



Foreign Direct Investment

by George DeMartino, Graduate School of International Studies, University of Denver

The global economic integration of trade, investment, and finance is raising new issues for U.S. foreign economic policy. Until recently, most policy discussions have focused on trade issues—a reflection of the importance of international trade as an increasing percentage of total economic output. Throughout the post-World War II period, U.S. trade has grown at a faster rate than the GDP.

But economic integration has also been associated with rising international flows of private finance, including bank lending, portfolio investment (the international purchase of foreign-denominated stocks, bonds, and other financial assets), and foreign direct investment (FDI). FDI entails the acquisition by a firm of a substantial ownership stake in and control over an enterprise located in a country other than its home base. This occurs when a company builds a plant overseas or acquires a controlling interest in an existing facility abroad.

Private financial flows have risen dramatically over the past two decades, both absolutely and relative to public finance (including development aid). During the 1980s there was substantial growth in North-North financial

flows, as investors in developed countries looked primarily to other developed countries for new opportunities. But the 1990s have been marked by an expansion of North-South flows, especially of FDI. In 1990, North-South FDI flows represented less than 15% of the world total; by 1996 that share had swelled to 40%. The vast majority of North-South FDI flows, however, are concentrated in a small number of countries. While the preponderance of corporate foreign holdings remain in the North, it is these new North-South flows that have attracted the greatest attention of economists and policymakers.

al corporations (TNCs), which are defined as firms with controlling interests in operations located in more than one country. Second, unlike in the past, today's TNCs coordinate vast systems of internationally integrated production. A typical TNC today is apt to produce components for and undertake final assembly of a product in several different countries. One striking indicator of this strategy is the scale of intrafirm trade. By 1989, trade between subsidiaries of corporations accounted for one-third of total world trade and 40% of U.S. trade. Third, the recent increase in North-South FDI has occurred while official development aid is declining, giving FDI new prominence as a source of development funds in the South. For every \$1.00 in North-South development aid in 1996, there was \$2.50 in North-South FDI flow.

There are divergent opinions about the effects of FDI. Orthodox economists, who treat nations as individual actors, contend that the elimination of political barriers to the free flow of FDI enhances global efficiency. In this view, capital flows to those sites where the highest rates of return are possible—and often where production costs are lowest. In many industries, this means investment flows from the capital-rich North to the capital-starved South. According to orthodox economic theory, the decreasing costs associated with FDI flows yield a rising standard of living for consumers in both the North and the South. Orthodox theory also claims free flows of FDI, like free trade, induce a mutually beneficial rise in global prosperity.

Skeptics, however, are not convinced. They argue that all successfully developed countries have relied on capital controls and trade restrictions to promote local industry. They also point out that nations are not individual actors but are composed of disparate and often opposing sectors. They claim that the power imbalance between capital and labor in the new global economy is causing a shift in income shares from labor to capital at both the national and international levels. Facing mobile firms, workers are forced to accept lower wages to persuade firms to invest in their communities. In addition, governments are finding their policy autonomy constrained by the need to provide an environment conducive to the interests of capital. These pressures are greatest in the South, where countries face particularly acute capital shortages. Unrestricted FDI flows, the skeptics conclude, undermine both democratic governance and the economic security of workers and their communities.

Key Points

- International private financial flows, including bank lending, portfolio investment, and foreign direct investment (FDI), have grown dramatically in recent decades—both absolutely and relative to official development aid.
- During the 1980s, most FDI remained within industrialized countries, but by 1996, 40% of new FDI flowed to developing countries.
- FDI has attracted the attention of policymakers across the globe due to its increasing magnitude and to recent changes in its nature and direction.

