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Toward New Rules on International Investment

This chapter explores the possible substance of an international accord on foreign direct investment (FDI) and global corporations. The proposal is framed normatively; that is, it lays out basic principles of an *optimum optimorum* of accords and largely ignores whether international agreement on such an accord can actually be achieved. At the level of detail, however, points at which major disagreements among negotiating parties will likely occur are noted.

At the level of principles, open investment policies should be the norm, with limited (and clearly articulated) exceptions allowed only when justified in the name of national security or some other overriding principle. Thus, the accord outlined here is not meant to unduly increase regulation of FDI or the activities of multinational firms; rather, it is intended to provide a basis for liberalization of restrictive policies that currently exist and to reduce government interventions that might lead to income-reducing inefficiencies.

This is not to say that there should be no regulation whatsoever of multinational firms. Governments, for example, must continue to ensure that markets remain competitive and that multinational firms are not exempt from competition policies. As is argued later in this chapter, competition policy is one domain where a more international approach is needed in the face of the globalization of business. More generally, one of the central tenets of an accord on investment should be that affiliates of multinational firms obey the laws of the host nations in which they operate.

Chapter 5 surveys the extent to which the principles outlined in this chapter have actually been achieved in existing agreements on investment. The reader is cautioned to pay attention to nuance; many of the principles enumerated in this chapter do in fact appear—in name, at least—in international agreements that have been struck. But often, the accompanying language diminishes their content significantly.

An Accord on FDI

The ideal accord would grant specific rights to, and simultaneously place certain obligations on, three sets of factors:

- governments of nations that are host to FDI (including subnational entities);
- governments of nations that are home to international corporations (again including, where relevant, subnational entities);
- foreign direct investors and the international operations thereof—that is, the global corporations themselves and their overseas affiliates (whether these be subsidiaries, branches, or other organizational forms).

In addition, the accord must also provide for an effective means to settle disputes both between governments and between direct investors and governments that might arise over interpretation or enforcement of these rights and obligations. The accord might also be supplemented by ancillary codes. The main ingredients of such an accord are described below.

Host-Nation Government Obligations

These fall into three categories: right of establishment, national treatment, and state intervention. Obligations for all three categories would enunciate normative principles and a list of acceptable exceptions and derogations to these normative principles.[1]

Right of Establishment

The subsection on right of establishment would spell out both obligations to apply to host governments and rights to apply to foreign direct investors. The underlying normative principle should be that national markets must be open to entry by foreign direct investors via the route of foreign direct investment (including acquisition of ongoing enterprises

1. The difference between an "exception" and a "derogation," following standard international legal usage, is that the former is considered more or less without time limit whereas the latter is considered to be a temporary measure.

already operating within the market) and that any exceptions or derogations must be completely transparent.[2]

No nation now grants full, unimpeded right of establishment to foreign-owned or foreign-controlled enterprises. For example, the United States traditionally prides itself on its degree of openness to FDI but has long imposed restrictions on foreign ownership of activities in certain sectors. Foreign interests cannot wholly own or exercise control over enterprises operating in the US broadcasting, coastal shipping, nuclear energy, oil pipeline, or domestic air transport industries. All countries have sectoral restrictions, and among the OECD nations, lists of restricted industries tend to be strikingly similar to the US list (OECD 1993; the restrictions listed in this somewhat dated document still exist, with little change).

Most nations can also block foreign takeovers of domestic firms, or even "greenfield" establishment of foreign-controlled operations, on grounds of national security. The United States made such power explicit in the Exon-Florio amendment to the 1988 Omnibus Trade and Competitiveness Act, and most nations give themselves similar powers.[3] Further, many nations screen FDI on economic grounds. Others reserve the power to do so, even though in recent years they have allowed these powers to fall into disuse. The issue of whether governments should screen FDI thus remains a contentious issue.

A more subtle establishment issue encompasses intangible barriers to entry, which are widely viewed as existing in Japan and certain other countries whose regimes are less open or less transparent than in America. In the case of Japan, for example, it is claimed that cross-holdings of equity in firms by other firms within the so-called financial *keiretsu* make it impossible for non-Japanese firms to acquire Japanese firms. (see, e.g., Bergsten and Noland 1993; Lawrence 1993) This has led to proposals for strict reciprocity in extending the right of establishment (or national treatment, see below) to particular countries.

What exceptions to the principle of openness are to be allowed? There are numerous justifications given for exceptions: national security, control of national patrimony, and various shades of mercantilism. The negotiation of exceptions would be very difficult because there is no consensus on the merit of these justifications. As was explored in the previous chapter, many of these issues boil down to a question of the extent to which a local subsidiary of an international corporation is an

2. Transparent means that the measure or policy is a matter of public record and that the affected parties can discern the direct and indirect consequences of the measure or policy (OECD 1983).

