements, quantitative restrictions on trade, and remittance restrictions. The major incentive TRIMs are those tax holidays, preferential financial terms, and direct funding that are used to encourage local purchase and/or export.

In regard to Chapter 11 of NAFTA, except for the measures pertaining to some specified issues such as health, safety or environmental protection, Article 1106 “Performance Requirements” has prohibited all restrictive and incentive TRIMs that have a direct negative impact on trade, whether these TRIMs are to be used separately or in combination. Paragraph 1 of Article 1106 prohibits export performance requirements, domestic content requirements, requirements or incentives regarding purchase or use of domestic goods or services, balance-of-trade or balance-of-payments requirements, and requirements on sales of goods or services. Paragraph 3 of Article 1106 prohibits the combination of any incentives and the performance requirements mentioned above.

Obviously, the prohibitions on restrictive and incentive TRIMs in Chapter 11 of NAFTA are more extensive in scope and more stringent in nature than those in the WTO TRIMs Agreement.

Therefore, as a minimum goal, the WTO regime should discipline all restrictive and incentive TRIMs that directly restrict or distort trade. Article 1106 of Chapter 11 of NAFTA can be a model for future WTO negotiations.

As the ultimate goal, all restrictive and incentive FDI measures should be disciplined in the WTO regime, due to their negative impacts on trade and each nation’s economic welfare. As a starting point, the WTO should strive to develop sanctions for those FDI measures that cause the most significant negative impacts on free flow of trade and FDI.

According to the experience of Canadian firms, the most prevalent types of FDI barriers as a percentage of frequency are: (1) Residency Requirements (42% encountered). This type of restriction often requires a number of members of the Board of Directors, certain corporate officers, or specialized workers must be national residents. (2) Discriminatory Restrictions (24% encountered). Discriminatory restrictions refer to government policies that restrict the level of foreign ownership in an enterprise, or limit the scope of foreign business operations and their access to financing and investment incentives (such as subsidies) in the host country. (3) Restrictions on Capital Flow (20% encountered). Remittance restrictions on repatriation of funds upon liquidation, remittance of profits and payments of dividend and royalties are the major problem. (4) Discriminatory Performance Requirements (17% encountered). These are often in the form of local content requirements and local employment requirements. (5) Expropriation or Nationalization (4% encountered).

This survey indicates that expropriation or nationalization is not a major barrier to FDI, with only 4% firms encountering the problem. In contrast, residency requirements (42%),
which tend to stem from the fear of foreign control or serve to increase local employment, along with discriminatory treatment (41%, II plus IV), are the most prominent problems Canadian firms encountered in host countries.

In fact, Chapter 11 has prohibited all these types of FDI measures that are not directly related to trade: (1) Ownership restrictions or Disposition requirements (Article 1102). (2) Transfer of technology requirements and monopoly-of-supply measures (Article 1106). (3) Residency requirements on senior management and the board of directors (Article 1107). (4) Transfer restrictions on investment (Article 1109). (5) Expropriation and Compensation (Article 1110).

Therefore, to ensure a basically free environment for FDI flows and for trade flows as well, the WTO members should give priority to regulating residency requirements, discriminatory treatment, and transfer restrictions – the three most significant types of FDI measures. The issue of expropriation and compensation should also be properly dealt with in the WTO in the future, taking into account NAFTA rules and experience in this respect.

B. The Basic Approach to Integrating FDI Rules in the WTO

With respect to the basic approach to incorporating a set of FDI rules in the WTO, I prefer a realistic problem-solving approach rather than a positive integration approach. The problem-solving approach calls for governments to target specific trade and FDI measures that significantly restrict or distort the flows of trade and FDI. The positive integration approach seeks to entrench substantial rights for firms engaging in international business. The successful development of GATT has proved that

175 See the CCC Survey, Supra note 82.
governments tend to accept the problem-solving approach more easily than the positive integration approach, because with the former, governments do not surrender their substantial power or national sovereignty to the WTO. Besides, as we learn from the CCC survey, the elimination of restrictive and discriminatory FDI measures rather than the protection of FDI is the major concern of foreign investors. Therefore, there is no imperative need to incorporate the substantial rights of foreign investors in the WTO. Restrictive and discriminatory measures on trade and FDI to some extent infringe on an investor’s rights. Nevertheless, they can be effectively resolved through the problem-solving approach through prohibiting or curbing certain kinds of government measures. For example, discriminatory FDI measures can be dealt with by the obligation of non-discrimination. If we can deal with discrimination by the problem-solving approach, there is no need to positively stipulate that foreign firms should enjoy specified rights in host countries. The failure of OECD MAI negotiations teaches us that it would be more difficult to reach an MAI in the WTO by using a positive integration approach, giving that the economic conditions and needs are more diverse among the WTO members than among OECD members.

