



Foreign Direct Investment – A Critical Perspective

A Re-Define Working Paper

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Introduction

The field of development, as others, is susceptible to fads, fashions and received wisdoms. The current narrative puts FDI right at the heart of the development process with everyone from the World Bank to bilateral aid agencies to the UN financing for development document championing its positive role in mobilizing international resources for development.

Headline figures for 'record' level FDI are widely reported without riders and the 'fact' that FDI is now the biggest source of external resources for developing countries is now common currency. It is such 'facts' that probably drive the focus of policy makers on increasing the **quantity** of FDI, without reference to its **quality**.

It would perhaps only be a slight exaggeration to say that the sum total of industrial and more alarmingly sometimes even development policy seems to have been reduced to "maximise FDI and everything else will follow". In the words of Hillary Benn, the ex-British secretary for development "The single most important thing a developing country can do to benefit from the trade and investment opportunities thrown up by globalization is to get their investment climate right"ⁱ.

Many policy discussions appear over-optimistic about the automaticity or universality of the anticipated developmental benefits of FDI flows. To sum up the received wisdom in the words of Leon Brittan, an ex European trade commissioner – FDI provides (can provide)

- A source of extra capital
- A contribution to a healthy external balance
- A basis for increased productivity
- Additional employment
- More effective competition
- More rational production
- Important technology transfer
- Critical managerial know how

To add to the list

- A source of development finance for the government in the form of taxes and royalties
- Additional contribution to the society through philanthropy or CSR

However, anything that sounds too good to be true probably is. While the benefits of FDI are touted around all the time the costs and pitfalls are seldom discussed. Most key decision makers in both developing and developed countries as well as multilateral institutions such as the World Bank hold a highly positive view of FDI not too far from Leon Brittan's.

However FDI is not a panacea. It is not 'good in itself' but is only useful if it is able to generate positive development outcomes. What is needed is a movement towards a more balanced and differentiated view, taking full account of anticipated positive effects and of potential negative impacts.

This report seeks to challenge the inordinately positive view of FDI by taking a critical look to help form a more objective stance and derive useful policy conclusions. Some of the questions this report seeks to address at least partially are

- Is this view of FDI too rosy?
- What does data and experience say and what are the costs of FDI?
- What policies should developing countries pursue to help maximise the gains from FDI and minimise costs?

The focus of this report is on 'plugging the leaks' associated with FDI and making policy recommendations that would help maximise its development footprint.

Foreign Direct Investment: Some Trends, Characteristics and Caveats

What is Foreign Direct Investment?

Technically, foreign direct investment is usually defined as money invested by a private sector firm outside its home country where the amount exceeds ten percent of the value of the venture in the foreign country. So, FDI is a broad category that encompasses foreign subsidiaries of most Multi National Corporations (MNCs), many joint ventures with local firms and most mergers and acquisitions made outside their home country.

In recent years FDI has become a major source of transfer of money between the developed and developing world. Net FDI to developing countries reached a record level of \$325 billion or about 2.9% GNI in 2006. Though as a percentage of GNI, this is less than the record level of 3.5% reached in 1999, FDI has been trending upwards again since the reversal associated with the dot com bust. The general pattern of rise in FDI flows since 1990 have resulted in a considerable increase in reported FDI stocks relative to GDP, from 9.6% in 1990 to 26.7% in 2006 or about \$2.4 trillionⁱⁱ.

The main reasons behind its recent growth had been

- A good investment climate in most developing countries
- Record levels of corporate profits which generates spare cash
- Rising stock market valuations which make it easier to finance investments
- A liberalization of foreign ownership rules around the world
- A low interest rate – high liquidity environment
- A steady expansion in the role of Multinational Corporations (MNCs) in the world economy
- Record levels of commodity prices which have stimulated new investment in the primary sector

Since the early 1990s FDI has become the largest source of net inflows into developing countries. While aid levels have been more or less stable or even decreased, FDI has increased sharply since the early 1990s. The 2.9% of GNI flow in 2006 was, for example, significantly higher than grants to developing countries which came in less than 0.6%ⁱⁱⁱ.

While the aggregate figures give us a feel for the overall trends, they disguise the uneven nature of FDI flows. These flows are heavily concentrated in a few of the largest developing countries with China alone, for example, accounting for as much as a quarter of all flows. Almost half of all flows went to the top five destinations.

The share of Least Developed Countries, for example, in global FDI flows has steadily decreased from 2.5% in the 1970s to just over 0.5% now even though they account for around 10% of the world's population^{iv}. FDI flows are still highly concentrated even after adjusting for a per capita basis.

Box: The effect of the ongoing Financial Crisis on FDI flows to Developing Countries

It would be clear from a reading of these that many of these trends have changed drastically since the onset of the ongoing financial crisis which has already turned into a full blown recession at least in the developed world. This has already started depressing FDI flows to a very significant extent with the main drivers being

As record profits turn into losses there are fewer spare profits to invest abroad

Falling stock markets have reduced access to capital although the higher relative falls in emerging economies may encourage investments in the form of distressed acquisitions

The recession has started to depress demand leading to a near investment freeze in new manufacturing projects and a closure of several factories which cater to export markets

As credit, which is often essential in financing both greenfield and brownfield projects, has dried up, many of these FDI projects have been shelved too.

The investment climate in many developing countries has deteriorated very sharply, at least in the short term

The large fall in the price of commodities which drive a significant proportion of the FDI especially to the poorest countries has nearly frozen investment in the extractive sector.

It is widely expected that FDI flows to developing countries will shrink significantly, especially in the extractive sector where many recently acquired mining concessions are also being mothballed. It would not be surprising if net FDI flows to developing countries for the forthcoming year were less than half of the figures of more than \$300 billion recorded in recent years.

The role of profit remittances in FDI

However, at the same time as FDI inflows have increased, outflows in the form of profits remittances (the profits on investment that are repatriated to the country of origin) have also grown substantially to about 1.1% of GNI. In 2006, for example reported profits on FDI in developing countries were \$210 billion of which \$125 billion was repatriated from the country where they were earned.