Although by no means a new phenomenon, FDI has attracted greater attention in recent years for several reasons. First, the past thirty years have been marked by a surge in the number, size, and influence of transnation-

Current U.S. policy promotes unregulated FDI. In negotiations over the North American Free Trade Agreement (NAFTA), for example, the U.S. secured the continental liberalization of FDI. NAFTA requires that each signatory grant "national treatment" to firms from all three countries. This provision prevents any signatory from giving preferential treatment to its home corporations, which Mexico might otherwise choose to do in order to promote indigenous development. The provision also prevents any of the parties from imposing special performance requirements on foreign firms, such as rules that mandate the use of local suppliers or that restrict profit repatriation. The agreement even forces Mexico to eliminate restrictions on foreign ownership of key industries, such as banking. Finally, the pact harmonizes property-rights protections such as patent and copyright laws. In sum, NAFTA provides capital (but not labor) with continent-wide citizenship rights.

At present the U.S. and other members of the Organization for Economic Cooperation and Development (OECD) are negotiating the Multilateral Agreement on Investment (MAI). The MAI is intended to liberalize FDI flows in much the same way as NAFTA. According to provisions of the January 13, 1998, draft document, OECD firms in any contracting country are to be given national treatment in all other contracting countries. "Most favored nation" rules also apply. These rules require each signatory nation to treat investors from all other signatory nations equally. The draft includes provisions that rescind most restrictions on foreign ownership of firms and most corporate performance requirements. Although the MAI will initially apply only to OECD countries, the long-term goal is to induce nonmember states across the South to adopt its provisions.

U.S. policy promotes unrestricted FDI in other ways. The U.S. government has actively encouraged the formation of export processing zones (EPZs) in developing countries as a means of attracting capital. These are sites (like the maquiladora region of Mexico) that are exempt from many domestic regulations. The U.S. also protects TNCs from political risks associated with FDI. For instance, the Overseas Private Investment Corporation (OPIC) provides insurance against foreign appropriation of U.S. facilities abroad. The U.S. government (along with the World Bank and IMF) also promotes international investment funds that subsidize corporate investment in developing countries. In this way, the

U.S. has fostered the privatization of publicly funded development aid.

Thus, U.S. policy favors the immediate interests of TNCs over those of workers and their communities both at home and abroad. U.S. law places no restrictions on firms that either choose to abandon sites within the U.S. in search of lower wage costs and less stringent regulatory regimes abroad or that threaten to do so in order to wrest concessions from workers and local governments as a condition for remaining. To the contrary, U.S. law internationalizes what is already a pressing domestic problem—namely, competition among the 50 states to steal investment from each other through tax breaks and other concessions. Today, this destructive competition occurs at the global level, with nations promising lower wages and less stringent environmental and labor standards as a means to lure investment.

One exception to this general pattern is the labor rights provisions written into both OPIC and several trade bills during the 1980s at the insistence of labor and human rights advocates. These provisions restrict OPIC coverage and various trade concessions to nations that take steps to ensure internationally recognized labor rights. But in practice these measures have had little effect, given the commitment of the current and previous administrations to liberalization of trade and FDI flows.

Many economists today express concern about the shift in the balance of power that liberalized FDI flows induce.

They have shown that increasing mobility of capital results in a new dilemma for nations: it undermines their ability to tax capital and to provide social insurance for labor at precisely the time when this insurance is most urgently needed. These economists conclude that economic liberalization may lead to social disintegration, with investors and key corporate employees abandoning any commitment to the needs and welfare of those harmed by globalization.

Key Problems

- The U.S. government promotes unrestricted FDI flows through new trade agreements, like NAFTA, the proposed Multilateral Agreement on Investment, and other foreign policy measures.
 - Unrestricted FDI undermines economic security and engenders destructive competition among communities and governments, with each forced to make concessions to firms to retain investment and employment.
 - Provisions in U.S. law that incorporate the protection of workers' rights have had little effect due to a lack of political will in successive administrations.
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The United States should promote a new set of domestic and international policy regimes to control TNC behavior and FDI flows. While the U.S. can take some beneficial steps unilaterally, it must also pursue multilateral approaches that minimize the capture of policy by corporate interests. Properly pursued, multilateralism can enable governments collectively to secure social and environmental protections that they cannot achieve individually. What matters in this regard are both the procedures by which multilateral agreements are reached (e.g. transparency and broad participation in negotiations) and the content of the agreements.

