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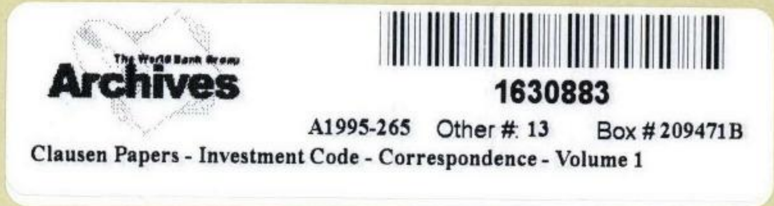
Clausen Papers: Investment Code



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1389

action Reading

August 9, 1982

Tom:

I have now read the attached.

I think the basic paper (i.e., not the two letters) is a suitable basis for a Managing Committee discussion. We should focus on a) the need and opportunity; b) whether the Bank should take the initiative; c) if so, where should responsibility be assigned. If we decide to take the lead we must recognize it will be a long and hard slog, involving lots of analytical work and much negotiations. We are not now staffed up anywhere to undertake such an effort seriously.

Ernie

Ernie

Mr. Clausen
So far nothing else has been scheduled for the next meeting on August 16. We can put this paper on the agenda for discussion ...
Roy
8/10/82

Attachment

ES:dpw

7-15-82

Ernie:

This morning Heribert, Munir, Fred Bersten and I had breakfast with Arthur Dunkel and David Hartridge of GATT to discuss ways in which we could further cooperate. We also discussed the possibilities of establishing a global framework which would be attractive for investments in developing countries.

It was a good session and I'll want to talk with you about this general subject when you get back. I am attaching Fred Bergsten's paper which resulted from our meeting with him several weeks ago.

Tom

A follow-up note from Bergsten is also attached.

A. W. Clausen

Copies to
M. Benjenk
H. Golsong
E. Stern

3563

INSTITUTE FOR INTERNATIONAL ECONOMICS
11 Dupont Circle, N.W., Washington, D.C. 20036
(202) 328-0583 Telex: 248329 CEIP

C. Fred Bergsten
Director

July 15, 1982

Mr. A. W. Clausen
President
The World Bank
Washington, D.C. 20433

Dear Tom:

Thanks very much for inviting me to this morning's breakfast with Arthur Dunkel et al. I think the session was extremely useful, on the broader issues of IBRD-GATT cooperation as well as on the more specific investment issues.

On the latter, it occurs to me that you might now want to consider three kinds of follow up:

-- development of the sketch of a specific proposal for a "GATT for Investment", perhaps along the lines laid out in the report of my Development Committee Task Force. I would stress that any such proposal should be limited to basic principles at this stage, because the first requirement is to get agreement on the concept and presentation of excessive details could easily impede doing so. However, some features of the idea will be needed if governments are to take the proposal seriously and give it considered judgment.

-- consultation with the U.S. Government, presumably Don Regan. Dunkel was right in saying that the United States has to decide what it wants from the different institutions; they have not yet made any decision on that, and your getting to them early could both accelerate the process and influence the substance of their choice. It is also important to boost Treasury as the focus for activity within the U.S. Government, both because of its central importance on the issues and its likely preference for working through the Bank.

-- consultation with other key governments, both in the industralized and developing world,per my earlier memo. This too need be only on basic principles at this point but is important both in formulating your own plans and in getting supportive statements from Ministers at Toronto.

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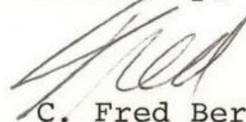
Mr. A. W. Clausen
Page two

Finally, a semantic point: we have referred on several occasions to the need for a new "code" in this area. Since that term conjures up images of the futile UN effort to negotiate guidelines for multinationals, I think it would be better to use different terminology since the present exercise is directed toward developing new obligations for governments. There is no convenient shorthand other than "GATT for investment", which is fine but frightens some people because it seems so grandiose. I thus tend to use the neutral "arrangements"; there may be a better phrase, but all involved should agree on a particular term and start using it consistently as part of the process.

Again, thank you for involving me in the discussion this morning. Let me know if I can be of help on any of the fronts mentioned above, or elsewhere.

Sincerely,



C. Fred Bergsten
Director

INSTITUTE FOR INTERNATIONAL ECONOMICS
11 Dupont Circle, N.W., Washington, D.C. 20036
(202) 328-0583 Telex: 248329 CEIP

C. Fred Bergsten
Director

July 12, 1982

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Henry Wallich
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Alan W. Wolff

The Honorable
A. W. Clausen
President
The World Bank
Washington, D.C. 20433

Dear Tom:

Per our phone conversation on Friday, I look forward to meeting with you and Arthur Dunkel for breakfast on Thursday morning. I am delighted that you have set up such a session, per my suggestion to Ernie that you do so, and hope it will help start the ball rolling on the investment issue.

Per your request when we had lunch last month, and hopefully of use in preparation for the breakfast with Dunkel, enclosed is a strategy paper on the investment issues and initiatives which the Bank could/should take to deal with them. As indicated in the paper, the U.S. Government (especially Treasury) is already strongly pushing the matter -- and should do so even more now that George, an early advocate of the whole idea, is coming to State. As I noted at lunch, Bank leadership in this area should also help generate general support for it from business communities in the industrial countries since they would all derive direct benefits from a successful outcome.

The punch line of the paper is that only the Bank can take the needed initiatives in this area because both the OECD and GATT exclude many of the key countries; the GATT is limited to trade aspects, which are important but inextricably linked to broader components of the investment equation, and has an agenda which Dunkel feels may already be overloaded; and most LDCs feel more comfortable pursuing such issues in the Bank than in any other feasible forum. You should therefore be thinking in terms of taking such initiatives in your speech at Toronto, and in starting to pave the way through informal consultation with key member countries. The breakfast with Dunkel can be a step in the process.

Again, it will be a pleasure to see you on Thursday. I hope the paper will be helpful. If you would like to pursue any of this further, before or after the breakfast with Dunkel, please let me know.

Sincerely,

C. Fred Bergsten
Director

TOWARD A WORLD BANK INITIATIVE

ON INTERNATIONAL DIRECT INVESTMENT

The Salience of the Issue

The outlook for developing countries in the 1980s is grim. World growth is down sharply and likely to remain low. Protectionism is on the rise. Private banks are looking to reduce their exposure. Concessional aid flows are stagnant, at best.

One potentially substantial source of help for the developing countries has been largely ignored, however: foreign direct investment (FDI). Such investment can be of central importance in dealing with the most critical needs of the poorer countries -- creating jobs, transferring technology, expanding exports and supplying capital *without* adding to annual debt service burdens.

Furthermore, partnership with multinationals can provide enormous benefits for developing countries in the industrialized world -- in resisting new trade barriers against them, and supporting continued financial support for them. It is thus natural that the World Bank should make every possible effort to expand the flow of FDI to the developing nations, particularly if its traditional means of support continue to be circumscribed by donors' budget problems and more general recalcitrance.

The Problem

The potential role of FDI in development has been ignored in recent years primarily because the mythologies of a decade ago, captured in such phrases as "dependencia" or "sovereignty at bay" or "global reach," stigmatized the multinationals as destroyers of

host-country values and independence. In fact, one of the most noteworthy (if largely unnoticed) stories of the 1970s was the increasingly decisive ability of virtually all developing (and other host) countries to harness the "powerful multinationals" to their -- the host countries' -- economic and social purposes. Indeed, the problem for the 1980s is that host-country control has gone so far that it has sharply curtailed the potential contribution of FDI to development, by triggering seriously negative reactions from both the firms themselves and the governments of the home countries where most of the firms are based.

Three major problems must now be addressed if FDI is to fulfill its potential in contributing to development in the decade(s) ahead. First, virtually all host countries increasingly employ tax and other incentive measures to attract internationally mobile investments. One result is a shift of production -- with its jobs, profits, technology, exports, etc. -- across national borders, often leading to uneconomic activity and often triggering the threat of retaliation from home countries (such as the United States) whose interests are harmed. Another result is a drain of resources from developing countries to the firms and treasuries of home countries, without much net benefit to any particular LDC since virtually all of them offer such incentives on similar terms.