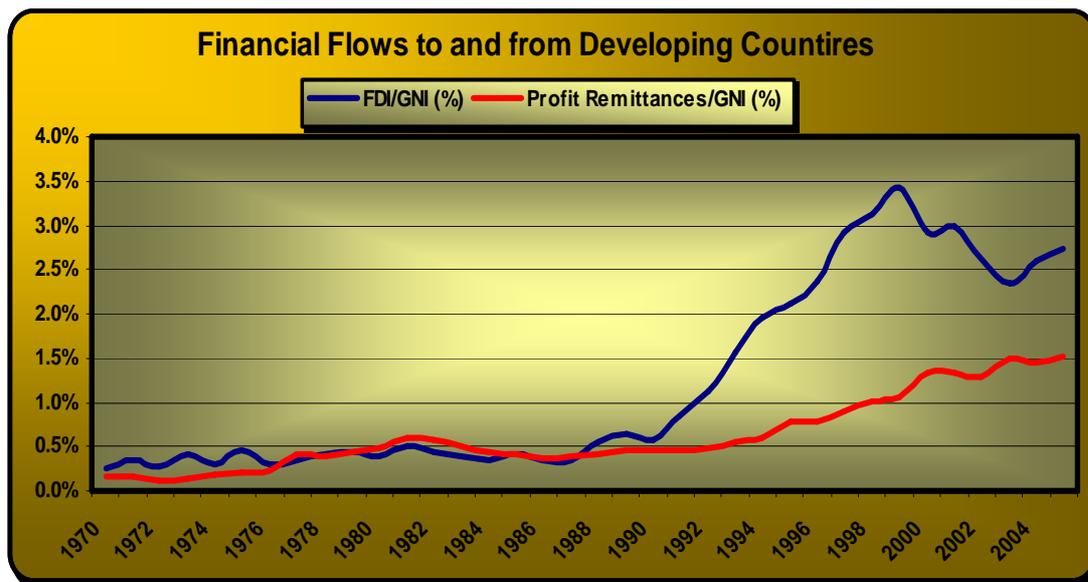


Figure 1: Source Author's calculations based on World Bank GDF data 2007

It is important to note that right until 1990, outward profit remittances on old investments nearly matched new investment inflows for developing countries as a group (See figure 1). While new FDI has grown much faster than profit remittances since, there is usually a lag of a few years before new investments start generating high levels of profit repatriation. This has implications for the future path that the net financial contribution of foreign direct investment would take.

In the case of sub Saharan Africa, profit remittances on existing investment actually exceeded the inflows of net FDI all the way up until 1996 and then again in 2000. The gap between inflows in the form of new FDI and outflows in the form of profit remittances is much narrower in the case of sub Saharan Africa than for all developing countries taken as an aggregate.

It is likely that one of the impacts of the financial crisis would be a relative increase in the repatriation of profits by MNCs. As they face losses in their home countries due to the recession in most OECD countries, they will be under financial pressure to generate cash from whatever sources are available to them. That is why they are likely to repatriate the profits they are holding in overseas subsidiaries and in some cases would also sell assets and divest overseas ventures. Coming at the same time as a severe slowdown in new FDI flows, this increased profit repatriation is increase the financial stress on developing countries.

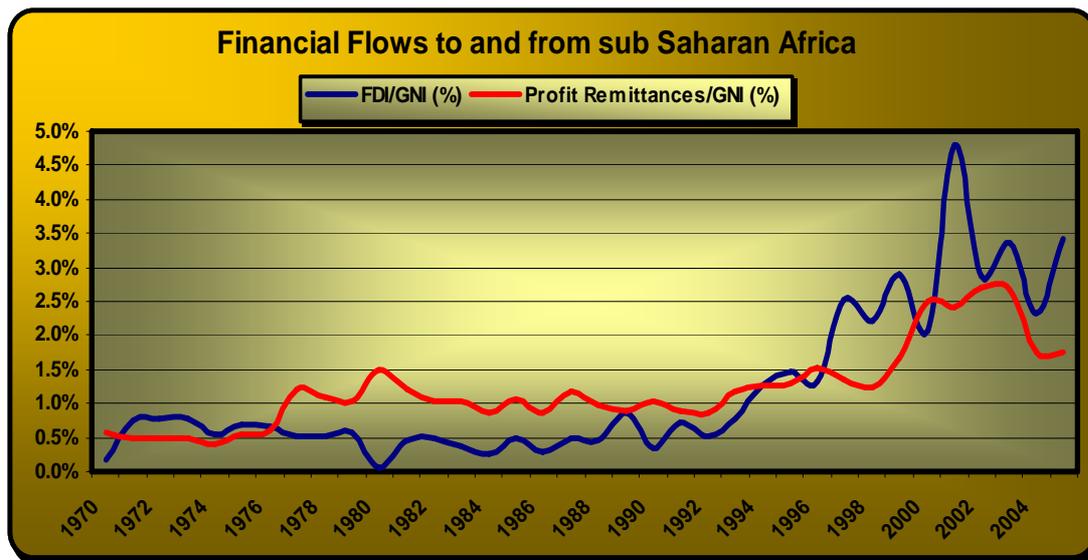


Figure 2: Source Author's calculations based on World Bank GDF data 2007

Another point to be noted here is that the coefficient of variation (a measure of volatility) of profit remittances at 0.67 is significantly lower than the value for net FDI which is 0.89 for all developing countries taken as a group. For sub Saharan Africa, the coefficients are 0.49 and 0.94 which means that profit outflows are highly stable and FDI inflow is highly variable.

This could have implications in economic downturns where net FDI could decrease sharply without a corresponding decrease in profit remittances and thus worsen the balance of payment contribution of the FDI channel. This has special relevance now given the scale and the extent of the ongoing financial crisis.