3. Interestingly, there are some nations that do not. Under the Investment Canada Act, the government of Canada, for example, can screen FDI on economic grounds but not, in the opinion of most Canadian legal scholars, on security grounds.

entity different from any locally owned and controlled business organization or is simply an ordinary, national entity that happens to have foreign owners. Nations that limit right of entry tend toward the view that the international corporation is an integrated entity potentially pursuing strategies or goals incongruent with national interests. Nations that maintain relatively open official policies toward direct investment tend to see the issue merely in terms of what activities should and should not be subject to foreign ownership, without much regard to the means by which the foreign ownership is exercised (e.g., US restrictions on foreign ownership typically apply equally to ownership by foreign "global" corporations and passive investors).[4]

The specific issues include the following: What sectors, if any, should nations be allowed to close to FDI? Should governments screen FDI, and if so, on what grounds? With respect to structural impediments to establishment (generally termed the "Japan problem," even though Japan is not the only country where such a situation may exist), how should openness be defined and maintained when there are opaque barriers? Should equity restrictions on foreign investors be allowed? (For example, should host governments be allowed to require local equity participation in domestic affiliates of international corporations?) And if so, to what categories of commercial enterprise would they apply? Should nations be allowed to "grandfather" existing sectoral restrictions and other limitations on right of establishment (as did the United States in the NAFTA), even if these do not fall on the list of acceptable exceptions?

Because some exceptions are inevitable, an overriding goal would be to achieve a high degree of transparency. That is, whatever the rules regarding right of establishment, countries should administer them in a way that is clear and unambiguous. Official exceptions to right of establishment should be published, or, where countries exercise administrative discretion in determining whether a particular case would be allowed or not, both the criteria for judging the case and the procedures for making a determination should be public information. Indeed, a universal benefit of an international accord on direct investment would be to make exceptions to right of establishment transparent and thereby to increase the likelihood that such exceptions would be subject to future liberalization.

4. Barriers to entry can, however, reflect private assessments of the merit or lack thereof of foreign ownership as well as official assessments. Again, to use Japan as an example, it is often said that a major barrier to direct investment in Japan is a distrust of foreigners that is deeply embedded in the local culture and is reflected in the unwillingness of private Japanese shareholders to sell controlling interests in local firms to foreign investors.

National Treatment

The subsection of the accord on national treatment for foreign investors would closely parallel that on right of establishment and would also simultaneously spell out obligations on host-nation governments and rights of foreign direct investors. The normative principles would be that foreign-controlled enterprises operating in a national economy should be subject to exactly the same laws and policies as domestically owned rival firms operating in the same sectors, and that any exceptions or derogations should be completely transparent. In many countries, foreign-controlled enterprises are in practice subject to different laws or policies than domestically owned ones, so an alternative articulation of the national treatment principle that has found acceptance may be called for: foreign-controlled enterprises should be subject to laws and policies *no less favorable* than those applied to domestically owned firms operating in the same sectors. This phrasing allows a host nation to apply laws to the foreign-controlled enterprise that are more favorable than those applied to domestic rivals.

National-treatment provisions should be augmented by a general provision for most-favored nation (MFN) status. In the context of international investment, MFN implies that if a nation that is party to the accord grants to investors (or their affiliates) from some nation treatment that is more favorable than that required under the national treatment obligation of the accord, that same treatment would be accorded to the investors (or their affiliates) of all nations party to the accord.

One sticky issue is whether exceptions to MFN should be allowed. The exception most likely to be accepted is one for so-called regional economic integration organizations such as the EU and NAFTA.

Another difficult, more general issue would be allowable exceptions to national treatment. For example, should government procurement policies for defense industries prohibit foreign-controlled enterprises from being contractors for certain goods? Should special requirements on foreign-controlled defense contractors that do not apply to domestically controlled ones be deemed acceptable exceptions from national treatment? Are there sectors in which foreign-controlled firms should be regulated differently from domestically controlled competitors for reasons other than national defense? Should foreign-controlled firms have the same rights to contribute to election campaigns as do domestically controlled firms?

There is little consensus among nations (or, for that matter, among the policy analysts of most nations, including the United States) on how extensive national security and other exceptions to national treatment should be. Therefore, negotiating an agreement on allowable derogations and exceptions to right of entry and national treatment would probably be difficult. Most likely, any future accord would include rather open-ended provisions regarding derogations and exceptions; that is to say, pragmatic considerations would dictate that countries be allowed to make pretty much all the derogations and exceptions they see fit. Otherwise expressed, lists of allowable derogations and exceptions would almost surely include all possibilities that any negotiating party seriously wanted to be on such a list.

Thus, transparency again becomes a very important issue. To ensure it, a procedure along the lines of the current process followed in principle by OECD members might be applied. Under this process, countries publicly state what derogations and exceptions are in effect and enforced and are prepared to periodically justify these derogations and exceptions before an international body.[5] Such a process would not only promote transparency but would bring pressure on countries whose derogations and exceptions are excessive by international norms.