Second, host countries require the firms to "pay" for these incentives -- or simply for the privilege of participating in their economies -- by levying performance requirements on them. These requirements include minimum export quotas, local content or value-added requirements, mandatory technology transfers, job quotas, etc. The Mexican auto decree is an infamous case in point but, like

incentives, the practice exists in virtually every host country. These performance requirements seek to tilt the economic benefits of international investment to host countries -- again, distorting the activities of the firms and adversely affecting their home countries (and perhaps third countries as well).

Third, there is increasing discrimination against foreign firms in a number of host countries. The principles of national treatment, and even most-favored-nation treatment (among foreign firms), are frequently violated -- with obviously negative impact on both the multinationals and their countries of origin. This trend is related intimately to the issues of incentives and performance requirements, since firms will suffer discrimination if they are not seen as substantially promoting the economic and social objectives of the host country and can avoid such treatment (as well as qualify for incentives) only by making major contributions to those objectives.

The problem underlying all three issues is the steadily growing effort by host countries to dictate the terms of the international investment process, and hence the benefits from such investment. Three ill effects derive from these trends. At the level of global macroeconomics, an increasing share of world production is being determined largely outside the market. Distortions are inevitable. World welfare is reduced. During a period of slow growth and continuing inflation, such losses are particularly costly.

At the level of the international distribution of income, an increasing share of world production is being negotiated between the governments of host countries and the management of multinationals. There is no representation in that negotiation of the interests of

the home country (or third countries). The results can only be negative for the latter, and is an untenable situation -- as evidenced by the growing profusion of bills in the U.S. Congress to retaliate and/or emulate these host-country practices, and the rapid growth of negative reaction to outgoing FDI in other home countries (such as Japan and Sweden).

At the level of policy, such deviations from market determination and national efforts to "beggar thy neighbor" can in fact only create substantial emulation, retaliation and steady erosion of the current, relatively open, international investment regime -- in short, "investment wars" akin to the trade wars of the past. In view of the close relationship between investment patterns and trade patterns, erosion of the relatively open trading system is likely as well.

In the United States, for example, there are rapidly growing political pressures to take action against these host-country practices. This pressure, so far, tends toward emulating the foreigners: proposals for United States local content rules (in the automobile industry, by the UAW), creation of a U.S. "Foreign Investment Review Agency" (like Canada's) or at least registration of inward foreign investment, "reciprocity" in the treatment of foreign investors here vis-a-vis the treatment of U.S. investors by their home country.

There are also proposals for more constructive action, however, usually along the lines of a "GATT for Investment" -- the creation of new international rules to limit, or even eliminate, the objectionable practices and thus improve the prospects for increased FDI in the developing countries. This approach has been advocated

by such individuals as George Shultz (most extensively at the Brookings symposium on the World Bank on January 7), Mike Blumenthal and Fred Bergsten. It has solid support within the U.S. Government, especially in STR and Treasury (including a major speech by Don Regan in London on May 7). The Senate Foreign Relations Committee has held hearings on the idea. The European Community has accepted a U.S. proposal to discuss the issue at the GATT Ministerial in November. The topic was cited (in general terms) in the communique of the Versailles Summit. Though there is a very long way to go, international momentum on the issue is clearly beginning to build.

Obstacles to Progress

Before laying out a strategy for pursuing such an approach, it is necessary to acknowledge four important obstacles to progress. First, we honestly do not know the extent of the three new categories of host-country measures and their actual economic impact on home and third countries. We observe such measures in virtually all host countries and the concepts are clear, but solid empirical support is lacking. Indeed, this lack of information is among the clearest indicators of the absence of international cooperation on investment issues -- on almost everything else, we at least have lots of data. The current OECD and World Bank/IFC exercises (see below) are aimed at developing a data base and are thus quite important, but they are still at very early stages.

Second, the hands of the industrialized countries are not clean. Though the United States has a basically laissez-faire approach to inward (and outward) direct investment at the Federal level, many states and even local governments offer a wide range of incentives

to foreign (as well as domestic) firms. Indeed, some offending foreign governments (e.g., Canada, U.K.) feel their most effective riposte to U.S. initiatives in this area is to ask how it plans to limit its own sub-federal entities. This aspect of the problem obviously poses a quite sticky dilemma: it will be domestically difficult for Washington to clamp down on the states, but it will be quite difficult to move very far internationally without doing so. A partial way out is through emphasizing performance requirements and national treatment, since most state/local intervention so far is concentrated on incentives.

Other home countries to multinationals -- such as Canada, France and Britain -- are much worse offenders in their (larger, at least at the margin) role as host countries. Indeed, it is these countries, more than developing nations, which have resisted discussing this issue seriously. It would obviously be impossible to limit the practices of LDCs without doing so for industrial countries, so any effort must be generalized geographically from the outset -- a key reason for operating through the World Bank.

A third problem lies with the role of the multinational firms. The growth of host-country intervention picked up momentum in the 1970s for many reasons, but among the most important were the perception that the firms were sometimes cheating their hosts and, as indicated above, that they were dominating the world. It must be recognized, therefore, that <u>host countries will be loathe to give up their "newly found" control over the firms</u>. At a minimum, they will insist on alternative forms of protection against certain MNC practices which are widely recognized as anti-market: restrictions on exports by subsidiaries, tie-in buying clauses, manipulation of tax and other liabilities via transfer pricing, etc. Any major

initiative to place limits on governmental intervention in the international investment process is thus likely to be met by a revival of (largely LDC) host-country efforts to place limits on the activities of the firms themselves.

At a minimum, this problem suggests that any effort to develop new international rules for FDI -- be it by the World Bank, the U.S. Government, or anyone else -- must avoid even the appearance of negotiating on behalf of the multinationals. Any such image would be certain to kill the negotiating effort, for political if no other reasons, in light of the history and ideology of the issue. However, such a posture should be quite achievable: the objective would be to improve the prospects for LDC development by expanding the flow of FDI to them. The firms would of course benefit substantially from a negotiated resolution of the problems, by a return to market determination of international investment opportunities and a substantial reduction of the risks of a seizing up of the international investment (and trade) environment.

Fourth, and closely related to the previous point, why would the other countries negotiate? Most seem quite content with the new status quo, within which they successfully manipulate the multinationals to their national advantage. Having just learned to do so, why would they give it up? The only solid U.S. ally at this point is Switzerland; Germany is a luke-warm supporter, but so far unwilling to buck "EC solidarity" based on the much stronger (negative) attitudes of France and Britain. Some LDC officials see the problem but, in light of reigning LDC ideology against multinationals, "G-77 solidarity" is an extremely high hurdle to cross.

The answer lies in both education and threats. On the one hand, widespread realization that virtually all host countries are caught up in the incentives race -- and are thus bascially transferring revenues to the firms (and perhaps to home country treasuries) -- might trigger at least a ceasefire, if all countries were to back off together. On the other hand, a credible threat that the United States (and perhaps the few other adherents to laissez-faire, notably Switzerland and Germany) was going to emulate and/or retaliate might jar at least some others into action. All countries are now desperate for additional investment, and a credible threat by several key home countries to cut off outflows and/or compete energetically for inflows might galvanize a positive international response.

How to Proceed: A Negotiating Strategy for the World Bank

As noted above, several international efforts to develop new approaches to FDI are now underway:

1. Building on agreements reached in 1976 (concerning voluntary cooperation on national treatment, incentives and disincentives, guidelines for multinationals), the OECD is studying the economic impact of the troublesome practices and reviewing whether/how to intensify its efforts. At the moment, little progress seems likely.

2. Mainly at U.S. prodding, the GATT Ministerial in November will consider whether to adopt a work program on trade-related investment problems (primarily export requirements and local content rules). The first step would probably be to compile an inventory of objectionable policies, like the inventory of non-tariff barriers in 1969-70 which laid the basis for the Tokyo Round. Such an

inventory would take 2-3 years to build and might be followed by negotiations on the topic as part of a new multilateral trade negotiation on all pending trade issues -- services, high-technology trade, outstanding issues from the past such as safeguards and textiles, etc. Also in GATT, the United States is formally challenging Canada's (inward) foreign investment review practices and considering testing certain investment incentives against the Subsidy Code.

3. The Bank/IFC itself, on a mandate from the Development Committee, is studying the extent and impact of incentives and performance requirements. The Report to the Development Committee of its Task Force on Private Foreign Investment, which was delivered in July 1980, in fact provides the basis for a much more aggressive Bank role on the whole issue.

