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THE NEED FOR A BROADER POLICY APPROACH TO FOREIGN DIRECT INVESTMENT

*Ambassador Marino Baldi, Switzerland
and Chairman, Advisory Group on Non-Members of the
OECD Committee on International Investment and Multinational Enterprises*

1. Introduction

Foreign Direct Investment (FDI) has long been considered an instrument of exploitation and a threat to national sovereignty in a number of countries. This attitude has considerably changed of late however. Today it is widely recognised that FDI can act as an engine of economic growth. It is, therefore, not astonishing that most countries – whether developed, developing, or in transition – seek to attract FDI to advance their economic development. In particular, developing and transition economies are often in great need of the resources that FDI typically provides: these are, besides capital, intangible resources such as technological know-how and managerial skills.

Home and host countries all have a common interest in maximising the gains from foreign investment and, more generally, from transnational economic activities. They should, therefore, strive for a better understanding of the conditions for increasing the benefits from FDI. The objective of the international community should be to make sure that all countries can benefit from the international division of labour and the ensuing growth of the world economy. In particular, less developed and transition countries should be supported in their efforts to reap the full benefits of FDI. To achieve this aim, numerous measures have been introduced around the world.

2. Traditional Policies

Let's first look at some of the well-known promotional measures, such as incentives for inward investment by host countries and supporting policies for outward investment by home countries. Afterwards, I should like to discuss what a broader policy approach to FDI, one that would suit the long-term needs of host and home countries in an ever more integrating world economy, could look like.

2.1 Host countries measures

The demand for FDI has sharply increased over the last ten to fifteen years. Governments on all continents now actively compete for FDI. In order to attract their share of the limited FDI supply, host countries apply a variety of measures. These include, on the one hand, fiscal and financial incentives as, for example, a reduction in the base income tax rate, tax holidays or government subsidisation. On the other hand, host countries also adapt their regulatory environment to suit the needs of foreign investors. They may, for example, enhance protection of intellectual property rights; they may, however, also be tempted to relax the enforcement of labour and environmental standards.

Most of these investment incentives have undesirable effects.[1] Fiscal and financial incentives, for example, entail direct costs: expenses of USD 100,000 per expected job are not unusual at all. The indirect costs of such incentives in terms of inefficient resource allocation and market distortions can be even more important. Rent-seeking behaviour by investors, not to mention corruption and bribery, waste scarce resources while investment incentives for foreign investors may lead to discrimination and discouragement of local investors. Such distortions at the expense of domestic enterprises are particularly detrimental in view of the need for many countries to develop a diversified and expanding domestic business sector. For host countries, however, the deployment of local business is key to reaping the full growth potential of FDI.

2.2 Home country measures

Home countries have an interest of their own to promote investment in developing and transition economies, especially in order to foster the internationalisation of their small and medium sized enterprises (SMEs). They support private companies in their endeavours to invest in developing countries by improving awareness of business opportunities in host countries and via financial intermediary instruments such as venture capital, leasing or guarantee funds. In Switzerland, to give a specific example, measures have been designed to meet the needs of investors at the different stages of implementation of a project, from the first draft to its completion. Instruments include a Government sponsored institution that provides information to interested companies, helps them in finding foreign partners and, more generally, offers them assistance during the pre-investment phase; and also a Study Fund that facilitates and financially supports systematic preparation of private investment projects through feasibility studies, pilot projects and risk-sharing with the promoters. The guiding principle behind this policy is to widen profitable and sustainable investment opportunities in developing and transition countries that are particularly in need of FDI. At the same time, the institutions referred to assume a share of the perceived increased investment risk.

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1 cf. Charles Oman: "Policy Competition for Foreign Direct Investment", Development Centre Studies, Development Centre of the Organisation for Economic Co-operation and Development, OECD Publications, Paris 2000.

2.3 Bilateral and multilateral instruments

Unlike in the area of trade in goods and services, there exists no global institutional framework governing international investment. International investment is mainly regulated within the scope of regional agreements (integration agreements of different types) and bilateral investment treaties (BITs). Within the OECD, the Codes of Liberalisation of Capital Movements and of Current Invisible Operations together with the Declaration on International Investment and Multinational Enterprises provide a relatively comprehensive and balanced framework for international investment. In terms of investment policy, the guiding principle of these OECD instruments is the concept of National Treatment. This concept reflects the perception that in an economically interdependent world, where countries actively compete for foreign investment, it generally speaking makes no economic sense to treat foreign investors less favourably than domestic ones. All 30 OECD member countries as well as five non-member countries (Argentina, Brazil, Chile, Estonia and Lithuania) already adhere to the Declaration on International Investment, while several other countries are actually undertaking steps to do so.