The U.S. should unilaterally adopt two initiatives that restrict corporate behavior and should then undertake negotiations to extend them across all OECD nations. During the apartheid era, the Sullivan Principles required U.S. firms with subsidiaries in South Africa to follow U.S. employment law. Economist Jagdish Bhagwati has argued that this same principle could be applied today to U.S. firms with operations in Mexico. Actually, this proposal should be generalized, so that all

U.S. firms operating in countries with weaker labor or environmental standards would be required to abide by U.S. regulations. Such a move would eliminate both the incentives for firms to relocate in pursuit of lower standards and the temptation for nations to weaken their standards in pursuit of investment. Ultimately, the U.S. should seek an agreement that requires all OECD-based TNCs to abide by a uniform set of environmental and labor standards, regardless of where they invest.

According to orthodox theory, if citizens place a high value on the behavior of businesses, firms will find it profitable to

introduce codes of conduct voluntarily as a means of winning market share. In this view, sovereign consumers can impose their values on firms by casting their dollar ballots in favor of responsible corporate practices. But this view is naive. A consumer lacks sufficient information to always make a responsible purchasing decision. She may also feel she lacks the ability to have any meaningful impact via individual purchasing behavior and so may be unwilling to shoulder the higher cost of a responsibly produced product. Moreover, many products do not reach consumer markets directly.

These obstacles can be overcome both by establishing a binding code of conduct covering all U.S. firms and by enacting trade laws that tie access to the U.S. market to corporate behavior abroad. Laws are needed that empower citizens, NGOs, and companies to file complaints against code violators before tribunals that have

the authority to levy fines and impose other sanctions. Over the long term, the U.S. should seek a multilateral agreement that would establish a uniform international corporate code of conduct and create a procedure to adjudicate all complaints.

Washington should also seek a new multilateral agreement to implement a harmonized, global TNC income tax. A global tax would prevent nations from pursuing mutually harmful tax competition. The proceeds of the global tax should be distributed on the basis of some set of negotiated, equitable criteria—keeping in mind the need to promote economic opportunity in the South and to protect displaced workers in the North.

A multilateral FDI regime must address the question of the differential position of developed and developing countries in the global economy. Not all regulations that make sense in the U.S. are appropriate in sub-Saharan Africa or Latin America. Moreover, domestic firms in poor countries often do not have the same means as wealthy TNCs to meet expensive restrictions. But this hardly means that citizens in developing countries are best served by an ethos of *laissez faire*. The task of distinguishing those regulations and restrictions that are universally appropriate from those that are context-dependent is a difficult and contentious one. Such decisions should, therefore, be made multilaterally, with input from broad sectors of the affected societies, including labor, human rights, and environmental advocates, among others.

Foreign direct investment should not violate the internationally recognized labor rights set forth by the International Labor Organization. Employment discrimination, infringements on the right to form independent unions and to bargain collectively, and violations of the rights of freedom of association and political participation are never justified, regardless of the level of national income. The U.S. should push for a multilateral FDI regulatory regime that requires these basic rights as a condition of a country's full participation in international trade and investment agreements. The regime must also provide the incentives and means (e.g., a global tax on capital) to address the asymmetries in North-South development patterns.

Washington should view multilateral economic governance as a means of achieving protections for working people and the environment both at home and abroad. This will require dramatic revisions in both the goals that multilateralism is to serve and the process by which these agreements are typically reached. In trade and investment negotiations, U.S. representatives should seek to champion worker rights, environmental protection, and community economic security rather than narrowly concentrating on promoting the interests of U.S. corporations.

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Key Recommendations

- U.S. law should unilaterally impose U.S. environmental and labor standards and a corporate code of conduct on all U.S. firms operating abroad.
- Washington should ultimately seek a multilateral agreement addressing labor and environmental standards, a corporate code of conduct, and a global TNC tax with the proceeds distributed internationally according to negotiated, equitable criteria.
- The U.S. must use multilateralism to defend workers, citizens, and the environment from the ravaging effects of unregulated capital mobility.

Sources for More Information

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