The first question, of course, is whether the Bank should take the/a primary leadership role and whether it can justify doing so. Assuming that the substantive objective is to develop a new set of rules and procedures to improve the international framework for FDI by limiting objectionable practices as outlined above, one could answer both questions in the affirmative. On the substance:

-- the OECD, by definition, excludes many of the key countries involved. Its main contribution is its 1976 package, which -- if disguised, for political reasons -- could very usefully provide a model for any more universal agreement.

-- the GATT also excludes some of the key countries (e.g., Mexico), is regarded by the LDCs as dominated by the industrial countries, and has a mandate which permits it to deal only with the trade aspects of FDI -- which are very important, but are

inextricably linked with broader dimensions of FDI. The GATT does have a track record as a locus for dispute settlement, but its image in that regard is none too strong at present and many trade experts (including Director General Dunkel) oppose giving it further responsibilities at this time.

-- the UN has repeatedly demonstrated that its highly political approach is futile for pragmatic dealing with international economic issues, has a track record of dismal failure on FDI (the long-stalled "code of conduct" for multinationals), and has a membership which is too broad (including the Communist countries which are largely irrelevant to this process and would likely use the issue for political disruption).

-- the Bank is the only institution with the proper membership, a decent (if not overwhelming) track record on the issue (ICSID, the several efforts to develop a Multilateral Investment Insurance Agency), a modicum of trust between industrialized and developing countries, and an open-ended mandate (permitting it to deal with the many aspects of FDI). The main drawback for the Bank is its absence of dispute-settlement machinery, which would represent a new endeavor for the institution and raise a host of questions concerning implementation.

The basic justification for IBRD leadership on this issue is the potentially major contribution to development from an improvement in the international framework for FDI. Such a contribution is clearly recognized in the Report of the Task Force on Private Foreign Investment of the Development Committee (especially paragraphs 4, 8, 58). Moreover, the Report provides the basis for

aggressive IBRD leadership on the key elements of the FDI issue:

> "The Task Force felt that (such) competition among host nations in granting investment incentives may be counter-productive." (para. 25).
>
> "The Task Force endorsed the objectives of seeking an understanding which would limit the adverse effects of foreign investment incentives." (para. 30, also para. 65).
>
> "Limits on foreign investment incentives could be an important part of the understanding . . . One way of introducing new arrangements might be to proceed through a phase of containment to one in which incentives are rolled back." (para. 34).
>
> "While noting the rationale of performance requirements, the Task Force also noted that performance requirements under certain circumstances could have adverse effects on the host country by discouraging investment and reducing capital inflow and by promoting and sustaining high cost inefficient industries. They could in some cases also cause distortions in international trade flows . . . They could become tantamount to a form of restrictive trade practices . . . which could lead to demands in other countries for countervailing action." (para. 44)
>
> "Given the objective of seeking an understanding with regard to performance requirements and foreign investment

<u>incentives</u> . . . the Task Force recommends a study . . . (to be) carried out under the general direction of the World Bank Group . . ." (paras. 54, 56).

"Thereafter, depending upon the outcome of the study, an attempt could be made to develop the concept and terms on which an understanding might evolve to limit the adverse effects of foreign investment incentives as endorsed earlier in the report, and to consider what further actions might need to be taken concerning performance requirements." (para. 57, also para. 66).

The only problem in using the Report as a justification for proceeding <u>immediately</u> to negotiations is the "thereafter" clause in the final citation. However, the Bank/IFC study is scheduled for completion in the fall and, in any event, it will take several months to prepare for a major effort. President Clausen could indicate an intention to launch the effort in his speech to the Annual Meeting in Toronto without violating the clear thrust of the Report of the Task Force, which was implicitly endorsed by the Development Committee in September 1981 when its study recommendations were approved.

To launch such an initiative, coordination is needed with those major governments already interested in the issue or potentially supportive of the approach:

-- the United States is a strong ally, though some elements within it (such as STR and perhaps State, almost wholly for bureaucratic reasons) may have to be convinced of the case for IBRD

leadership -- which means leaning on Treasury to take leadership within the U.S. Government, and lining up support from Secretary-designate Shultz for Don Regan and Beryl Sprinkel. (Switzerland would also be a strong supporter if it were a member, and could be helpful in any event.)

-- Germany, including Helmut Schmidt specifically, strongly support efforts to promote FDI. The issue here is to get them to fend off "EC solidarity" with their heretofore less enthusiastic partners in London and Paris, but the EC has no legal competence for FDI (except perhaps as it relates to trade) and it should be possible to sway London and/or Paris anyway (see below).

-- such a market-oriented initiative should appeal greatly to Mrs. Thatcher, Geoffrey Howe _et al_ (as it already _did_ to Keith Joseph). Presentation at the top should override the nay-saying of lower-level U.K. bureaucrats.

-- Mitterand and Cheysson are actively looking for positive North-South initiatives. Placing the new organ in Paris would probably clinch their support, though it might be too high a price.

-- Japan has indicated a willingness to go along, and in fact places very high priority on FDI to pursue some of its own key interests.

-- OPEC countries might well be supportive, as was Kuwait in the Task Force, given their role as investors and possible spillover from FDI to portfolio investment.

-- some of the major LDCs might get on the bandwagon, due both to the general need for greater FDI and the growing realization that their incentives are mostly duplicative and hence simply cost

them money. The Indian representative was in fact a leader in the Task Force, and the Philippines' representative was sympathetic. Careful soundings would obviously be needed, however, and Mexico (though not Brazil) will probably be a major problem.

Given the undoubtedly continuing involvement in FDI policy of other key international organizations, particularly the OECD and GATT, consultation with them would also be helpful to avoid duplication and pull together effectively all that was going on. They might welcome an IBRD lead, if it succeeded in galvanizing much more active progress on the issue, though the usual bureaucratic jealousies must be taken into account. It would therefore be useful to have early discussions with van Lennep and Dunkel.

Epilogue

The absence of agreed rules and institutional arrangements to govern international investment is the primary gap in the network created since 1945 to preserve an open international economic order, based on market principles and equitable treatment of all countries. Yet offshore production by multinationals approximates $2 trillion annually, as great as the level of international trade -- with no GATT, IMF or IBRD to protect it against encroachment by governments seeking to export their national problems to others.

The absence of such rules is particularly acute in light of the expansion of rules in other areas. Governments try to stay "one step ahead of the judge", and thus will manipulate particularly in those few areas -- notably, now, investment -- where manipulation has not been proscribed or at least circumscribed. It is thus no fantasy to conjure up the image of "investment wars" as the next

major battleground of international economic conflict. Skirmishes in that war have already been fought and guerrilla tactics abound throughout the world, threatening yet one more blow to the prospects for world economic progress in general and development of the poorer countries in particular.

The time is thus ripe for a major new initiative to make the world safe, or at least safer, for FDI. No existing institution is ideally positioned to be the locus of such an initiative, but the IBRD appears to be the most feasible possibility. Its doing so could make a major contribution to both its developed and developing member countries over the years and decades ahead.

Action

908

23.

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

March 3, 1982

Tom,

I spoke with Fred Bergsten about a brief paper on the international code of investment conduct. He would be pleased to do the paper and, as you know, he has worked on the subject before. In fact, he recently did some work on it for the U.S. Treasury.

He will prepare a brief outline. I told him to cover three broad issues:

a) what should such a code cover,

b) where are the political problems and what are the substantive ones,

c) what are the appropriate approaches and tactics.

Upon your return, he wants to talk to you before he drafts the paper to discuss your own thinking. I told him that you would call him when you got back.

ES.

Ernie

328-0583
Inst. for Intl. Economics

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June 29, 1982

Mr. Clausen

Tom:

Attached is the cable to Dunkel which we discussed. If a meeting is set up I suggest you invite Bergsten and whoever is working on the topic for you here (Golsong and Richardson, IFC?).

Ernest Stern

ES:ct

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TO: MR. ARTHUR DUNKEL, DIRECTOR-GENERAL, GATT,

CITY/COUNTRY: GENEVA, SWITZERLAND.

I UNDERSTAND THAT YOU PLAN TO BE IN WASHINGTON JULY 14 AND 15. IF YOUR SCHEDULE PERMITS I WOULD APPRECIATE AN OPPORTUNITY TO DISCUSS OUR INTERESTS IN A POSSIBLE CODE FOR INVESTMENT. THURSDAY MORNING WOULD BE MOST CONVENIENT TO ME BUT IF ANOTHER TIME IS PREFERABLE PLEASE LET ME KNOW.