On both counts, sub Saharan Africa is more vulnerable than developing countries taken as a group. The collapse of new FDI inflows have combined with more robust (licit and illicit) profit repatriation and a mini collapse in commodity prices to produce what is sure to be a very high degree of strain on the finances of sub Saharan Africa in general.

In sub Saharan Africa, profits remitted by existing investors have (throughout most of the history since 1970s until 1996) exceeded new net investment coming in. For many countries such as Burundi, Cameroon and Kenya, the FDI channel (net FDI minus profits remitted) continues to act as a net drain on resource flows. This means that for this region at least, foreign investment has resulted in a net drain of resources rather than being a source of money to finance development

The role of reinvested earnings in FDI

As discussed above, the income earned on existing FDI stock in developing countries also hit record levels of \$210 billion of which a significant chunk (nearly 60% in recent years) of earned income is repatriated every year. The rest, which are reinvested, has account for as much as half of the total inflows of FDI into developing countries since the 1990s.

This has interesting implications for the balance of payments of the host countries.

For the year 2005, for example, this means that of the total 2.74% GNI net FDI developing countries received about 1.37% of GNI as fresh flows of FDI from abroad with the balance coming from reinvested earnings from existing investments. At the same time, 1.51% of GNI of profits were transferred from developing countries. (See figure 3).

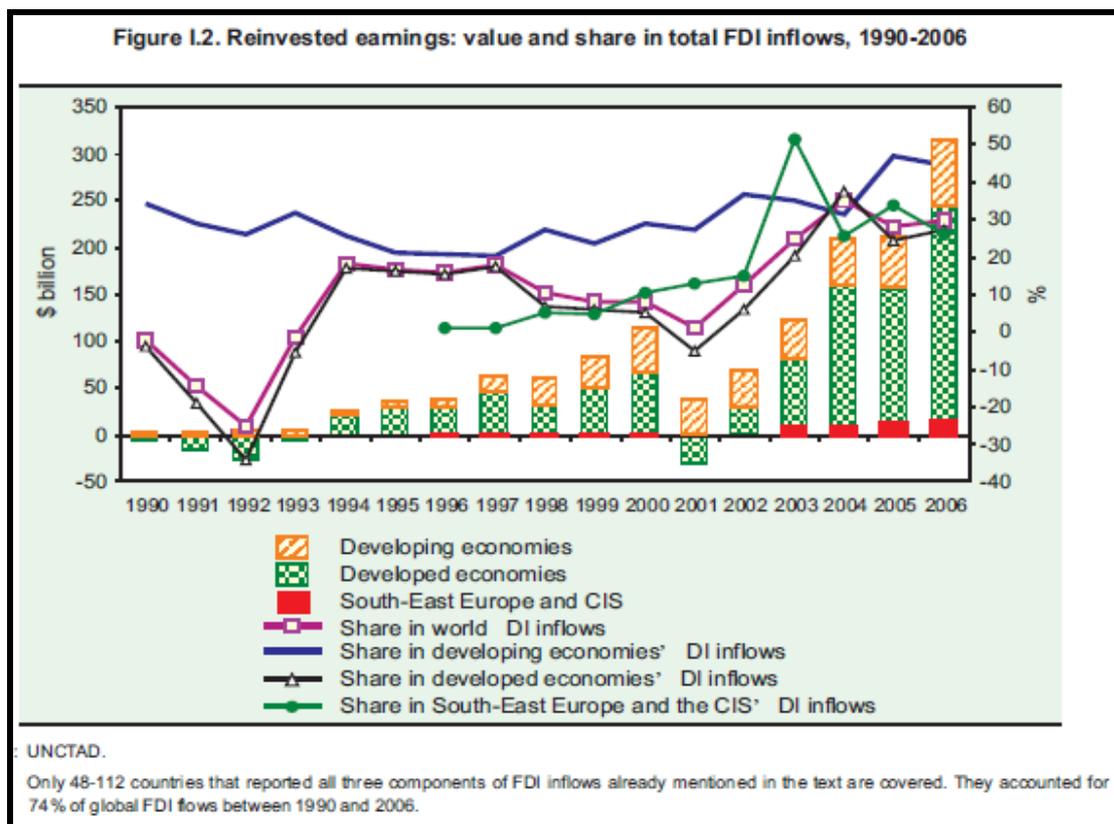


Figure 3: Source UNCTAD

This means that the headline number of net FDI inflow, the most commonly used statistic, is highly misleading. It implies that FDI is the ‘biggest source of external finance for developing countries’ when in fact it is a drain on a country’s external balance. In 2005, for example, FDI was responsible for a drain of 0.1% GNI from the balance of payment of developing countries.

While this may not appear to be large the main policy point is the fact that FDI which is usually touted as the largest source of external financial support for developing countries is actually a net drain on their resources’.

Box: A note on FDI Statistics

Accurate FDI statistics are a critical input into good policy making both at a national and international level. Unfortunately, available data is not very good and can even be misleading. The two most important FDI related statistics pertain to flow and stock and both are problematic –the data on stocks more so.

FDI Flows

When FDI flows are reported using Balance of Payment statistics, reinvested earnings, investment in kind (such as machinery) and intra company loans are often not captured and can lead to significant underestimates. For example a quarter of the countries surveyed by UNCTAD did not report reinvested earnings which on average contribute to as much as 40% of FDI every year.

FDI Stocks

To report FDI stock a number of countries simply add up the historical figures for FDI flows. This causes a problem at three levels all of which result in a downward bias in the estimate of FDI stock.

1) Since collecting FDI data is a relatively recent exercise especially for many developing countries, a simple sum of FDI flows will not capture the stock that predated the first reporting of data. Many developing countries, especially in Africa were colonies with significant foreign investments so this can make a big difference to the accuracy of the figure. Some of these countries started collecting data on FDI flows relatively recently, some as late as 1980. This means that FDI stock that pre-dates the data collection date is missed out.

2) Since FDI flow data does not include re-invested earnings which constitute a significant proportion of FDI, the stock estimates based on adding these flows would be significantly lower than the actual stocks.