C. A Stand-alone MAI vs. FDI Rules under Other Trade Agreements

What is the best way to incorporate FDI rules into the WTO? Technically, there are two basic approaches: to establish a stand-alone MAI or to integrate FDI rules with other trade agreements. A stand-alone MAI should have a set of relatively independent principles and rules. The integration of FDI rules with other trade agreements means that FDI rules are constructed under and integrated with other related trade agreements. The
issue of whether FDI rules should be a stand-alone or integrated with other agreements mainly depends on whether FDI and FDI rules have their own characteristics.

I posit that the proposed FDI rules in the WTO should be a stand-alone agreement for the following reasons: (1) As I have indicated in Chapter 2, trade and FDI have a different nature and function. Trade is a mode for international business practice, while FDI is a cross-border capital flow. (2) FDI has an identical and consistent nature in all three kinds of international business, i.e. international production, independent intra-firm trade in goods, and international service through commercial presence. The identical and consistent nature of FDI is capital flow. And this nature distinguishes it from the nature of arm’s-length trade in goods and services or other trade topics such as trade-related intellectual property. (3) FDI is a long-term capital commitment that involves a wide range of operational issues, while arm’s-length trade in goods and services generally is a short-term business transaction or does not involve a long-term business commitment. Therefore, FDI faces more complicated issues and government measures than arm’s-length trade, and usually involves much higher business risks. (4) As discussed above, many concepts and principles pertaining to FDI are different from those relating to trade. For example, one major objective of a MAI is to ensure the free flow of capital, while that of GATT is to promote free trade. Besides, FDI faces many barriers that are different from trade barriers in nature. For example, residency requirements, FDI entry discrimination, remittance restrictions target specifically FDI. FDI also concerns investment protection issues. These are only some issues that either GATT or GATS cannot deal with effectively.
In order to create a stand-alone MAI, some arrangements and adjustments in the current WTO regime should be taken into account. Firstly, the contribution of FDI to world trade as well as to economic growth and development should be recognized in the preamble of Agreement Establishing the World Trade Organization. Secondly, international services through commercial presence should be integrated into the MAI. Lastly, the TRIMs Agreement should also be integrated into the MAI.

III. THE COMPATIBILITY OF THE WTO WITH THE PROPOSED FDI RULES

Is the WTO regime compatible with the proposed basic FDI rules? Basing on the previous discussions, I draw the following conclusions:

Firstly, from the study of the economic relationship between trade and FDI in Chapter 2, we know that trade and FDI do not substitute for each other, nor do they exclude each other. On the contrary, FDI supports trade in international production and independent intra-firm trade, and trade contributes to FDI in the case of independent intra-firm trade. Therefore, trade and FDI are compatible with each other.

Secondly, at the policy level, both trade and FDI measures have an identical and consistent effect on trade and FDI. Restrictive trade measures discourage trade and hence inhibit trade-related FDI; restrictive FDI measures deter FDI and hence constrain FDI-related trade. Similarly, liberal or incentive trade measures promote trade as well as FDI; liberal or incentive FDI measures encourage FDI and consequently trade. Therefore, the WTO disciplines on restrictive- or distorting- trade measures benefit not only trade but also FDI. Similarly, disciplines on FDI measures in the WTO would enhance not only
free capital movement but also free trade. There is no evidence that regulating trade measures would promote trade but impede FDI, or that regulating FDI measures would encourage FDI but hinder trade. Therefore, any discipline on an FDI measure, if incorporated into the WTO regime, will not contradict or compromise the main objectives of the WTO regime, i.e. freer trade and economic growth. Rather, it will facilitate these objectives.

Thirdly, comparing the basic principles of the WTO regime with those proposed basic FDI principles, we can see that except for the principle of "adequate and fair compensation upon expropriation", which is specific to FDI, trade and FDI principles are similar.

Fourthly, the dramatic growth of both intra-regional trade flows and FDI flows under the NAFTA regime demonstrates that an MAI and a free trade agreement do not conflict with each other. On the contrary, they are compatible with each other.

In conclusion, the WTO regime and the proposed MAI should be compatible with each other.