BEST REGARDS, CLAUSEN.

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June 7, 1982

Mr. Clausen

Tom:

This is the 1980 Bergsten report. The items he referred to are on pages 6 and 7 and in the Conclusions -- paras. 57, 65 and 66.

Ernie

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ASSISTANT SECRETARY

JUL 31 1980

Dear Mr. Chairman:

As Chairman of the Development Committee's Task Force on Private Foreign Investment, I am pleased to transmit herewith its final report. I believe that our effort has been highly productive, and that the report presents several proposals which can improve the international framework for private direct investment and thus enhance the contribution of such investment to development.

It is my strong hope that the Development Committee will endorse the recommendation made in the report, and I will urge it to do so in my oral report at the meeting on September 29. Please let me know of any further steps I can take toward that end.

Sincerely,

C. Fred Bergsten

His Excellency
Cesar E. A. Virata
Chairman, Development
Committee
1818 H Street, N.W.
Washington, D.C. 20433

Enclosure

TASK FORCE ON PRIVATE FOREIGN INVESTMENT

REPORT TO THE DEVELOPMENT COMMITTEE

1. The role of private foreign direct investment in development was included in the Work Program at the September 1977 meeting of the Development Committee. The report of this work was presented by a working group to the Development Committee in September 1979, under the title "Working Group on Access to Capital Markets Report to the Development Committee on Direct Foreign Investment" (DC/79-1).

2. At a meeting of the Development Committee in September 1978, a Task Force on Private Foreign Investment was established to continue consideration of issues relating to direct investment. The mandate of the Task Force was to "examine, within the framework of these general (home and host) government policies (that affect the direct investment process), possible government policies both in the host country and in the home country, on specific aspects of direct investment on which there is a need for better understanding, with a view toward general consensus on which of these policies are most likely to maximize the international benefits of direct investment. . . . The Task Force should remain flexible on which issues it examines, taking into account the topicality, significance, and general interest in the various issues to be examined."

3. The Task Force held six meetings in the course of a year, during which it considered papers written by members on: (a) home country policies affecting private foreign direct investment; (b) investment incentives of host countries; (c) host country performance requirements; and (d) new forms of foreign direct investment. This report presents the principal conclusions and recommendations of the Task Force.

4. The Task Force recognized the importance of private foreign direct investment in the economic development of the developing nations and regions of the world, both in terms of capital provided, and technology, management and marketing skills transferred to the host country. Increasing flows of

private foreign direct investment to developing nations are especially important at the present time, both because of the contribution that capital inflows can make to financing growing balance of payments deficits, and because of the contribution that the direct investment package can make to increasing productivity.

5. Private foreign direct investment capital flows from OECD DAC countries to developing countries were $10.9 billion in 1978 and $12.9 billion in 1979, and these flows have accounted for approximately one-third of total direct investment flows to all countries in 1979. In addition, there has been increasing private direct investment among developing countries. In real terms, the flow of private foreign direct investments to developing countries increased during the last decade by an average annual rate of 5 per cent, which is slower than the growth of other non-concessional flows to developing countries and domestic investment in developing countries, but faster than the growth of official development assistance (ODA) and of domestic investments in the OECD countries.

6. Direct investment flows to developing countries, therefore, have been sustained during the 1970s despite world economic difficulties. The distribution of this investment, however, has been changing, with a tendency for it to be concentrated in certain types of activity (e.g., export-oriented manufacturing industries and service industries) and to be concentrated in a limited number of middle-income countries. It has to be recognized that these actual flows of direct investment represent the outcome of a variety of demand and supply forces. Some developing countries, for example, have not been disposed to accept private foreign direct investment in some sectors of their economies. Other developing countries are small, remote from major markets, and poor in natural resource and labor endowments. The Task Force agreed that further consideration should be given to increasing private foreign direct investment in these small and poor countries, and that means other than private foreign direct investment will have to be found for fostering their economic development.

7. In general, the Task Force accepted that general economic conditions, such as the size of the domestic market, proximity to major markets, resource and labor endowments, and the general policy environment, were the principal determinants of private foreign direct investment flows. The benefits of private foreign direct investment to the host nation may vary according to the sectors in which the investment is received and the terms upon which it is made. The Task Force noted that the character of private foreign direct investment has been undergoing changes in that its three traditional components, namely, capital, technology and management, are not always necessarily associated. Technology and management are sometimes being provided separately. The provision of these facilities to developing countries is increasingly being related to the circumstances of the individual developing country and its national objectives and priorities.

8. Recognizing the changing character of foreign investment flows and the changing needs of host countries, the Task Force agreed to focus its attention on specific policies of both home and host countries as they affect the

flow of private foreign direct investment and the location of production in the international economy. Bearing in mind that different types of investment respond differently to alternative policies, the intent was to suggest policies which would provide a framework within which private foreign firms might increasingly invest in, and provide technology to, developing countries.

HOME NATION POLICIES

9. In its final report, the Working Group on Access to Capital Markets stressed a theme of "neutrality" in policies relating to private foreign direct investment by developed home nations:

> "The main policy issue for the developed countries considered by the Working Group was that of neutrality versus discrimination in policies relating to foreign and domestic private investment. The Working Group accepted that neutrality, defined as non-discrimination against outward foreign investment in relation to domestic investment, was a clear principle on which policies affecting foreign investment could reasonably be based. The Working Group did not find any rationale for basing developed country policies on discriminating against foreign investment as such and it suggests that the Development Committee should urge countries to avoid such discriminatory policies."

10. The members of the Task Force on Private Foreign Investment favored the adoption of policies by home nations which would eliminate disincentives to outward flows of private foreign direct investment, and in addition give private investors some positive incentive to invest in developing nations. An incentive would encourage investors to increase investment inter alia through increasing the private rate of return or decreasing the perceived risk of investing in developing nations. Members were divided on the question of whether these incentives should be larger for the low-income countries; a majority, however, felt that such an approach should be explored by concerned governments.

11. In considering what policies would be appropriate, the Task Force reviewed capital controls, trade policy, fiscal policy, preferential credit, and investment insurance policies which may be considered, among others, by home governments. It was recognized that the promotion of private foreign direct investment is not the primary objective of most of these policies.

12. Capital Controls. There was unanimous agreement among the members that home nations should not employ capital controls for the purpose of hindering capital outflow to LDCs. In the event that capital controls are necessary for macro-economic reasons, home country governments should strive to mitigate the effect on private foreign direct investment flows to developing countries.

13. Trade Policy. There was agreement within the Task Force that an open world economy is one of the best ways to assure that foreign investment continues to flow to developing nations, and that home nations should not enact border restrictions which discriminate against imports of goods from developing nations. Outward looking policies would encourage private foreign direct investment that would help improve the international division of labor and

utilize and develop the abundant resources of the host countries. Expansion of trade opportunities among developing countries could also help to encourage investment and promote the division of labor.

14. <u>Fiscal Incentives</u>. There was general agreement within the Task Force that home nation fiscal policies could be used to stimulate outward investment. However, any specific incentive, to have universal application, would require a degree of consistency between home and host nation tax policies that would be difficult to achieve.

15. In order for fiscal policies to be at least neutral toward foreign investment, home nations that tax income from foreign investment should give credits for foreign taxes paid on this income.

16. Neutrality of the tax system as between home and foreign investment also requires that home countries either extend any incentives given through the tax system (e.g., investment tax credit and tax allowance) to foreign as well as to domestic investment, or the tax systems of home countries should permit host countries, if they so desire, to provide incentives for private foreign direct investment equivalent to those given by the home country to investments by local firms. This may be accomplished by means of tax sparing, tax deferral, or both.

17. Most members of the Task Force endorsed the principle of tax sparing, and all members endorsed tax deferral. Tax deferral is the practice of not taxing the profits of overseas subsidiaries until they are remitted as dividends. Tax sparing is a practice by home countries of crediting foreign taxes that would have been paid on foreign source income if a tax incentive had not been given to the investor. Both methods maintain the effectiveness of host country tax incentives.

18. Those home countries that do not tax foreign source income do not attempt to achieve tax neutrality as between home and foreign investment. The relative attraction of home and foreign investment in terms of taxation for firms in these home countries will depend on the tax rates of the home and host countries. Countries exempting foreign source income from taxation thus will find difficulty in giving fiscal incentives to foreign investment, but will allow host country incentives to operate. Exemption of foreign source income and reduction of the tax rates applied in home countries is often accomplished by means of bilateral tax treaties (discussed below).