3) Using the sum of flows represents historical costs not current value which may be a significant underestimate. For example the stake of Unilver, an MNC in its Indian subsidiary HLL is now probably worth millions of times the original investment it made more than 100 years ago.

This is why the reported levels of FDI stocks are believed to be significant underestimates.

FDI profits

It is also believed that FDI profits, especially profits repatriated are heavily underreported mostly as a result of a significant amount of manipulation of profits through a mis-reporting and mis-pricing of trade and financial transactions especially with affiliated companies.

Round Tripping

As the incentives offered to foreign investors have grown, the motivation for domestic investors to pretend to be foreign investors to take advantage of special tax breaks etc has also grown. This has meant that in the past decade or so, as much as 20%-30% of new FDI coming into countries such as China, where the tax on foreign MNCs is half of their domestic counterparts, is actually not real FDI but domestic investors posing as foreign investors. This practice is called "round tripping"^{vi}.

Investors are able to engage in round tripping by siphoning money out of the country in the form of capital flight and then channelling it back through tax havens such as the British Virgin Islands disguised as foreign investors.

Trans Shipping

Another practice that is becoming more widespread is what is called "Trans Shipping". In this, companies transfer assets (on paper) from one country to another to take advantage of special tax regimes without any contribution to the host economy. The funds are transferred to a third country for investment. The current method of measuring FDI is not able to distinguish these types of transfers and for countries such as Luxembourg, which offer special tax regimes, such Trans Shipping may account for as much as 80% of their reported FDI^{vii}.

The role of privatizations and mergers & acquisitions

FDI has shown a large increase throughout most areas of the developing world since the 1990s. This increase is partly explained by privatizations wherein state monopolies especially in telecommunications, transportation, electricity and water and other assets owned by the governments were sold off fully or partly to foreign private investors. For example in Mexico alone, between 1988 and 1992 state enterprises worth \$22 billion were privatized^{viii}.

These privatizations were driven by a complex set of factors in which the International Monetary Fund and the World Bank, who asked countries to privatize as a condition for giving loans, played a major part. While this was most prevalent during the 1980s when Structural Adjustment Loans were common, privatization and investment liberalization still form part of many of the loan conditions. Some were also driven by the need to shore up flagging government finances by generating one off payments that helped plug fiscal deficits. [This is likely to recur given the fiscal stresses being faced by many governments now]. Many of the privatizations, especially in the essential services sectors have been very controversial for increasing tariffs which has resulted in a reduction in access to these services.

During the WTO Uruguay round (1986-1994) the OECD countries put a lot of pressure on developing countries to liberalize financial services and telecoms in particular. During the ongoing Doha development round the pressure has shifted to the opening up of water, health, education and other essential services to foreign investment. Many of the original objectives relating to the liberalization of investment regimes not achieved through multilateral negotiations are being actively pursued especially by the US, EU, Canada and Japan through the extensive and proliferating use of Bilateral Investment Treaties and Free Trade Agreements (see later section).

There has been a related trend of increasing M&A - Merges & Acquisitions (many of which have been linked to privatizations), which have also happened as developing countries have been forced to liberalize their investment regimes under pressure from the WTO, bilateral treaties and the IMF and World Bank. For example between 1990 and 2001, the share of foreign ownership of banking assets in Mexico went up from nearly zero to more than 90% as a result of the acquisition of all major Mexican banks by foreign banks^{ix}. [The ongoing financial crisis has exposed the vulnerability of the majority foreign ownership of the banking sector where problems in home markets get transmitted in the form of the withdrawal of credit from foreign markets. This problem is now especially visible in Eastern Europe where the majority of the banking sector is foreign owned].

Also, a large chunk of the M&A was associated with privatizations and sale of domestic enterprises at fire-sale prices in the aftermath of financial crisis such as the South East Asian crisis. In the late 1990s M&A accounted for a large chunk of inward FDI. In the period 1997-2001 for example, it constituted more than 44% of the total net FDI flows to the developing world^x. In 2006, M&A accounted for a lower but still significant 33% share^{xi}.

Until the credit crunch hit, the M&A environment remained benign even through the amount of privatizations has gone down significantly (there is less left to privatize). In 2006, it was increasingly driven by the supply of cheap financing (low interest rates and high liquidity), high stock market valuations and the emergence of substantial private equity funds. Much of that is now history.

However, three developments mean that the slowdown in M&A might only be partial.

- The stock markets in developing countries have collapsed even more than in developed countries so many companies there would look relatively cheap

- A number of private equity funds had raised substantial resources just before the crisis hit and these are experimenting with new financial models which could mean more acquisitions in the developing world.
- Many developing country governments will have stressed finances so might resort to further bouts of privatizations.

While M&A does release money in developing countries for investment in the domestic economy, the primary result is in the change of ownership of productive capacity. Whether or not there is an addition to the overall productive and investment capacity and a positive development impact, depends on a number of factors some of which are

- Whether the money that is released is reinvested productively in the country in new capacity or whether it itself is used for more M&A abroad or domestically, or for consumption.
- Whether the foreign investor brings more efficient means of production and transfers skills or technology or not

Overall, M&A is less likely to have a positive development impact compared to green field investment which directly increases the stock of productive capital. The privatization of essential services is likely to lead to reduce access to services and is highly controversial.

In the long term, production may be increased indirectly, for example through improved efficiency, technology, access to export markets and/or access to finance; but any such benefits may be at least partly off-set by reduced backward linkages into the domestic economy, and negative balance of payments effects arising from profit remittances (and potentially higher import content of inputs).

A Cost Benefit Analysis Approach to FDI – A Framework

The impact of most FDI can be classified into two broad categories which can then be used to analyse its contribution to development. In this section we focus on the direct and indirect financial benefits and the indirect benefits are discussed briefly in the subsequent section.