State Intervention

The third set of obligations applying to host-nation governments encompasses the issues addressed in the Uruguay Round Agreement on Trade-Related Investment Measures (TRIMs)—namely, which national and subnational government interventions into the behavior of international corporations should be allowed and which should be prohibited. Prime on the list of these interventions are investment incentives and performance requirements, some aspects of which were discussed in chapter 3 and others that were tackled in the Uruguay Round are covered in the following chapter. Two brief notes will suffice here. First, most performance requirements on MNC subsidiaries have distortive effects both on allocation of investment resources and on international trade flows generated by direct investment. Hence, most such requirements should simply be banned. Second, prohibitions or other disciplines on these requirements should be linked with restrictions on investment incentives, which also have distortive effects.

The Uruguay Round TRIMs agreement has fallen short of establishing wholly effective rules in this area; only certain performance requirements are addressed. Those practices that are addressed are banned, as are the subsidies (which have the nature of investment incentives) linked to these. Some regional arrangements cover more. For example, NAFTA covers more categories of performance requirements but leaves investment incentives untouched. Articles 92 and 93 of the Treaty of Rome—the basic document of the European Union—potentially caps most investment incentives. These arrangements are covered in the next chapter, and all that we shall say here is that stronger agreements on both investment incentives and performance requirements would be useful at the global level.

5. This process is described in more detail in the following chapter (see also OECD 1993).

Again, what exceptions ought to be permitted? Would nations be allowed to impose performance requirements deemed necessary for national security? Are there classes of performance requirements that should be permitted? For example, should governments be allowed to require that foreign-controlled enterprises perform certain levels of research and development? (On this issue, while NAFTA bans most categories of new performance requirements, it apparently does not ban R&D requirements.) Would existing performance requirements be grandfathered? If so, should there be a schedule for rollback and elimination of these?

Other obligations of host governments would pertain to fund transfers and payments, expropriation, and sojournment (temporary residency) of personnel.

Under an accord on investment, international firms would have the right to transfer funds and to make payments in and out of jurisdictions where they operate. These transfers and payments would include those of profits, dividends, interest, realized capital gains, royalty and licensing fees, technical assistance fees, management fees, proceeds from the sale of assets, payments for material inputs (e.g., imported raw materials or semifinished products for further processing), and other transfers and payments associated with the normal conduct of business. Host- and home-nation governments could not restrict these, except insofar as restrictions related to judicial proceedings (e.g., the firm in question were bankrupt or in a state of insolvency) or were imposed pursuant to criminal investigations. An exception would be allowed where a nation suffered extreme balance of payments difficulties, in which case restrictions could be imposed consistent with the Articles of Agreement of the International Monetary Fund (IMF).

The businesses and properties of an international firm would not be subject to expropriation or nationalization unless it were to be conducted on a nondiscriminatory basis and subject to due process of law. If business and property were expropriated, the investors would be entitled to prompt compensation for their fair market value in an international currency (e.g., US dollars, Japanese yen, or German marks).

With respect to sojournment of personnel, global corporation affiliates should have the right to employ technical and other personnel designated by the parent organization, and these personnel should be able to obtain nonpermanent resident status in the host country. Host governments should create special visa categories for personnel requiring visas. Staffing decisions would be at the discretion of the subsidiary and its parent organization—that is, not subject to host-nation requirements to employ local nationals in key positions.[6]

6. The company might nonetheless wish to do so; indeed, there is a trend worldwide for global corporations to employ local nationals at all levels in their overseas subsidiaries. Nonetheless, explicit rights of sojournment would be desirable to provide against undue state intervention into an individual firm's management practices.

Host-Nation Government Rights

In addition to obligations on host-nation governments, the ideal investment accord would spell out certain rights of these governments:

- The host government should have the right to regulate the activities of foreign-controlled enterprises operating within its sovereign territory, consistent with the principles of right of establishment and national treatment discussed above. In particular, the host nation should have the right to force a subsidiary of an international firm legally incorporated in that nation's territory to follow host-nation law and policy, even if these should conflict with the law and policy of another sovereign state's jurisdictional claims over the subsidiary, such as those of the corporation's home-nation government.
- The host government should be able to tax the earnings of the subsidiary, again consistent with obligations set down elsewhere in the accord. In particular, the host-nation government should have the right to adjust reported earnings of a local subsidiary to correct for underreporting via constructed transfer prices. However, there should be uniform standards for transfer pricing to which all host nations would subscribe (see the discussion below pertaining to an ancillary code on taxation).

Home-Nation Rights and Obligations

At least two rights of, and one obligation on, home-nation governments should be made explicit. These governments should have the right to tax its citizens, including corporate citizens, on worldwide income. This would include the right to choose how to treat host-nation taxes on income earned abroad (e.g., whether to grant credits for these taxes, to allow them to be deducted from taxable income as expenses, or to treat them in some other fashion) and the right to adjust earnings for possible distortions caused by transfer pricing (again, see discussion of an ancillary code on taxation below). However, it would be desirable for nations to agree to refrain from exercising this right and tax instead on the basis of residence ("territorial" taxation), whereby the earnings of overseas affiliates would not be deemed taxable.[7]

The second right of home governments is the power to otherwise regulate the activities of their citizens. But home governments should

7. A complete discussion of the taxation of multinational corporations and a series of recommendations for reform is contained in Hufbauer and van Rooij (1992). See also Hufbauer and Gabyzon (1996).

also accept as an obligation the right of host-nation governments to regulate economic activities of citizens (including affiliates of firms that are based in the home nation) operating within the host territories. There should be no exceptions to this obligation, although governments might seek international mechanisms for implementing needed regulations in domains such as taxation and competition policy (antitrust); see discussion below. Host nations might sometimes voluntarily cede rights of regulation to home governments. For instance, a host-nation government might recognize another government as supervisor of banking operations that are conducted in the host nation's territory but are controlled by banks based in the other government's territory.