3. New Approaches

3.1 The concept of 'functioning markets'

During the 1990s, when FDI flows soared and many of the recipient countries registered amazing growth rates, the various measures taken by host and home countries did in fact seem to be crowned with success. But then, in 1997, the Asian crisis abruptly called traditional policies into question. It suddenly became clear that liberalisation and promotional measures do not by themselves guarantee sustainable economic growth and development. Many economists will argue that this insight was not new. Be that as it may, at least since the Asian crisis, it has widely been accepted that the globalisation of markets and the removal of obstacles to trade and investment can only bear their fruits if the freed market forces are integrated into appropriate national (and international) legal and institutional frameworks. These frameworks should guarantee the rule of law, transparency and accountability of government policies as well as responsible corporate governance: all crucial elements to ensure the long-term 'functioning of markets'.

The various elements of this concept of 'functioning markets' do not as such, i.e., individually, represent new measures. They have to be seen as an *ensemble, a coherent set of regulatory and institutional measures that in their interplay are conducive to an enabling environment*, both for foreign investment and domestic entrepreneurship. The equal treatment of foreign and domestic investors is, as we have seen, important to no small degree for developing countries. An essential feature of the concept of 'functioning markets' is also its long-term orientation, i.e., the inclusion of *sustainability concerns.* Indeed, ignoring aspects of social and environmental viability in economic policy may, over time, also lead to market failure and disruptions in economic development. Let's now look at some of the key elements of this whole concept:

3.2 Key elements of 'functioning markets'

- *The rule of law and good (public) governance*

What is most important in order to create and maintain the functioning of markets is the rule of law. This includes, besides basic principles of justice, an efficient judicial system to resolve disputes, and enforcement mechanisms to implement the subsequent decisions. Furthermore, it includes the setting-up of a sound legal framework for business activities in general. Basic economic freedoms, such as property rights, the right to free commercial and industrial activity, and the freedom to enter into private contracts are all essential pillars of such an economic environment based on the rule of law. On an international level, the notion of the rule of law finds its expression, *inter alia*, in the concept of good (public) governance. Apart from the rule of law, this concept also encompasses responsible government practices and the absence of corruption. There are good reasons for which nowadays the fight against corruption forms an important part of international economic co-operation.

- *Corporate governance*

Modern economies with numerous transactions involving foreign countries also need sophisticated sets of norms in such fields as company law, capital market law, or contract law and bankruptcy law. The economic rationale of these rules is that they provide transparency and accountability. The Asian crisis has demonstrated how important the observance of such standards is for the stability of economic activities, and that neglecting them can destroy the fruit of otherwise promising prosperity in newly emerging economies practically over night. Some of the principles recommended in this field are generally referred to as corporate governance. They are promoted in various fora, most prominently in the OECD. All stake-holders in companies, be it the shareholders, workers, creditors, suppliers, or the State, are interested in sound business practices in such fields as accounting, managing company finances and dealing with human resources in order to create an environment of confidence and transparency for investment and related economic activities.

- *Competition law*

An important prerequisite for the 'functioning of markets' is undeniably represented by competition laws. They ensure the contestability of domestic markets, thereby favouring efficiency and dynamism and working against the accumulation of rigidities and harmful oligopolistic rent-seeking behaviour. A state-of-the-art competition law constitutes one of the main pillars to guarantee equal competitive opportunities and to prevent the benefits from liberalized trade and investment from being reduced through collusive practices and abuses of dominant market positions. At an international level, we are far from asking for a harmonized universal competition law, but we recognize the need for convergence of rules and effective international co-operation. The application of multiple and often diverging national antitrust laws on the behaviour of enterprises with transnational activities, i.e., that act in a variety of markets, leads to unwholesome situations which should be avoided in the interest of economic operators as well as of the States involved.