- Direct and Indirect financial benefits such as
 - i. The direct Balance of payments impact – how FDI generates a net inflow or net outflow on the balance of payments account initially and over time through the interplay of new investment, reinvestments, disinvestments and profit remittances
 - ii. The indirect balance of payment impact – whether FDI, through its impact on trade generates more exports or imports
 - iii. Benefits for Domestic Resource Mobilization such as tax revenue for the state and the costs in terms of providing subsidies etc
- Indirect spill-over benefits such as
 - i. Jobs created and destroyed
 - ii. Technology transfer
 - iii. Skills transfer
 - iv. Growth
 - v. Forward and backward linkages with the local economy etc

Let us look at the financial aspects in some detail

When FDI, say \$100 million, first flows into a country, the normal assumption is that an equivalent amount of foreign exchange has come into the country. While it makes sense at an intuitive level, in reality the net flow of FDI into the country may have a substantially different impact. This could happen for a variety of reasons some of which are listed below

The direct Balance of payments impact

- The initial purchase of the equity could be partly or wholly funded locally. For example, when the Japanese tyre-maker Bridgestone purchased the US based Firestone in 1988, the deal was financed primarily through loans from the United States meaning there was little new money coming into the United States
- A significant chunk of FDI, especially in the primary (extractive) and manufacturing (high value) sectors is highly capital intensive. Moreover most of the sophisticated equipment is imported which means that much of the initial investment flows out in the form of payments for import of equipment
- When FDI enters a country in the form of M&A especially with either a domestic player or another previous MNC owner, the proceeds of the sale paid often do not stay in the country and thus generate an offsetting outflow which neutralizes any impact on the balance of payments.
- We have already seen in the previous section that once allowance is made for reinvested profits as well as profit remittances, net FDI flows into developing countries and hence their overall impact on the balance of payment shrinks into insignificance. In fact since FDI is a for profit investment, it follows naturally that investors will take more money out of the country than they put in. So the direct balance of payments impact of FDI over the long term is always negative.
- Moreover FDI profits, especially in sub Saharan Africa are often in the range of 25%-35% annually so this means that the net BoP contribution of FDI can turn negative within a space of as little as 3-4 years.
- Another statistic that was highlighted in a previous section was how large the stock of FDI in developing countries has become. The official figures are now close to 30% of GDP but as we have highlighted, the real figure is likely to be at least 2-3 times higher. This means that the potential for a substantial negative balance of payment impact from FDI is very high in the event that investments are wound up.

The indirect balance of payment impact

- When FDI is targeted towards the domestic market, whether in the services sector or the manufacturing sector, it usually generates a net negative external balance impact in the long run. Import content of goods and services sold to domestic consumers in developing countries is usually non negligible and often quite significant. This translates into a negative trade balance impact of FDI. For example, FDI in Mexico had a net overall negative impact on the trade balance as imports related to FDI were higher than exports^{xii}.
- When FDI is oriented primarily towards the export market, it has the potential to generate significant external balance gains though some of these might be offset if the import content of exports is high. India, Malaysia and Taiwan are amongst the countries that have reported net exports from FDI^{xiii}.

It is thus far from obvious that FDI flows generate a net positive impact on the external balance of a developing country. If anything, the likelihood of a long term negative impact on

the external balance is much higher except perhaps in the case of an export oriented extractive or manufacturing sector.

The tax impact of FDI

A direct and often cited link between FDI and development is through the public revenues generated in the form of taxes as well as royalties (in the extractive sector). Public revenues raised from FDI can be used for targeted development expenditure such as provision of education, health and other public services and construction of basic public infrastructure.

However, both the examples elucidated in the next section of this paper as well as several studies point to the low and decreasing tax footprint of FDI in developing countries^{xiv}. For example, in exchange for a \$600 million FDI and creating 1300 jobs in Brazil, General Motors received a direct subsidy of \$250 million for infrastructure costs, a \$150 million loan from a state government and a further \$1.5 billion in tax breaks over a 15 year period.

Despite many references to the benefit of additional public revenues in FDI literature, the real picture of the net generation of public revenues by FDI is much more mixed. The whole of the next section looks at this issue from a critical perspective.

A brief discussion of some of the potential spill-over impacts of different sectors^{xv}

Manufacturing

Experience has shown that the most beneficial form of investment, in terms of spill-over effects, is likely to be greenfield investment creating new capacity in the manufacturing sector. This has the potential to create significant employment, and is less likely to displace local production particularly when oriented towards exports. It is also more likely to provide spill-over effects in the form of substantial opportunities for backward linkages, creating opportunities for suppliers of both material inputs and business services. Skill development of the local workforce and technology diffusion are other important positive spill-overs from manufacturing.

That is why it is an area of concern that the share of manufacturing in FDI flows has declined over recent years. This is partly due to

- The rise of the service sector in the global economy
- The increasing internationalization of the service sector
- The privatization of publicly-owned services and utilities as already discussed

Services

The share of services in the global stock of inward FDI has increased from around 25% in the early 1970s to 60% in 2002.^{xvi}

The benefits and spill-overs of FDI in the service sector are most difficult to generalize. There are major differences between domestically oriented services such as financial services, telecommunications, water, health services and export-oriented cross-border services such as call centers.

Many of the common features of the first category include

- predominance of mergers and acquisitions as a mode of market entry,

- orientation to the domestic market (implying at least some substitution for local supply),
- and the absence or near-absence of foreign exchange earnings (giving rise to potential concerns about balance of payments effects).

Export oriented services such as call centers and back office support services of the kind pioneered by India, on the other hand have an enormous potential to generate foreign exchange earnings.

The potential for the transfer of technology is important in some service sectors, and may have substantial positive spill-over effects for the economy as a whole, for example in telecommunications. Wage levels in foreign affiliates also tend in many cases to be higher on average in some service sectors (such as the IT sector in India) than in manufacturing, reflecting higher skill levels.

UNCTAD has identified three types of risks (negative spill-overs) associated with FDI in services.