Under this right, combined with the right of host-nation governments to regulate the activities of foreign-controlled firms operating on their shores, contradictory policies could be aimed at the same corporation. For example, one nation might embargo sales of goods and services to a second nation, but a third nation might not honor the embargo. What ought to be the position of a multinational corporation with affiliates in both the first and the third countries, each of which does business with the second? (In this case, the "affiliate" could be the parent organization.) According to the principles enumerated here, the affiliate in the first country could be required by that country's government to comply with the embargo, but that government could not require the affiliate in the third country to honor the embargo. But even so, the issues are not wholly clear-cut. For example, can the first country's government prevent the affiliate in the first country from selling goods and services to the affiliate in the third if this were likely to result in resale to the embargoed country? If technologies are transferred from the first-country subsidiary to the latter, does the first country's government have the right to require that these not be further transferred to the second (embargoed) country?

The point is that no matter how tightly the rights and obligations of home and host nations are constructed, it will not always be clear which government can regulate a particular transaction or activity. Thus, an important adjunct to the rules will be a means by which jurisdictional disputes between home and host governments can be settled. Just such a scheme is discussed later in this chapter.

Rights and Obligations of Global Corporations

The industrialized nations, especially the United States, have long resisted obligations upon business enterprises through international law, arguing that such obligations would invariably discriminate against international corporations. This rationale was buttressed during the 1970s by the rather extreme positions taken by the Group of 77 developing nations in UN discussions on codes of conduct to regulate international corporations and restrictive business practices (discussed in chapter 5).

Yet such provisions are desirable for at least three reasons.

First, it is difficult to imagine all host-nation governments accepting significant limitations on their abilities to regulate foreign direct investors if these investors themselves were not subject to obligations at the international level. Multinational firms do often have objectives that are at variance with the laws or policies of the nations in which they operate, and these governments have a right to expect that local affiliates will comply with local law or policy.

Second, clearly stated international rules could save international corporations from situations in which they otherwise would be "damned if they did and damned if they didn't," as when they face conflicts between policies of home and host governments. Clearly, these firms can benefit from rules indicating which government was to be obeyed—under the principles enumerated here, this would almost always be the host government.

Third, these rules could provide a standard against which the conduct of a specific firm could be gauged. Such standards could very much be in the firm's own interests. Say, for example, a firm believes that it faces unfair or discriminatory treatment under the law or policy of a host government that is in contravention of obligations of an accord on investment. The host government, for its part, counters that the firm's conduct necessitated the discrimination. If there were dispute settlement procedures in place, the firm could plead its case before an international panel and argue that its conduct was acceptable by the standards of the accord and hence did not warrant government intervention.

Specific obligations on international corporations would fall into two categories. First would be rules specifying whose laws and policies such corporations must follow under what circumstances. The underlying principle should be that entities operating in host countries should follow host-government law while entities operating in home countries should follow home-government law. When, as in the example above, two governments claim jurisdiction over a transaction or activity and these parallel claims put conflicting demands upon an international corporation, the situation would be resolved via the dispute settlement mechanism.

The second category of obligations on international corporations would prohibit or discourage "restrictive business practices." Some such practices should be banned entirely—for example, central office policies requiring subsidiaries to source inputs from specific overseas suppliers where these inputs could be economically obtained from local suppliers. These policies are analogous to host-nation performance requirements, and the Group of 77 long ago rightly sought international sanctions against them.

There is widespread disagreement among nations with respect to exactly what practices might fall into this category. Pragmatism therefore suggests that an accord on investment likely would contain two lists of restrictive business practices: those that all signatory countries could agree to prohibit, and those that all signatory countries could agree to discourage. The latter list could include practices that some but not all nations believed should be prohibited.

Practices falling on the first list would be banned per se. Practices on the second list could be banned by individual nations, but the prohibitions would apply only to operations conducted on this nation's sovereign soil.

In addition to these basic obligations on international corporations, there could be other obligations linked to ancillary codes; these are discussed later in this chapter.

Dispute Settlement

Two generic types of dispute can be envisaged under the proposed accord: "state-to-state" disputes between governments (e.g., between a home and a host government over one or the other's policies as they bear upon a particular international corporation) and "enterprise-to-state" disputes, where the government may be home or host to the corporation.