19. <u>Preferential Credit</u>. The Task Force recognized that many home countries provide credit to direct investors in developing countries through the mechanism of public development finance companies. A majority of the Task Force believed that this practice is to be encouraged.

20. <u>Investment Insurance</u>. Almost all capital exporting nations provide investment insurance to their overseas investors. The coverage of this insurance varies, but usually includes political risks such as expropriation; inconvertibility of dividends, capital and other payments;

and loss due to war, revolution and insurrection. Some countries also provide coverage of commercial risk, and most limit coverage to developing countries. These instruments should be steadily improved wherever necessary.

21. There was some support within the Task Force for a voluntary multilateral investor insurance program. It was noted that such a program would enable risks to be spread among a larger pool of insurers than is possible via national insurance programs. Some members of the Task Force were opposed to such a program, however.

HOST NATION POLICIES

22. In its deliberations, the Task Force considered host country foreign private direct investment incentives,1/ and requirements for specific performance by foreign investors.

23. The Task Force agreed that general economic conditions in host and investing countries are major determinants of foreign direct investment. In this context some members stressed the need for transparency, clarity, and broad continuity of host countries' policies, as well as the importance of orienting the regulatory framework of host countries toward providing generally beneficial relations among all parties concerned.

Investment Incentives

24. Incentives are given by host countries in order to stimulate investment in general. In some cases, incentives are provided to foster private foreign direct investment in particular. Certain host developing countries believe that incentives are needed in order to increase foreign investment flows and to improve their composition. Incentives are designed either to increase the return on investment or reduce its risk.

25. Host nation investment incentives fall roughly into six broad categories: (a) fiscal incentives, (b) front-end cash grants, (c) preferential access to local capital markets, (d) public provision of infrastructure specific to a particular investment project, (e) provision of protective trade barriers to a sector into which new investment is sought, and (f) provision of operating subsidies to the investor. Incentives can be broadly based, i.e., made available to all potential investors irrespective of nationality or sector. Alternatively, they can be narrowly based, i.e., made available only to a specific category of investors, such as firms operating in specific sectors or foreign investors. At the extreme end of the spectrum are incentives "custom tailored" to specific investment projects.

26. In its final report, the Working Group on Access to Capital Markets recommended the following with respect to foreign investment incentives:

1/ Including those incentives available only to foreign investors and those available to both foreign and domestic investors.

"The Working Group agreed that incentives given by developing countries to attract direct foreign investment are not always productive in a cost-benefit sense for the developing country involved and that, as a general rule, less emphasis should be placed on incentive policies than on the creation of a sound general investment climate. Competition among developing countries in granting of incentives to foreign investors should be avoided. Some members thought that an international mechanism to review incentive policies and to monitor competition would be desirable. It was felt that in some developing countries, scarce financial resources provided as incentives could more profitably be employed directly to facilitate decisions by foreign investors, for example, by initiating and financing the preparation of pre-feasibility and feasibility studies. In this way, a system of project preparation that would also create a basis for the negotations between the host government and the foreign investor could be established."

27. The Task Force recognized the rationale of host countries providing incentives for private foreign direct investment. However, several aspects of foreign investment incentives given by all host countries, both developed and developing, are worrisome from a developmental point of view. First, studies of the foreign investment decision process have shown that host nation incentives play a relatively minor role in the investment decision of the foreign investor. Thus, the possibility arises that host nations, by offering incentives, do little to increase net flows of foreign investment to them. Rather, the foreign investment incentives increase profits on investment that would have been made in any event, in turn also ultimately increasing taxes paid to home country treasuries if the home nations tax foreign source income.

28. To the extent that foreign investment incentives do affect decisions, they may tilt investment from one region or nation into some other region or nation of similar characteristics. Hence, even though the net effect of the incentives on the investor is slight, one host nation very well could use incentives to draw foreign investment from other host nations. This in turn would cause those other host nations to emulate the incentives of the first nation, or even to retaliate against them. Indeed, a study of factors affecting private direct investment in developing countries found that 38 of 41 countries surveyed offered tax incentives to foreign investors. The Task Force felt that such competition among host nations in granting investment incentives may be counter-productive, especially when incentive packages are custom-tailored to lure a specific project into a nation or region.

29. Incentives offered by developed host nations also may serve in some cases to divert foreign investment flows from developing nations, although some high technology investments are more likely to go to developed host countries in any event. However, the Task Force was not unanimous in the view that developed and developing host countries compete for particular foreign investments. Nevertheless, examples cited of such competition led the Task Force to conclude that the problem of foreign investment incentives could in

some cases be common to both developed and developing nations, to the detriment of the latter. Thus, the Task Force considered that any remedy, though primarily concerning developing nations, would have to involve developed host nations inasmuch as they offer foreign investment incentives competitive with those offered by developing nations for the same projects.

30. In seeking a remedy to the existing competition for foreign investment, most members of the Task Force deemed advisable a multilateral approach to the problem. The Task Force endorsed the objective of seeking an understanding which would limit the adverse effects of foreign investment incentives. On the basis of present information and pending further studies, the Task Force agreed that such an understanding could embody the following elements: (i) coverage, (ii) transparency, (iii) equivalent treatment, (iv) limits on competition, and (v) a consultative mechanism.

31. Coverage. The understanding should cover the full range of foreign investment incentives including those at state and local levels, and those offered by autonomous authorities within national administrations. It would be necessary to establish that governments were in a position to extend control over all such incentives to foreign investments.

32. Transparency would require that nations notify one another of the incentives which they grant to foreign investors. In order to compare foreign investment incentives of one nation with those of another, common methods for valuation of incentives would be required. The understanding should establish a presumption against "opaque" incentives, i.e., those which could not be assigned a value under these methods. The first phase in achieving an understanding would involve the collection of information on the foreign investment incentives that are now being granted.

33. Equivalent treatment should be offered by host nations to domestic and foreign investors alike. However, nations could offer to foreign investors incentives greater than those offered domestic investors so long as these did not exceed certain limits. Developing nations grant preferential treatment to local entrepeneurs in some sectors, and it was considered that the understanding should recognize the validity of such treatment.

34. Limits on foreign investment incentives could be an important part of the understanding. Limits could be a specific value arrived at under the common valuation methods established under the transparency rules if valuation problems can be overcome. The general purpose of the limits would be to prevent competitive granting of incentives among host nations from escalating into bidding "wars". Limits might vary be class of host nation, viz., developing nations might be allowed higher limits than developed nations. Also, higher limits might be allowed in the case of less developed regions of nations than for the nation as a whole. One way of introducing new arrangements might be to proceed through a phase of containment to one in which incentives are rolled back.

35. A commitment to abstain from competitive bids could become a central element of such an understanding. The commitment would permit any country to

match the incentive package offered by another, but would preclude over bidding for a given project by another participant country, as soon as the first country had notified others of the incentives it intended to grant.

36. The Task Force noted that in the context of its regional policy the EEC had established procedures which included provisions for limiting incentives granted by member countries. These have a legal basis in the Treaty of Rome and involve attempts to lay down a common method for evaluating incentives, ceilings on incentives measured in terms of the common method, and a system of supervision administered by the EEC Commission. It was pointed out that considerable difficulties had been encountered in operating these arrangements, in part reflecting the variety of circumstances in the Community. The fact that this had been the case, notwithstanding the legal basis and the relative homogeneity of the EEC, showed the problems which would arise in any attempt to establish international arrangements in this area covering a much wider range of countries. Some members believed, however, that this experience also illustrates the possibilities for developing and implementing such arrangements on an international basis.

37. The consultative mechanism would allow a nation which believed itself to be injured or threatened by injury as a result of foreign investment incentives of another nation which exceeded limits to call for official consultations between officials of the two nations.

38. Methods for reaching the desired understanding are discussed in the last section of the report.

39. Some members of the Task Force were of the opinion that the above approach to foreign investment incentives applies in particular to custom-tailored incentive packages which lure specific projects to locate in a particular country. Other members, however, saw objections to a selective approach of this kind; in their view a broad approach to this question of incentives was called for. Since most host countries have general incentive schemes, it was the view of the former group that host countries should review their fiscal incentive schemes so that incentives that are duplicated, negated by some home countries' policies, or which invite retaliatory measures, such as countervailing duties, are appropriately amended.