- systemic risk, when the absence of efficient regulation exposes a host economy to significant economic instability;
- structural risk, when the institutions and instruments needed to manage, say, privatization and utilities, are weak and there is the risk of turning state-owned monopolies into private ones;
- contingent risk, when FDI in socially or culturally sensitive areas causes unintended harm.

Primary sector

At an aggregate level primary sector related FDI constitutes only a relatively small share of the total FDI flows to developing countries. However, most FDI into low-income and least-developed countries, particularly in Sub-Saharan Africa, is in the primary sector. This is in large part due to the facts that

- the domestic markets are small
- and the skill level of the workforce is low
- many of these countries are well endowed in natural resources

In primary sectors, employment creation is relatively limited due to generally capital-intensive production methods, and the potential for backward linkages is limited. This greatly reduces the potential effects of FDI on growth and employment relative to manufacturing^{xvii}. The potential for technology transfer is also limited in most cases, as technologies are readily available on the open market.

By far the most important contribution of FDI in extractive industries is the generation of public revenues, through royalty payments and taxation of business profits. The actual revenues (as a % of the value extracted) generated vary widely between 25% and 90% in oil and gas, and 25-60% in metals^{xviii}.

Since contractual terms are heavily dependent on the relative bargaining strength of investors and host governments, they are likely to be lowest in the poorest countries, where needs are greatest (more on asymmetric bargaining strength in a subsequent section).

It is also possible that for developing countries as a group, the price effects of increased production of primary commodities produced primarily by developing countries may outweigh the benefits^{xi}.

The next sections discuss some of the issues raised in this section in more detail.

The Tax Dimension of FDI: A Critique

A brief discussion of Tax and Revenue generation from FDI

One of the possible attractions for the host country of the high levels of profits reported in the section above is the possibility of generating significant amount of tax revenues for the host country government. The shortage of government revenues is even more of a serious problem in poor countries than overall resource availability. Government social, health, education and infrastructure spending is absolutely critical and taxes on FDI profits could potentially finance a significant portion of this spending.

This is especially so since we see dismal levels of government revenues and spending especially in the poorest countries. In Guatemala, where the fiscal revenues are in a particularly bad shape, state expenditure barely reaches 10% of GDP (the OECD country average is closer to 40% of GDP) and the government simply does not have the capacity to meet its obligations to provide basic services.

Despite the massive growth in the flows of FDI to developing countries, the significant growth in profit opportunities because of increasingly liberalized regimes, frequent financial crisis and large scale privatization programs all evidence points to MNCs paying less not more tax on profits earned through their developing country operations. For example, effective tax rates paid abroad by large US manufacturing affiliates revealed that average rates had fallen by more than 15% already between 1984 and 1992^{xx}. There is overwhelming anecdotal evidence that they have fallen even more since.

There are two basic factors responsible for MNCs being able to avoid significant amounts of tax liability. 1) The perception that FDI is very important^{xxi} means that developing countries are in a race to the bottom to lower tax rates and give exemptions in a bid to attract FDI 2) Wherever possible, MNCs have used means (mostly legal – but sometimes not) to minimise their tax liability. Most of these are to do with an exploitation of the multi-country presence (especially in tax havens) to shift profits to the lowest tax jurisdiction by misreporting the fair value of inter subsidiary trade and financial transfers. Examples of both are offered below in this section.

The Guardian newspaper recently reported the results of an investigation into the affairs of three MNCs Fresh Del Monte, Dole and Chiquita, which between them control over two thirds of the world banana trade^{xxii}. Bananas are the biggest UK import from Latin America and the market is worth hundreds of million pounds every year.

The Guardian's summary of the typical transactions being carried out by these firms was as follows

Box: Large Scale Tax Avoidance by Banana MNCs^{xxiii}

For every £ 1 worth of Bananas sold in UK supermarkets

13p to the growing country: 1.5p is labour, 10.5 p is costs and 1 p profit;

8p to a Cayman company for use of the 'purchasing network';

8p to Luxembourg for use of 'financial services';

4p to Ireland for 'use of the brand';

4p to the Isle of Man for insurance;

6p to Jersey for management services;

17p to Bermuda for 'use of the distribution network';

This gives rise to a 60p price into the UK which is then marked up to £ 1;

1p of profit is declared in the UK;

And 39 p are classified as cost of sales

So the transactions of these firms are structured in such a way so as to minimize tax liability both in the producing and the consuming countries where the bulk of the economic activity takes place.

"The investigation reveals that large corporations are creating elaborate structures to move profits through subsidiaries to offshore centers such as the Cayman Islands, Bermuda and the British Virgin Islands, to avoid handing money over to tax collectors in the countries where their goods are produced, and in those where they are consumed. Governments at both ends of the chain are increasingly being deprived of the ability to raise tax for development or services."

Box: A reinterpretation of FDI statistics

The discussion thus far has highlighted the danger that the channel of foreign investment can become a source of leakage of scarce resources from developing countries through high profits and disinvestment. Unfortunately the availability of data on FDI is poor and in general tends to understate the potential of negative flows.

This happens as 1) profits are underreported and 2) the existing stock of FDI (which can be disinvested and hence generate significant outflows) is underreported.

MNCs use transfer pricing (treated below), high royalty and licence fees (see box on Microsoft), funds borrowed at above market rates and a host of other mechanisms to understate profits (reducing taxation is one motive) so reported profits do not capture the total return on investment. These mechanisms also generate an outflow of resources equivalent to profit remittances (which are already high) so the inflow/outflow balance for foreign investment is worse than it may seem on the basis of reported figures alone. One estimate of outflows on income on FDI puts the real figure at twice the reported level^{xxiv}.

The underestimation of the actual stock of FDI is even more serious. For 123 developing countries, the stock is based merely on cumulative flows since reporting began. In the case of some African countries this was only in the 1980s and 1990s. This completely ignores the FDI stock that existed before this time which especially in the case of ex-colonies can be substantial^{xxv}.