For state-to-state disputes, a modified settlement mechanism similar to but stronger than the current WTO Dispute Settlement Body would be desirable. Appropriate measures to strengthen the WTO mechanism are embodied in the Canada-US Free Trade Agreement (Horlick, Oliver, and Steger 1988); a model for enterprise-to-state dispute settlement is to be found in the chapter 11 provisions of NAFTA (Graham and Wilkie 1994).

Borrowing from the FTA and current WTO procedures, the essential elements of a mechanism to settle state-to-state disputes are as follows:

- The party initiating an action must notify the other party or parties of its intentions in writing.
- The parties must attempt to work out the problem via mutual consultation.
- If consultation fails, the parties can submit the dispute to a panel of experts with powers to arbitrate the dispute. On this panel would sit, inter alia, representatives that the parties themselves select.

WTO procedures follow the first two of these steps. The third step in WTO procedures is, however, quite different. A WTO "panel" cannot arbitrate a dispute. If mutual consultation fails to resolve a dispute within a specified time, the dispute may be brought before a panel, which can then recommend by majority vote whether the action of the "defendant" state in the dispute violated its WTO obligations. The panel also recommends remedial action. Its decisions may be appealed to an Appellate Body, whose findings are adopted automatically unless the Dispute Settlement Body decides by consensus to block the adoption. If upon appeal the defendant does not take the recommended remedial action within some reasonable period (which is decided case by case), the "plaintiff" government is then entitled to initiate trade-related sanctions against the "defendant."

For enterprise-to-state disputes, somewhat different procedures are warranted. International corporations are not sovereign states and hence do not have the rights accorded to such states. Generally, issues between an international corporation and a nation state are (and should be) settled within the legal system of the state. Indeed, under the accord described above, international corporations and their affiliates would be bound to obey the law and policy of governments in the territories over which these governments hold jurisdiction. However, three general cases can be identified where the legal system of a nation-state could prove unsatisfactory as a means of settling a dispute:

- where a government believed that an international corporation's practices outside national territory harmed its interests and that the firm had violated its obligations under the accord;
- where a firm believed that government regulations or policies affecting its operations were inconsistent with the government's obligations under the accord and where efforts to resolve the matter with government agencies failed to resolve the issue;
- where a firm believed that one government's laws, regulations, or policies contravened those of another so that the firm could not follow both. In such a case, the firm might initiate dispute resolution proceedings with both governments.

For these situations in which the firm is party to a dispute, a different dispute settlement mechanism should be established. A two-step procedure is envisaged:

- One of the parties to the dispute appeals to a panel, the sole role of which would be to determine if there were merit to the appeal. "Merit" here would be decided largely on procedural grounds, perhaps by the following criteria: Were efforts made to resolve the dispute via consultation between the affected parties or via the established legal procedures of the affected government? Did the dispute involve interpretation of the investment accord, and in particular, did it appear *prima facie* that a party to the dispute could be in violation of some provision of it?

- If this panel were to judge that the appeal had merit, a second panel would hear the substantive issues of the dispute. This panel would be empowered to recommend a solution, which could entail awarding of damages to the firm, a recommendation that the relevant government or governments cease or desist from a particular practice, or a recommendation that the firm take (or cease or desist from) a particular action.

One purpose of this two-stage dispute settlement approach is to filter out frivolous or nuisance cases. A second purpose is to induce parties to settle disputes via consultation: The first panel could require the disputing parties to engage in further consultation if it believed that all possibility of a mutually satisfactory resolution had not been exhausted. Thus arbitration in the second panel could be restricted only to those substantive cases where resolution was impossible.

This procedure clearly raises issues of nation-state sovereignty. What would be the legal status of any recommendation of this second panel? Would the recommendation be binding upon firms? If the procedure is to have any meaning, the answer would have to be yes. But then would the recommendation be binding upon nation-states? If the answer were no, the whole procedure would be asymmetric and corporations likely would view it as latently punitive. If the answer were yes, signatories of the accord would have to yield a certain amount of sovereign power.

The NAFTA chapter 11 dispute settlement procedures—discussed in some detail in chapter 5—offer a partial precedent for these proposals.[8] Under these procedures, NAFTA member-country investors (but *not* their investments such as a subsidiary) as well as the member governments themselves can submit certain types of disputes to binding arbitration.[9] Consultation and negotiation must be tried first. An investor can seek arbitration if consultation and negotiation fails *and* if the investor can claim monetary loss or damages resulting from an alleged breach of obligations under section A of chapter 11 of the NAFTA agreement (or certain other articles).

Under NAFTA procedures, a tribunal would then fulfill both steps of the arbitration procedure outlined above unless the disputing party asserts that the measure at issue falls under any of the stated exceptions to NAFTA (set forth in annexes I through IV of the agreement). In this last case, the NAFTA commission can make a ruling on this interpreta-

8. The federal governments of Mexico, the United States, and Canada, as well as the state and provincial governments of these nations and investors from them, are parties to the agreement and thus have recourse in these procedures.