In a recent discussion in the WTO Working Group on Trade and Investment, some members questioned the compatibility of the WTO regime with an MAI. For example, one member argued that, since the objective of the WTO is trade liberalization through the establishment of rules on market access, including national treatment and MFN treatment, while investment liberalization is conceptually different from market access, these two objectives and concepts might not be reconcilable. Another member argued that a multilateral approach to trade is perhaps not equally applicable to investment, given that trade relations are affected by government measures, while investment involves
private parties. These members believed that the right to trade under free and non-discriminatory conditions was an accepted principle but the right to invest or establish, which more often than not means production operations taking place in the same country of sale, did not lend itself easily to the same approach. ¹⁷⁷

These arguments are flawed in two ways: First, the differences between trade liberalization and FDI liberalization do not create any obstacle for an MAI in the WTO. Although differences between trade and FDI and between trade liberalization and FDI liberalization exist, they are not significant. The major difference between trade and FDI is that trade in its nature is a mode for international business while FDI is the capital flow underlying international business practices. The main difference between trade liberalization and FDI liberalization is that the subject for trade liberalization is trade while the subject for FDI liberalization is FDI. However, these differences do not constitute an obstacle to integrating a MAI in the WTO regime, because trade liberalization and FDI liberalization are quite similar in essence. The nature of the barriers relating to both trade and FDI is similar, i.e., market access restriction and discrimination. The objective for both trade and FDI liberalization is to eliminate or reduce market access restrictions and discriminations. The basic approach for dealing with market access restrictions and discriminations in the WTO regime is the problem-solving approach or the “negative integration” approach, which, as I have suggested, should apply to an MAI in the WTO. Therefore, the differences between trade liberalization and FDI liberalization should not lead to the conclusion that the WTO regime is not suitable for an MAI.

¹⁷⁶ See WTO, Supra note 23.
¹⁷⁷ Ibid.
Second, the argument that free capital flow is a privilege rather a natural right is incoherent and inconsistent. Since both trade and FDI are international business practices that are undertaken by firms, and WTO members can recognize free trade as a right, there is no reason to reject free capital movement as a right.

As FDI flows are becoming increasingly important to economic growth and development, the need for action by governments to provide a framework of rules on investment has become more urgent.\textsuperscript{178} Now that governments have made great achievements in trade liberalization by circumscribing their discretion on trade in a politically and economically rational way, they should use the same wisdom and devote as much of their will to liberalizing FDI barriers and disciplining FDI incentives, so as to create a freer global environment for FDI flows.

\textsuperscript{178} \textit{Ibid.}
CONCLUSION

This thesis has suggested that the study on the relationship between trade and FDI should be conducted at the firm level. International production and independent intra-firm trade are two basic modes of international business. Trade can act as a function in international production, or can be an independent international business mode. FDI is the capital flow that accompanies and underpins international production and independent intra-firm trade. Trade and FDI are mutually supportive of each other. FDI strongly supports trade in both international production and independent intra-firm trade, while intra-firm trade contributes to FDI. There is no substitution effect between trade and FDI.

The conventional approach of treating trade and FDI as two parallel and comparable international business modes is inappropriate. This inappropriate approach cannot explain the real relationship between trade and FDI, and has led studies to inconclusive or even contradictory results. The new Eclectic Paradigm is a proper FDI theory that can explain the comprehensive relationship between trade and FDI.

Restrictive IRTMs deter trade-related FDI and thus constrain further trade flows.

Restrictive TRIMs discourage FDI, thus impede FDI-related trade. Incentive IRTMs and TRIMs distort trade flows and/or disrupt the allocation of capital and other resources, hence reducing national and worldwide welfare. Both restrictive and incentive IRTMs and TRIMs should be abandoned by governments, or disciplined by multilateral rules.

Liberal IRTMs are FDI incentives that tend to alleviate government intervention in the market and thus should be encouraged.
The main purpose for governments to maintain IRTMs and TRIMs is to attract and exploit FDI. This thesis concludes that the most effective and efficient way to attract and exploit FDI is to provide foreign investors with the human, legal and physical infrastructure in which firms can thrive in the long run rather than to meddle in the market with FDI restrictions or incentives.

The close link between trade and FDI calls for the WTO regime to recognize the important contribution of FDI to trade and economic growth. The trade- restricting or distorting effects of restrictive and incentive IRTMs and TRIMs necessitate the incorporation of FDI rules in the WTO regime. The basic approach to incorporating FDI rules in the WTO should be the conventional problem-solving or “negative integration” approach rather than the positive integration approach. Chapter 11 of NAFTA may provide a useful model for incorporating relevant FDI rules in the WTO regime. The proposed FDI rules should be incorporated as a stand-alone MAI. The proposed MAI should be compatible with the WTO regime because restrictive and incentive FDI measures in nature are similar to those trade measures that have been disciplined under the WTO, and the objectives and basic rules of the proposed MAI are similar to those existing in the WTO.