In addition, the mere addition of FDI flows also underestimates the true value of the stock in other ways. The correct way to value the stock would be the market value (the financially most widely accepted way of valuing companies) which will determine how much outflow a sale or disinvestment can generate. This, in most cases is a multiple of the book value, which in turn is again likely to be larger than the mere sum of flows. Using the S&P 500 as a benchmark^{xxvi}, the market value of FDI stock in developing countries is likely to exceed the book value by at least a factor of three. This is a conservative estimate since profitability (hence relative market value) is higher in developing countries and a large chunk of the FDI was made at fire-sale prices in the immediate aftermath of crisis.

The picture that emerges is very disturbing because the significance of FDI as a (existing and potential) channel of outflow of resources is much larger than official data seems to reflect. Real outflows associated with FDI may be twice as high as reported remittances of profits. The stock of FDI is likely to be three times as much as the officially reported figure of 1/3 of GDP.

Tax Competition and Incentives to attract FDI

“ the idea that FDI responds to rather than creates success has met with resistance and the notion that it may carry costs as well as benefits almost completely ignored” UNCTAD, World Investment Report 2005

In many countries, attracting investment has become the sum total of industrial policy. Under the original ‘Washington consensus’ and its subsequent variations, foreign investment is regarded as the central engine for economic growth^{xxvii}.

Given the insistence of key donors like the US, the IMF and the World Bank on the Washington Consensus, attracting FDI is now at the top of the economic policy agenda for most developing countries. For years developing countries have been told that to get more FDI they have to liberalize their investment regimes and deregulate.

In the global competition for FDI most countries have now opened up most of their economies to foreign sectors. This has been accompanied by a number of measures to actively attract FDI, usually involving incentives, such as subsidies, cheap land, tax holidays and breaks, and exemptions from regulations, including environmental and labour standards. Between 1991 and 2002, 95% of changes to investment regimes globally were designed to attract FDI^{xxviii}.

Box: The Bolivian oil and gas industry^{xxix}

In 1996 the Bolivian gas and oil industry was privatized, under heavy pressure from the IMF^{xxx}. The government negotiated a deal with a consortium of companies from the USA and Europe, offering them generous financial incentives to invest and the state company YPFB was sold off for a total of \$835 million^{xxxi}.

The companies paid very little tax on the value of the gas and oil extracted at the wellhead^{xxxii} - only 18% of the market price for the new reserves which made up 95% of Bolivia’s reserves, and 25% on the rest. The government hoped these low rates would increase investment in gas and thereby boost production. However, while production did increase dramatically at these low tax rates Bolivia’s earnings barely rose. The companies involved, including British Gas, BP and others continued to enjoy healthy profits, while rapidly depleting Bolivia’s main non-renewable resource. Only 8,737 people were employed in the sector^{xxxiii}. In

addition, despite having very low local production costs^{xxxiv}, Bolivians were paying US\$1.60 per gallon for petrol, almost as much as US consumers.

As the Bolivian example shows, offering tax incentives is often likely to carry an immediate opportunity cost in terms of lost government revenues and 'could be considered equivalent to a (hidden) subsidy that developing countries are providing to MNCs^{xxxv}.

Box: Chile Copper mining^{xxxvi}

Chile under Pinochet followed fiscally permissive economic policies and did not charge royalties for the use of natural resources. These policies over-stimulated investment and resulted in overexploitation of natural resources in the short run. As Chile is the largest producer of copper these policies have contributed to a long cycle of overproduction and low prices in the world copper market, with several negative implications for the domestic economy, employment in the mining sector and government revenues.

Copper production tripled in the 1990s, so now Chilean exports account for about 40% of the world market. Finally, following the initiative of a group of members of the National Congress, the Chilean government introduced, on 5 July 2004, a 3 per cent royalty on the sales of copper producers.

Facing revenue shortfall, the developing countries, which are trying to attract investment and stimulate growth, are being played off each other by MNCs who demand increasing tax concessions. Economically, this competition amongst countries is a zero sum game with MNCs and mobile capital being the prime beneficiaries.

Drastically reduced corporate tax rates and ever more generous tax breaks and tax holidays have meant that MNC's have reduced that tax liability dramatically. In some cases such as Honduras, most foreign investors have no tax liability. In Senegal, Jamaica and Namibia firms have been granted permanent tax exemptions and tax holidays in export promotion zones in many countries such as Sri Lanka are now being stretched to as much as 20 years^{xxxvii}. In some countries such as Guatemala, where state expenditure barely reaches about 10% of GDP tax revenues is so low that the state is in danger of disintegrating.

In particular cases, especially in Africa, certain investment projects have been associated with 'negative rates of taxation' where states already offering zero tax rates have tried to outdo each other in the provision of subsidies. More than 120 countries now have some form of investment promotion policy in place most of them including tax breaks.

This has happened despite the fact that evidence linking tax breaks to increased long term investment is at best ambiguous^{xxxviii}. Though there are, no doubt, individual cases where tax rates have swayed locational decisions, there is overwhelming evidence that MNCs rank quality of infrastructure, well-educated workforce and a local dynamic market far higher in their list of priorities. All evidence points to the idea that governments have conceded too much to MNCs in exchange for too little^{xxxix}.

Hence, severe tax competition means that the potentially positive benefits of FDI are being heavily undermined and the negative impacts (through provision of subsidies, the competitive

disadvantage for local firms, the erosion of government revenue and a restriction of policy space) are being amplified.

Tax Avoidance and Profits Laundering

As though being able to rope in extremely generous tax concessions and extractive agreements were not enough, MNCs extensively indulge in aggressive tax avoidance strategies. Some of the most common ones are:

- 1) Using inaccurate prices to value inter-subsidary trade transactions in such a way so as to maximise profits in a low tax jurisdiction (transfer mis-pricing). This is dealt with in the next section on trade.
- 2) Using intra-corporate or parent subsidiary financial transactions such as loans from parent to subsidiary at exaggerated interest rates to shift profit out of the host country.
- 3) Using exaggerated values for intangibles such as goodwill or patents and royalties etc. to underreport profit.
- 4) And a whole host of other such practices such as mis-invoicing the quality and or quantity of imports and exports.