9. In particular, an investor can request arbitration of a government measure that is alleged to violate subchapter A of chapter 11 or of Articles 1502(3)(a) or 1503(2) of the NAFTA (see discussion in chapter 3).

tion that would be binding on the tribunal. If the commission makes no ruling, the interpretation is left in the hands of the tribunal. The tribunal then proceeds under either the rules of the International Center for the Settlement of Investment Disputes (ICSID) Convention or those of the UN Commission on International Trade Law (UNCITRAL). If it finds in favor of the company, the tribunal can make a monetary award, which each party agrees to enforce in its own territory, but the tribunal cannot order a party to cease or desist from a practice, policy, or law that it determines to be in contravention of NAFTA obligations.[10] If a member government is alleged to not enforce the award, the commission can establish a panel to determine whether this is so and, if it is so found, to recommend that the defaulting government comply.

Thus, both the scope of disputes that can be resolved under NAFTA chapter 11 procedures and the outcomes of the resolution procedures are narrower than what is envisaged in the dispute settlement mechanism in the ideal accord on international direct investment. The main weakness of the NAFTA procedures is the fact that arbitration is possible only if monetary damages can be established *by the investor*. However, in some situations, it might be difficult to establish such damages—as with those resulting a government's failure to adhere strictly to a national-treatment standard. Nonetheless, the NAFTA procedures go substantially beyond any thus far created and serve as an important precedent for any future multilateral investment accord.

On the matter of the ceding of national sovereignty, the European Court of Justice provides another precedent. The Court can hear issues arising between firms and EU member nations where the issue involves a possible conflict between EU rules and national laws or policies bearing upon the operations of the firm. The Court's decisions are binding upon both the firm and the member-nation government. To date, European governments have abided by the Court's rulings. However, the power of this court goes far beyond anything that has been envisaged at a worldwide multilateral level, and it is almost surely politically impossible that such power would be granted to an institution at this level.

Arbitration and Sanctions

Nation-states could accept the obligations outlined above in principle but fail to live up to them in practice. Or they might not heed the recommendations of a dispute resolution panel. Such failures do indeed lie at the heart of the international trading system's weaknesses. Before the

10. In certain circumstances, instead of awarding monetary damages, the tribunal can award restitution of property, but in this case, the disputing party can pay monetary damages in lieu of the restitution.

creation of the WTO, GATT law was particularly weak in enforcing obligations, and its working thus largely depended upon voluntary compliance. The new dispute settlement procedures described above strengthen the WTO's enforcement powers significantly in principle, but these procedures are largely untested in practice. As already noted, enforcement of an investment accord would in some ways be more problematic than enforcement of trade agreements. For example, the accord would affect corporations whose activities span the jurisdictions of multiple nation-states; if the dispute settlement panel were to recommend that such a firm cease and desist from an activity and local authorities were disinclined to enforce the recommendation, what would be the recourse?

The usual (but historically weak) mechanism for enforcement is some sort of sanction, including so-called countervailing measures. Should an investment accord make provision for sanctions? If so, what forms should these take? Are there alternative means to ensure compliance?

The answer to this last question is almost surely no. Thus one has to ask whether the sanction-based system can be improved upon. Modern game theory suggests one approach that derives from the observation that, to be effective, sanctions must have "bite."[11] The right amount of bite is not easily determined, but possible means of increasing it include cross-retaliation, reciprocity, and "ganging up." In the context of an investment agreement, cross-retaliation would imply that governments would ultimately be empowered to use trade measures to retaliate against failure of a nation to implement the investment rules. Under reciprocity, one nation would be allowed to withhold right of establishment or national treatment to firms controlled by investors in a nation that denies similar treatment to the investors of the first nation. And "ganging up" means a group of nations might jointly and collectively impose sanctions on a nation whose policies were deemed out of line.

Ancillary Codes

A number of ancillary codes should be negotiated alongside (or attached to) an international investment accord. The primary objective would be to harmonize conflicting national practices that affect business activities related to international investment. The issues discussed here do not have to be part of an accord on investment per se; in many instances, they might be dealt with separately. Likewise, inclusion in the following list does not imply that they ought to be part of the accord. Rather, the effort here is to summarize all of the major issues that have been raised as potentially ancillary to international investment.

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11. A brief description of this approach and the rationale behind it is provided in appendix B.

Taxation and Transfer Pricing

There are numerous issues involving taxation of the income of international corporations and their affiliates that might be usefully addressed. An international code on taxation could, for example, set standards for transfer pricing and delimit options for governments for adjusting reported earnings to reflect possible transfer pricing discrepancies. Transfer pricing refers to the prices one affiliate (which could be the parent firm) charges another for intermediate goods or services. In deciding what prices to charge, the global corporation seeks to shift its income out of high-tax countries and into low-tax ones, to the detriment of the high-tax countries' revenue base. Transfer pricing disputes typically involve two governments (those of the exporting and importing countries) as well as the firm itself. Resolution of such disputes, where they could not be solved via consultation, could be referred to the dispute settlement procedures outlined earlier, but only if there were international standards for transfer pricing to which reference could be made.

A further objective might be creation of a central clearinghouse for intergovernmental sharing of information on taxation to provide a means by which tax authorities could check the consistency of tax returns filed in various countries. Such information would be useful to determine whether transfer prices were consistently reported to all affected tax authorities. If authorities could make such checks easily, disputes over transfer pricing might then be minimized.