Performance Requirements

40. "Performance reuirements" are requirements placed on domestic and/ or foreign investors by host nations to promote the achievement of national objectives. The typical national objectives served by performance requirements include (1) favorable impact of foreign investment on balance of payments and employment; (2) training of local nationals for technical and managerial positions; (3) inclusion of domestic inputs in the manufacture of product by local subsidiaries of foreign companies; (4) development of economically less-developed regions of the nation; (5) fostering of local technological research and development and technological capabilities; and (6) off-setting market imperfections resulting from some operations of multi-

national firms. The Task Force recognized that performance requirements can be an important component of host nation policies desigend to achieve these objectives.

41. The Task Force also recognized that the importance of these objectives may vary from country to country and even in the same country from time to time, depending upon the economic circumstances. The Task Force believed that performance requirements should not hinder the units to which they apply from becoming economically viable. The Task Force noted that performance requirements are generally tied up with rationalization schemes of certain sectors of the economy and are not imposed on foreign investors alone. Such requirements are adopted after a study of their economic feasibility and an examination of their viability before they are applied to specific projects.

42. Types of performance requirements which fulfill these objectives include:

(1) local content requirements, whereby the firm must shift procurement of inputs from foreign sources to sources within the host nation;

(2) export requirements, whereby the firm is required to export some portion of its output;

(3) technology transfer requirements, whereby the firm is required to transfer technology to the host nation from foreign sources; and

(4) local management and employment requirements.

43. The report of the Working Group on Access to Capital Markets noted the following with respect to performance requirements;

"The Working Group also discussed more direct policies of developing countries to shift benefits from private foreign investors and developed countries to developing countries, to minimize the costs of foreign investment and to induce investors to contribute as much as possible to the achievement of the various development objectives of the host country. (These policies include measures intended to: encourage use of domestic inputs including domestic manpower and management; control access to local financial markets; increase exports; reduce tax evasion and control transfer pricing; encourage use of adequate technology; prevent the creation of excessive market power; and limit restrictive business practices.) The Working Group considered whether some mechanism could be found to insure that such practices would not be carried to excessive lengths. It was recognized that identical policies could not be applicable to all

countries and to all private foreign investors, and that excessive performance-oriented policies could in fact have detrimental effects. For these reasons, the respective developed and developing countries need to discuss the conflicts that may arise."

44. While noting the rationale of performance requirements, the Task Force also noted that performance requirements under certain circumstances could have adverse effects on the host country by discouraging investment and reducing capital inflows and by promoting and sustaining high cost inefficient industries. They could in some cases also cause distortions in international trade flows and conflict with the principle of comparative advantage. They could become tantamount to a form of restrictive trade practice whose quantitative significance is not easily measured but which could lead to demands in other countries for countervailing action.

45. Thus, while the Task Force concluded that performance requirements could play a role under certain economic circumstances, host countries should keep the various types of performance requirements, especially those which have an impact on international trade, under constant review in light of changing development needs. Some members believed that any such requirements should be limited in time, while others were opposed to prescribing time limits.

46. The Task Force believed that too little is known about the consequences of performance requirements. It would be desirable as a first step toward gaining a better understanding of these consequences to achieve a much greater degree of transparency on the part of host nations which use performance requirements as an instrument of development policy.

INTERNATIONAL COOPERATION

47. There are various actions that home and host nations can take together to improve the possibilites for the productive flow of private foreign direct investment. Some of these, such as bilateral treaties, have already been mentioned. Existing international mechanisms may also have a role to play in establishing an environment for direct investment flows to developing countries. Finally, the Task Force had some recommendations for additional international initiatives to deal with the issues of foreign investment incentives and performance requirements which were raised earlier.

Bilateral Agreements

48. A majority of the Task Force agreed that the establishment of bilateral agreements between home and host countries may be a useful device for formalizing the relevant principles in this respect.

49. A great number of bilateral investment protection treaties containing *inter alia* provisions on investment security, transfer of funds and returns and on the settlement of disputes between home and host countries and between investors and host countries have been concluded especially during

the last two decades, between home and host countries. These treaties contribute to a reduction of the perceived riskiness of private direct investment. The majority of the Task Force recommended that other countries consider the conclusion of such treaties.

50. Bilateral treaties are particularly useful in establishing the framework for taxation of private direct investment. Such treaties establish the mechanism by which double taxation is avoided or at least mitigated. Model agreements for the avoidance of double taxation have been developed by the Economic and Social Council of the United Nations and by the OECD. The Task Force recommends these models for consideration by home and host countries.

51. Some members indicated that all matters related to foreign investment are governed by national laws and policies, and emphasized the fact that some countries are opposed to the signing of bilateral agreements on private foreign investment.

Existing International Mechanisms

52. The complaint mechanism of the General Agreement on Tariffs and Trade (GATT) is one remedy which might apply to incentives and performance requirements of member countries which adversely affect members by means of their effects on international trade. Although this mechanism could not deal with all problems which might arise from host nation incentives and performance requirements, it allows a GATT member nation to bring a complaint against the practice of any other GATT member which "nullifies or impairs" directly or indirectly benefits of free trade accruing to the first member. The challenged practice need not violate another specific GATT provision, but must only be shown to undermine the benefits of tariff concessions on a particular product. Some members stressed that this mechanism, of course, would not apply to countries that are not signatories to the relevant instruments, or to those types of measures not covered by these instruments.

53. International dispute settlement mechanisms also are available, including the International Center for the Settlement of Investment Disputes (ICSID), which can be used by members in the case of disputes between investors and host countries. The Task Force noted that not all countries are members of ICSID. Some members underscored the importance of access to international arbitration for the settlement of disputes while other members emphasized that dispute settlement falls within the jurisdiction of the legal system of the host country.

Action on Foreign Investment Incentives and Performance Requirements

54. Given the objective of seeking an understanding with regard to performance requirements and foreign investment incentives, it is necessary to obtain information as to their use and effects. The Task Force recommends that a study of foreign investment incentives and performance requirements

should be undertaken in order to obtain information regarding the types of measures used; the extent of their use; the value of the incentives on a comparable basis; and their effects on investment, production, and other aspects of performance of foreign direct investors. Likewise, the extent and impact of performance requirements need to be assessed. The study should not duplicate the work in OECD or elsewhere.

55. The terms of reference of the study would be as follows:

(a) Information on the actual incentives granted, and performance requirements imposed in host countries should be collected. Information collection might follow the model of the study of non-tariff barriers, conducted by GATT, wherein member countries were asked to identify both their own non-tariff barriers and those of other countries that had come to their attention.

(b) The quantitative and qualitative impact of incentives and performance requirements can be assessed in terms of:

- the level and country pattern of investment (geographical, sectoral);
- technology choice and indigenization of management;
- international trading patterns; and
- financial and economic costs and benefits to host countries.

56. The Task Force recommends that the study be carried out under the general direction of the World Bank Group in association with an intergovernmental group of experts appointed by the Chairman of the Development Committee, taking into account work going on elsewhere. It is hoped that both home and host governments would give their full support to the study, particularly through the provision of information in relation to their foreign investment incentives and performance requirements.

57. The results of the study would be reported to the Development Committee. Thereafter, depending upon the outcome of the study, an attempt could be made to develop the concept and terms on which an understanding might evolve to limit the adverse effects of foreign investment incentives as endorsed earlier in the report, and to consider what further actions might need to be taken concerning performance requirements.

SUMMARY AND CONCLUSIONS

58. The Task Force believes that private foreign direct investment plays a significant role in the effort to promote development in developing countries, and that it should conform to the objectives and policies of those countries.

Such investment would help to transfer, either singly or in combination, capital, technology, and skills to developing countries. Increasing flows of private foreign direct investment to developing nations is especially important at the present time given the difficulties many are having in adjusting to growing balance of payments deficits. The Task Force noted the increasing use of new forms of investment, some of which comprise aspects other than ownership and involve less control by the investor over the activities generated.

59. The Task Force agreed that general economic conditions in host and investing countries are major determinants of foreign direct investment. The Task Force considered that, wherever possible, both home and host countries should try to avoid policies that would act as disincentives to potential investments.

60. In recognition of the potential importance of foreign investment to development, the Task Force decided to concentrate on policies in home and host countries which might promote an increase in the contribution of such investment to the developing countries.