- *Core labour standards*

Another ingredient that, in my view, should be part of a sustainable economic order is the observance of basic labour standards. By now, this seems to be largely accepted by the participants of the world economy. In 1998, the International Labour Organization adopted a Declaration on Fundamental Principles and Rights at Work. This instrument calls for freedom of association, effective recognition of the right to collective bargaining, the elimination of all forms of forced and compulsory labour, effective abolition of child labour, and the elimination of discrimination with respect to employment and occupation. I would like to particularly stress the importance of the freedom of association and of the right to collective bargaining. Freedom of association not only creates the basis for a good relationship between employers and employees – which in turn constitutes an important pillar of social stability, but also fosters transparency and accountability, thereby constituting an important prerequisite for public and corporate governance. In addition, freedom of association and the right to collective bargaining guarantee that employees partake in the fruits of economic liberalisation and new technologies, thereby indirectly fostering higher labour productivity.

- Protection of the environment and sustainability

An essential element of long-term ‘functioning markets’ at national and international levels is the protection of our environment and, in particular, our shared global heritage. The fact that we all share the same environment leads to the inevitable need for co-operation among nations to promote sustainable growth and prevent the degradation of the global environment. In this context, let me point to a particular issue in the discussion on international investment. There already exist international instruments that prohibit – or at least discourage – the lowering of environmental standards with a view to attracting FDI. Provisions to that effect would also have been, by the way, an important ingredient of the Multilateral Agreement on Investment (MAI) that was negotiated during the late 1990s. Debates on how such standards can be integrated into existing OECD instruments are continuing.

4. The role of international co-operation

Most of the policies that I just described have to be designed and implemented on a national level; all the more so, since existing international structures would be far too weak to secure their effective enforcement. National policy and lawmakers need, however, the support of the international community. With a view to the integrating world economy, it is crucial that measures be coordinated on an international level. This does not imply that national laws have to be identical – nevertheless, a certain functional equivalency of national rules is essential; to achieve this aim, a minimal international consensus on common values is indispensable.

The various issues related to the concept of ‘functioning markets’ are tackled in many international fora, *inter alia*, the OECD, the Bretton Woods Institutions, the United Nations and the WTO. I would like to take this opportunity to emphasize the pace-setting role of the OECD in the investment field. From its earliest days, member governments have used the Organisation as a mechanism for systematically reducing the extent of their restrictions on international capital flows of all kinds. But, more importantly, the Organisation has never limited its activities to mere liberalisation. The OECD has always adopted a much broader approach. Over the years, it has made a unique contribution to the study and understanding of the economic effects of FDI on the world economy. It has also worked extensively to manage the effects of globalisation through the development of rules and the encouragement of best practices, thereby dealing with important issues such as good public or corporate governance, the behaviour of multinational enterprises, or corruption and bribery. All in all, the OECD has developed a fairly comprehensive and balanced framework to improve the international investment climate and to encourage the positive contributions multinational enterprises can make to economic, social and environmental goals. The various OECD instruments are widely accepted and oftentimes even taken up in other fora, such as the United Nations and the World Bank.

International co-operation should not only involve governments, but also multinational enterprises (MNEs). While governments need to provide an appropriate regulatory framework for investment, it is also important that MNEs conduct themselves as good corporate citizens. Especially in recipient countries, where rules and institutions do not yet allow for long-term sustainable development and stability of liberalized markets, MNEs should make their contribution to ‘functioning markets’. They should, for instance, avoid that individual corporations gain undesirable competitive advantages by sidestepping or ignoring international labour or environmental standards. One important instrument towards this goal is the OECD Guidelines for Multinational Enterprises. I could go on talking about the importance of the contributions by MNEs, but will refrain from doing so as the topic is to be discussed in another presentation during this Conference.

5. Final remarks

Traditional policies and measures for attracting or promoting inward investment can, at the utmost, play a complementary role. They do not by themselves attract (sustainable) FDI. We should always bear in mind that investors make their investment decisions on the basis of economic considerations! In other words, FDI tends to flow to countries where investors can expect a reasonable return on capital. And such returns depend primarily on market opportunities, along with sound economic policies and a legal framework that is transparent and predictable. In other words, they depend on 'functioning markets'.

To conclude, let me reiterate that instead of concentrating on measures that are at the most second-best options, countries should focus their endeavours on shaping a pro-business environment in recipient economies and on improving the long-term functioning of markets – a concept that, as we have seen, also takes into account sustainability concerns. How can this concept be turned into effective action? What is needed above all are *new partnerships* between host and home countries – which should possibly also involve multinational enterprises and civil society groups – with a view to contributing to the capacity building efforts in recipient economies.

I hope that this first Conference under the auspices of the OECD Global Forum on International Investment will be a significant step towards this goal.