An ultimate objective might be harmonization of tax law among signatories. OECD member nations have achieved some limited progress along these lines through a series of mostly bilateral tax treaties that strive to eliminate double taxation. A more far-reaching approach would be an agreement by governments to give up the right to tax income on a worldwide basis and to instead tax on a territorial basis. Under such a system, governments would no longer tax income on overseas affiliates of corporations based in their territories (although not necessarily on dividends deriving from this income). The rationale for such a move is detailed in Hufbauer and van Rooij (1992).

Worthy of consideration along these lines would be adoption of a system of worldwide unitary taxation. Worldwide unitary taxation addresses an almost intractable problem in taxing international firms' operations: notably, that it is all but impossible to determine what profit originates in one country versus some other when the firms' operations in these two countries can be interlinked in so many ways (e.g., by direct transfer of product or service or by transfer of intangible assets such as technology or managerial know-how). Unitary taxation would allow a national (or a regional, state, or provincial) tax authority to prorate the percentage of the total profits of the firm worldwide on the basis of a formula that takes into account the percentage of the firm's total sales, assets, or employees that are located within its jurisdiction and to assess a tax on the basis of this prorated share.

The firms themselves oppose worldwide unitary taxation, largely because of the efforts by certain governments (especially those of the US states; see Graham and Krugman 1995) to impose it unilaterally. These governments typically have done so because they believe that such a system would increase local tax revenue. Not surprisingly, governments that would lose revenue from such a system have not joined these governments. Firms might not, however, oppose universal adoption of worldwide unitary taxation, if they were to be reasonably assured that their worldwide tax assessments would not significantly rise. The OECD, it should be noted, has indicated that worldwide unitary taxation does not violate principles of national treatment as long as the local operations of international firms are not, as a result, taxed at rates higher than similar domestically-controlled firms.

Competition Policy

Competition policy encompasses antitrust (antimonopoly) and restrictive business practices issues but also extends into such areas as state aids to enterprises. Both legal and economics scholars have argued that, in an era of global businesses, the regulation of competition should be global in scale, and some proposals have already emerged (e.g., Scherer 1994; Fox 1995). Some aspects of the regulation of competition are very international. Transborder mergers and acquisitions have become commonplace, and the question naturally arises as to which authorities should review them. Allegations abound of the existence of international cartels.

However, there are significant substantive and procedural differences among national competition policies (Graham and Richardson 1996), and some nations do not even have formal policies. In the United States, for example, certain violations of competition statutes carry criminal penalties, whereas in most nations violation of competition laws is a matter of civil law only. Both the United States and Europe scrutinize large mergers and acquisitions, but under quite different criteria. In the United States, a so-called “efficiency defense” can be used to justify a merger that would significantly increase seller concentration in a market (i.e., the merger might be allowed if significant cost savings were to be realized that would result in savings to consumers); in Europe, an efficiency defense is not allowable. However, in Europe, whole industries can be routinely granted “block exemptions” that immunize them from certain aspects of competition law, whereas with one exception (major league baseball!) such exemptions are unheard of in the United States. Japan has what appears on paper a tough antimonopolies law, but critics allege that Japanese enforcement is so weak that the law effectively does not apply to many large corporations (see, e.g., Bergsten and Noland 1993).

In recent years several nations that previously did not have competition laws have enacted them. This includes China, which now has a law on restrictive business practices but not yet one on monopolies (such a law is contemplated, however). The new Chinese law has been criticized as being ineffectively enforced and not capable of dealing with some of the most salient competition-related issues in China (Liu 1994; Li 1996; Ma 1995; Song 1996). Other nations that have passed competition laws during the past 10 years include Russia, Poland, the Czech Republic, France, Italy, Taiwan, Mexico, Colombia, and Argentina. Korea has substantially modified an existing law in order to strengthen enforcement procedures. Malaysia, Indonesia, and a number of other countries are considering such laws.

A spectrum of global approaches to the problem can be envisaged: at one end, creation of a worldwide authority, perhaps within the WTO; a middle ground of harmonization of national laws; and at the other end, creation of better means by which national (and in the case of Europe, the supranational DG IV) authorities could consult and cooperate.

A worldwide authority has a certain appeal, but actual implementation of such an authority would be bedeviled by an almost endless string of problems: Without consensus among nations on the appropriate substantive standards for competition policy, what would be the standards at worldwide level? What would be the powers of discovery of a worldwide authority—for example, would it have independent powers or would it work through national agencies? What remedies could it propose, and how would these be enforced?

Harmonization of competition laws also makes substantive sense (worldwide operations of global corporations would probably be more efficient if subjected to consistent competition standards), but again, differences in substance and procedures are probably too great to enable effective harmonization in the near future.

Probably the best shot for improvement in international competition policy therefore lies somewhere in the domain of new or better mechanisms for cooperation among national (and European) authorities (see Graham and Richardson 1996).