61. The Task Force recommends that home countries eliminate disincentives to investment abroad, and provide some incentives to private investment in developing countries. In considering what policies would be appropriate, the Task Force reviewed home country trade, tax, credit and investment insurance policies as well as capital controls. Concerning fiscal policy, for example, the Task Force endorsed either tax deferral or tax sparing as a means of encouraging investment in developing nations.

62. The Task Force examined two major categories of host country policies: incentives to foreign investment and performance requirements. The Task Force recognized the rationale of some host countries' providing incentives to foreign investment. It also recognized that performance requirements are designed to enable host countries to ensure that they obtain adequate benefits from incoming investments.

63. Host countries' use of such measures is oriented toward allocating direct foreign investment in accordance with national objectives and priorities. However, in some cases the use of such measures may work to their disadvantage. Recognizing that the impact of foreign investment incentives is not known with certainty, and may in any event not be a major factor in the decisions of foreign investors, sometimes they may represent a needless expenditure of resources, while at other times they may increase the net benefits for recipient countries. Performance requirements may also, under certain circumstances, discourage investment or produce distortions in the economy of the host country.

64. Moreover, the use of these measures by one country may have adverse effects on others. In attracting direct investments to their territories, countries may divert them from other countries. Likewise, performance

requirements may have protectionist effects. Third countries, concerned about such effects on their interests, may be stimulated to emulate or retaliate.

65. The Task Force concluded that the central issue with foreign investment incentives and performance requirements is how to reconcile host countries' legitimate needs to pursue their national interests through their use with the need to ensure that investment capital is channeled to its most productive uses. Therefore, it endorsed the objectives of seeking an understanding which would limit the adverse effects of foreign investment incentives and of considering what further actions might need to be taken concerning performance requirements.

66. In view of the present lack of information concerning the precise impact of both incentives and performance requirements, a first step should be to study and analyze existing foreign investment incentives and performance requirements and to consider how their quantitative and qualitative impact can be assessed. The Task Force recommends that this study be carried out under the general direction of the World Bank Group, in association with an intergovernmental group of experts, and taking into account work going on elsewhere. Thereafter, depending upon the outcome of the study, whose results will be reported to the Development Committee, an attempt could be made to develop a concept and terms upon which an understanding might evolve.

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February 11, 1982

Mr. A.W. Clausen
President
The World Bank
1818 H Street, N.W.
Washington, D.C. 20433

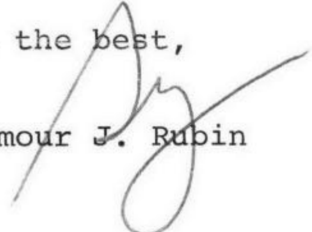
Dear Tom,

Thanks for your letter of February 8.

I will try informally to remain in touch in connection with developments in the UN Commission on TNCs and its working group on the code. I expect to be, briefly, at the UN for the next session, and probably will be there throughout the May session. If all remains as it is at present, I will again head the U.S. Delegation at the Commission meeting itself in Manila.

I'll call Heribert Golsong to see if we can get together. Since, on behalf of the U.S. Delegation, I initiated the effort in 1963 in the OECD toward a multilateral investment insurance scheme, and followed its progress - or lack thereof - when the Bank was last involved, I am very much interested.

All the best,



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February 8, 1982

Seymour J. Rubin, Esq.
Executive Vice President and
Executive Director
The American Society of International Law
2223 Massachusetts Avenue, N.W.
Washington, D.C. 20008

Dear Sy:

Thank you for your letter drawing my attention to the negotiations of the Intergovernmental Working Group on a Code of Conduct for Transnational Corporations (TNC).

I share your general assessment of the relevance of this endeavour as well as its possible impact on the Bank. We, therefore, have followed the developments quite closely through regular contacts with the Centre on Transnational Corporations. The issues of specific interest to the Bank - nationalization and compensation, renegotiation, jurisdiction - reached a crucial stage in the January 1982 Meeting of the Working Group (WG). Thus, the question as to whether the Bank should make a statement would properly have to be decided with respect to the next two sessions of the WG or to the next meeting of the Commission on TNC in September of this year in Manila.

However, as you know, the Bank at present is involved in a new assessment for a possible initiative towards the establishment of a multilateral investment insurance scheme (MIIS). In view of the sensitive nature of the subject of investment protection (which I assume you will have experienced during your recent New York meetings), we would prefer to deal with this matter with extreme caution. Any possible advantage of an official Bank appearance in the political-ideological battles taking place at the UN would therefore have to be carefully balanced against its potentially adverse impact on the Bank's ongoing work on the establishment of a multilateral investment insurance scheme.

I therefore would prefer, at least for the time being, not to see us become closely involved in the work of the negotiations on a Code of Conduct for Transnational Corporations. However, we appreciate your interest and sharing your thoughts with us.

Warm regards,

Sincerely,

T

HGolsong:tk
cc: Mr. Golsong

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

828

TO: Mr. A. W. Clausen

DATE: February 4, 1982

FROM: H. Golsong

SUBJECT: UN Code of Conduct; Letter of Mr. Seymour Rubin; Suggested Draft Reply

The Bank has observer status in the UN Commission for Transnational Corporations (TNC) and in the Plenary of the Working Group established by the Commission (WG), but it is not admitted to the drafting groups of the WG which negotiate the specific wording of the various sections of the proposed Code of Conduct. Only observers from the OECD, the ILO and the EEC are allowed to participate there. Thus, the Bank could make a statement only in the Plenary Session which then would be reflected in the final report of the WG.

Since the 7th Session of the WG (January 1980), the actual discussions have taken place in the drafting groups. A mere statement of the Bank in the Plenary without follow-up in the drafting groups would probably carry little weight.

We could of course try to overcome this procedural difficulty but, in my opinion, the matter of our involvement in the UN work on Transnational Corporations has more than procedural aspects; it is primarily a political issue.

While it is true that we have the status of a Specialized Agency of the UN, we have, in practice and for obvious reasons, successfully avoided to become clearly perceived as being "part and parcel" of the UN.

In the same spirit, we should avoid participating in the political-ideological discussions within the UN on the Code of Conduct of Transnational Corporations, and more so as the present climate in the UN is considerably more hostile to investment protection than the attitudes of individual developing countries expressed in bilateral contracts.

Since any Bank statement in this form would presumably do more harm than good, I would advise against it. This is the sense of the draft letter attached hereto.

Enc.

THE WORLD BANK
Washington, D. C. 20433
U. S. A.

A. W. CLAUSEN
President

D R A F T

February 4, 1982

Seymour J. Rubin, Esq.
Executive Vice President and
Executive Director
The American Society of International Law
2223 Massachusetts Avenue, N.W.
Washington, D.C. 20008

~~Re: Your letter dated January 19, 1982~~

Dear Sy,

Thank you for your ~~above-referenced~~ letter drawing my attention to the negotiations of the Intergovernmental Working Group on a Code of Conduct for Transnational Corporations (TNC).

I share your general assessment of the relevance of this endeavour as well as its possible impact on the Bank. We have, therefore, followed the developments quite closely through regular contacts with the Centre on Transnational Corporations. The issues of specific interest to the Bank - nationalization and compensation, renegotiation, jurisdiction - reached a crucial stage in the January 1982 Meeting of the Working Group (WG). Thus, the question as to whether the Bank should make a statement would properly have to be decided with respect to the next two sessions of the WG or to the next meeting of the Commission on TNC in September of this year in Manila.

However, as you know, the Bank is at present involved in a new assessment for a possible initiative towards the establishment of a multilateral investment insurance scheme (MIIS). In view of the sensitive nature of the subject of investment protection (which I assume you will have experienced during your recent New York meetings), we would prefer to deal with this matter with extreme caution. Any possible advantage of an official Bank appearance in the political-ideological battles taking place at the UN would therefore have to be carefully balanced against its potentially adverse impact on the Bank's ongoing work on the establishment of a multilateral investment insurance scheme.

I would therefore prefer, at least for the time being, not to see us become closely involved in the work of the negotiations on a Code of Conduct for Transnational Corporations. However we appreciate your interest and sharing your thoughts with us.

Warm regards

~~Regards,~~

Sincerely

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TREASURER
JAMES R. PATTON, JR.

January 19, 1982

Mr. A.W. Clausen
President
The World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Tom,

I recently returned from the latest of the meetings of the Intergovernmental Working Group on a Code of Conduct of the UN Commission on Transnational Corporations, on which, as you know, I represent the United States. There remain, in my opinion, many very important and difficult issues to be resolved before we can anticipate a generally acceptable code. Among these are several of great importance to private foreign investment (a large part of which moves through, or is held by TNCs). These key issues include key clauses on nationalization and compensation, and on renegotiation of contracts.

The World Bank Group has, I believe, observer status on the Commission; but I do not recall any Bank Group statement there. Yet it seems to me that if there is to be a viable program of economic development which relies on a mix of public financing, whether via bilateral agencies or the multilateral development banks, on the one side, and private investment on the other, the code exercise is important, not only to the private sector but also to the Bank. I happen to think that the practical value of a code can be greatly exaggerated; but the psychological impact, either of achievement of an agreement, or, on the other hand, of a spectacular failure to achieve anything after all these years of work, can be substantial. I also think that the considered advice of the Bank roup would have a major and beneficial effect on deliberations in the Commission.

There are of course specifics I have in mind: the role of the IFC in general, in promotion of private investment, depends a good deal for its success or failure on the investment climate; and such matters as multilateral investment insurance

are likely to take up the attention of the Commission and its Secretariat, the UN Centre, in the future.

Perhaps we could get together to talk about some of these matters at your convenience, or that of your staff.

Regards,

Seymour J. Rubin

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1982 JAN 20 PM 5: 12
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Roy
Sent to MC,
for information.

Mr. A. W. Clausen

April 8, 1982

Richard W. Richardson

No record of any discussion at a meeting.

Bill

International Investment Codes of Conduct

1. You have asked me, through Mr. Hans Wuttke, to examine the question of international codes of private investment conduct, and to make a recommendation on the potential role of the Bank in this area. I have therefore undertaken a brief but intensive review of the present state of affairs in this field and have come to two conclusions:

(a) Existing efforts to forge a global code of investment conduct, whether as a formal "GATT for Investment" institution or as a looser collection of "rules of the game" are likely to fail. Moreover, it seems risky for the Bank to intervene in, or to duplicate, efforts now underway, especially in the UN forum, because the Bank is no more likely to succeed in a similar essay, and because such intervention could widely be interpreted as disruptive.

(b) But if global efforts seem far down the road at this date, one can be more optimistic about an incremental, country-by-country approach based on practical, rather than philosophic considerations, in which the Bank could play an instrumental role tailored directly to its particular strengths.

What follows is a summary of reasons for the first conclusion and an outline of a strategy for the second.

Global Codes of Investment Conduct

2. There are a variety of reasons why periodic efforts have been made to establish some rules of the game for private foreign investment. But from the point of view of public policy, there is one broad argument: the development of the poorer countries depends importantly on a substantial transfer of capital and technical resources from the industrial countries, and official development lending cannot do the whole job. Therefore, private foreign direct investment must take part, and perhaps -- in light of recent donor country attitudes -- an increasing part, of the burden. But the evidence, although unclear, suggests that this is not happening, or is not happening at a fast enough rate. There are many reasons why foreign investment may flow at a faster or slower rate, including general economic conditions and policies in both home and host countries; conditions specific to the target industries; and the warmth of the host country reception, and treatment, of foreign investment. And that reception depends, in turn, on the host country perception of the role, behavior, and all-around usefulness of the foreign investors and their activities.

3. It is the latter set of problems that have been addressed by past efforts to establish global rules of behavior for all participants, to be policed either by new institutional arrangements or by less formal mechanisms. These efforts have been reviewed elsewhere (e.g. memorandum from H. Golsong, "International Investment Protection and Multilateral Investment Insurance Agency," December 18, 1981) and I concur that they are not likely to be fruitful. The current UN exercise is both the most ambitious and most recent, and its final product, frequently delayed, is likely to be a set of highly negotiated, ideologically biased, and largely non-operational guidelines.

4. This is hardly surprising in view of the great diversity of interests and issues that separate the different players. From the LDC point of view, traditionally high political sensitivity to foreign investment ("exploitation") is rarely offset by a clear understanding of its economic benefits. Host governments have often regarded the activities of MNC's with hostility and suspicion, frequently attacking their policies on corporate disclosure, transfer pricing, technology transfer, royalties and management fees, local employment, ownership and control. In contrast, the concerns of the multinational corporation are often the mirror image of those expressed by the host government. The corporations are concerned with sanctity of contract, creeping expropriation, obdurate bureaucracy, foreign exchange availability, freedom to repatriate capital, national treatment, performance requirements, and a general desire to be free of overwhelming regulation.

5. The industrial countries, for their part, have themselves done little to reach global accommodation on direct foreign investment. The OECD Code, for example, is a nonbinding declaration which avoids many sensitive areas and issues of enforcement. Fears abound, in one quarter or another, that outflows of such investment results in the export of jobs and value-added (e.g. US labor), or that inflows compromise national goals and policies (e.g. France and Canada). As a result, some industrial countries have frequently discriminated against foreign direct investment in ways that hardly qualify them as models for LDC behavior.

6. In sum, the effort to create an effective global code of investment conduct is a game with uncertain rewards and without many enthusiastic players.

Role for the Bank

7. It seems clear that any approach to a set of investment rules of behavior must be based directly on an appeal to the self (national) interest of the participants, and must be pragmatic rather than ideological. It must address, in other words, actual political and economic circumstances in individual countries, rather than abstractions to which all (or some) may

subscribe and none need observe. This suggests that any progress in this field will have to be fashioned on a country-by-country rather than global basis, and it also suggests an aggressive but sensible initiative that could be taken by the Bank -- and only by the Bank.

(a) The Bank would announce its intention to undertake, in a select group of interested LDCs, an identification by sector and industry of the developmental potential for new or expanded private sector investment and financing. The study would try to ascertain the potential in each country for additional private investment, both domestic and foreign; the sectors or industries that might appropriately be targeted for such investment; and the impediments that stand in the way. Central to the study would be an analysis of obstacles to the flow of private foreign investment. This would be done in consultation with prospective investors as well as with government authorities. The small sample of countries for first study would be from among those that have experience with foreign investment, in both extractive and manufacturing industries.

(b) If this initial investigation yields positive results -- i.e. suggests that increased foreign investment would be both beneficial and forthcoming under specified conditions -- the Bank would take another step. It would approach one or more of the sample countries to propose a collaboration for enlarging the inflow of direct foreign investment. Several elements would be involved in this experiment:

(i) The Bank would propose to incorporate this new approach in its regular programming for that country, outlining not only total investment goals but possible allocations of such investment by industry and by different sources of financing -- domestic and foreign, private and official. By this device, a strategy would emerge that would reserve for official financing that investment which has little or no recourse to private markets, and which at the same time presents a program of specific opportunities for private financing. The program would of course have to be quite flexible since the amount and type of access to private markets cannot be forecast with any precision. But the purpose of this exercise would be realized if the country and the Bank reached agreement on priorities for private financing in certain activities and industries.

(ii) The Bank would propose, on the basis of this program, to lend good offices in securing new foreign investment in the target areas. Bank support would begin by devising, jointly with the country, a set of "rules of the game" governing foreign investment. These rules would draw upon previous experience with global codes of investment conduct such as that of OECD, but would be tailored to encourage foreign investment on terms satisfactory to the host government. The national investment code would be published in conjunction with its overall development program as agreed with the Bank.

(iii) The Bank would indicate its readiness to help mobilize additional direct foreign investment, as part of its country program, which would enter on conditions established by the new national investment code. This would, of course, be the main incentive to establish such arrangements, and would be the object of much attention elsewhere. A matter that requires careful study is whether the Bank would involve itself simply on a "best efforts" basis in attracting new foreign investment, or whether it should be willing to commit extra Bank Group resources to lubricate the effort. This might take the form of direct IFC involvement with equity and loans; some form of multilateral insurance; and/or a Bank commitment to fund infrastructure projects associated with the foreign investment. As part of its association with the program the Bank might propose an expanded use of ICSID for dispute resolution.

(iv) Compliance with these arrangements ultimately will depend on the goodwill of the parties concerned and the real control mechanism will be the fact that neither governments nor private investors will be anxious to create serious confrontations within the framework of a Bank program. But the Bank will want to examine the extent to which its own program should be used for leverage in securing compliance.

RRichardson/rso