Accounting and Reporting Standards

The development of common accounting and reporting standards for all international corporations has long been discussed. Common standards would be exceedingly useful for a variety of reasons. First, if all international corporations meeting threshold requirements were required to disclose basic balance sheet and income statement requirements at the levels of both the consolidated corporation and the national subsidiary, most of the pressure for unilateral national reporting requirements (e.g., the failed "Bryant amendment" to the US 1988 trade act) would be obviated. Second, it would then be possible to create a data bank for such corporations from which information for research and regulatory purposes could be drawn. Third, and perhaps most important, because markets work best when participants are well-informed, it would be desirable, simply on market efficiency grounds, to have uniformly prepared, publicly disclosed information about the activities of multinational firms.

Environment

Environmental damage done in one nation can undoubtedly harm other nations, and one step toward controlling this damage would be uniform standards for meeting environmental objectives. While an international environmental code would surely depend upon national authorities for its enforcement, it would nonetheless be useful for nations to agree upon minimal acceptable standards (see Esty 1994; Cline 1992). National treatment considerations (and common sense) would argue that such standards would be binding upon locally controlled enterprises as well as subsidiaries of international corporations. The existence of a code would not preclude that national (or supranational or subnational) authorities in certain nations might choose to enforce a higher level of standard than that called for in the code.

Intellectual Property

International rules in this domain have already been agreed upon and embodied in the Trade-Related Aspects of Intellectual Property (TRIPs) agreement in the Uruguay Round (see chapter 5). The relevant issue for this chapter is whether stronger and more comprehensive rules are needed. Beyond this, there might be a case for harmonization of national laws and mutual recognition across boundaries of patents, trademarks, and other forms of intellectual property protection. Intellectual property issues pervade the area of international investment as much as the area of international trade, and greater enforcement of intellectual property rights is a priority of multinational firms.

The main provisions of the TRIPs agreement call upon countries to enact and enforce effective laws to protect intellectual property rights. Developing minimum standards for IPR was a priority in the Uruguay Round both because multinational firms found the coverage or enforcement of such laws in many countries inadequate and because countries found that the lack of such laws and enforcement was often a deterrent to technology transfer. Whether TRIPs actually improves protection for intellectual property is an issue to watch.

As just suggested, TRIPs could be expanded to cover such issues as harmonization and mutual recognition. If nations could agree to recognize each other's patents, trademarks, and other forms of intellectual property protection, firms could make fewer filings to obtain such protection. This would result in lower costs and greater efficiency.

Mutual recognition would require at least some degree of harmonization of intellectual property laws. At a minimum, nations would have to first agree on minimally acceptable standards, and certain procedural differences would have to be resolved. (For example, the United States grants patents on a first-to-invent basis, whereas most other nations grant these on a first-to-file basis. So if the United States and one of these nations agree to recognize each other's patents, legal problems could arise when a patent challenger shows that it invented the relevant product or service ahead of the patent holder. Such challenges presumably would be unacceptable to other nations.)

It is premature, however, to recommend that nations harmonize their intellectual property laws and grant each other mutual recognition. The costs and benefits of such a system would first have to be assessed. All that is suggested here is that such a system ought to be at least considered.

Labor Standards

A number of labor unions around the world, especially in the United States and Europe, have expressed concern that multinational firms seek to locate activities in areas where labor standards are below those that are considered internationally acceptable as per existing international agreements (most especially, those of the International Labor Organization, which ban, among other things, child labor, slave labor, and unsafe working environments). It has been suggested that some sort of new instrument is necessary to ensure that global corporations follow such standards. Thus, labor standards has been raised as a potential "new" issue for future multilateral trade talks under the WTO aegis. This issue could equally (and perhaps more effectively) be dealt with in the context of an investment agreement if consensus on the need to address the issue multilaterally could be achieved.

Corruption and Illicit Payments

Likewise, there is sentiment (coming largely from within the US business community) that there should be standards to regulate illicit payments to corrupt government officials (Elliott, forthcoming). Corruption is doubtlessly a fact of life virtually everywhere, and the main issue is whether corruption could be curtailed via multilateral agreement. US business executives are particularly galled by the fact that illicit payments to foreign governments and their agents are essentially forbidden under the US Foreign Corrupt Practices act, whereas certain other advanced countries not only fail to forbid such payments but in some cases even allow home-country tax benefits to offset or partially offset such payments. The case thus has been most forcefully argued that there should be common rules for home-country treatment of such payments, and the OECD has in fact launched an effort to achieve such rules.

Although corruption is probably a fact of life occurring in virtually every nation at some level, excessive levels of it can significantly retard the economic advance of a whole nation. There is thus a good case to be made on grounds of economic efficiency and equity for a mechanism that would curtail corruption. The issue is whether an effective mechanism can be designed and implemented on a multilateral basis.

Conclusion

This chapter has laid out principles that should be at the heart of an international accord on international investment. Also, the chapter has presented outlines of some areas ancillary to international investment where international agreement at some level might be desirable and feasible. The next chapter explores the extent to which progress has or has not been made in achieving these principles.