“The tricks are simple. World bouquet plc, let's call it, imports flowers to sell in Britain from a Colombian associate—and pays a “transfer price” that is double the real price. Or maybe World bouquet (Antilles) raises \$500m and lends it on to the British company—at an excessive rate of interest. In either case, the result is fat profits abroad, none in London^{xi}.”

Box: High interest inter-corporate loans used for tax avoidance in Chile Copper Mining^{xii}

Despite record levels of copper extraction in Chile, private mining companies, with only two exceptions, paid no taxes until recently. Private companies extracted and exported 20.8 million tonnes of copper between 1993 and 2002, roughly equivalent to two years'—worth of world consumption. The value of these exports amounted to more than \$34 billion, with the net income of private companies roughly half that sum.

Meanwhile, they have paid just \$1.7 billion in taxes, while accumulating \$2.6 billion in tax credits, thus holding the Chilean state liable for a net \$900 million. Compañía Minera Disputada de Las Condes, a mine owned by Exxon, ostensibly operated at a loss for 23 years. Therefore, it did not pay any taxes at all and, on the contrary, accumulated \$575 million in tax credits. Nevertheless in 2002, Exxon (by then Exxon Mobil) sold this “money-losing” operation for \$1.3 billion. Exxon had engaged in the practices mentioned above, and exported the mining operation's substantial profits, mostly disguised as interest payments to Exxon Financials, a subsidiary in Bermuda.

Box: Microsoft using royalty payments for tax avoidance^{xiii}

Microsoft, which has set up an Irish subsidiary, is being accused by the Inland Revenue Service of the United States of having avoided hundreds of millions in taxes. The IRS says that Microsoft has transferred the ownership of hundreds of its patents over to its Irish subsidiary for a below market value and the Irish subsidiary is now charging significant royalty costs for the use of these patents from Microsoft entities world wide and avoiding taxes in many countries.

Microsoft subsidiaries in the developing world also have to pay these substantially higher royalties which means that they too are reporting lower profits than they otherwise would. This has a negative impact on taxes paid in developing countries.

The Wall Street Journal wrote that "a law firm's office on a quiet downtown street [in Dublin, Ireland] houses an obscure subsidiary of Microsoft Corp. that helps the computer giant shave at least \$500 million from its annual tax bill. The four-year-old subsidiary, Round Island One Ltd., has a thin roster of employees but controls more than \$16 billion in Microsoft assets. Virtually unknown in Ireland, on paper it has quickly become one of the country's biggest companies, with gross profits of nearly \$9 billion in 2004."

Box: The use of transfer pricing, shell companies and tax havens to avoid taxes^{xliii}

Volcafe is the world's second largest trader of raw coffee and has a market share of 13%. The papers [uncovered by an investigation] reveal a hidden world in which Volcafe transfers millions of dollars from its subsidiaries in the coffee-producing countries to a 'phantom' operation in Jersey called Cofina. It is a complex structure in which Volcafe buys beans from small co-operatives in developing countries at the market price, say 80 cents a pound of coffee. It then 'sells' the raw coffee to Cofina in Jersey at a similar price. Cofina sells this on to customers such as Nestlé and, in the past, Starbucks. By trafficking the beans through the tax haven island, the bulk of Volcafe's profits are made there, which means it pays minimal tax to the developing countries.

The Observer has seen confidential details of Cofina's 1998 accounts showing that while most of Volcafe's subsidiaries in developing countries made marginal profits and paid no tax, Cofina sold \$408 million (£224m) worth of coffee and made a gross profit of \$27m. The firm paid no tax because the profit was booked in Jersey.

Yet Cofina does not really exist: it is just a postbox operation with one or two administrative staff. The beans Volcafe buys from farmers are delivered straight from the coffee countries to the end customers such as Nestlé.

Company documents reveal that the firm goes out of its way to keep everything top secret. Volcafe employees are told to identify themselves as staff of Cofina, although they are not. One document states: 'You should program your fax machine in a way that your name does not appear on faxes dispatched in the name of COF [Cofina].'

The extensive use of tax havens by Banana MNCs referred to in the earlier section also of course involves several post box or shell companies located across different tax havens.

A significant percentage of FDI is channelled through tax havens to provide zero tax jurisdictions to accumulate profits through the mechanisms such as those discussed in the boxes above. An equally important for using these jurisdictions is the secrecy they provide which makes detection very difficult and minimise the likelihood of success of any investigation by tax authorities. This is why countries such as Spain and Argentina have now enacted special legislation that puts additional reporting burdens on any inward investments being channelled through tax havens. It is too early to evaluate how effective this legislation has been.

Cayman Islands, a tax haven of 70,000 people for example, had an inward FDI stock of \$25 billion in 2000. While this is very high for such a small population the real story unfolds when we look at the stock of outward FDI which was more than \$20 billion. So investment is merely being routed through tax havens. Liberia, one of the poorest and most inhospitable countries in the world had an inward FDI stock 483% of its GDP in 2004. Of course, the only reason it is so attractive for foreign investors is because it too is a tax haven. Outward FDI stock for 2004 was also a staggering 280% of GDP. It was recently reported by the US senate that a single building in the Cayman Islands Uglan House, hosts more than 18,000 companies.

Box: How corporate claims are fleecing tax payers

In Mexico, a successful case was brought for refusing to renew an annual permit for a foreign investor to operate a hazardous waste storage facility, following protests by local communities. The foreign investor claimed compensation and the tribunal ruled in its favour, noting that under NAFTA, there is 'no principle stating that regulatory administrative actions are *per se* excluded from the scope of the Agreement, even if they are beneficial to society as a whole – such as environmental protection'.

In Argentina, during the 2001–2002 financial crises, amid dramatic increases in unemployment and a precipitous decline in the value of household savings, government emergency measures forced foreign investors to stop charging dollar-equivalent rates for basic utilities such as water and gas. Thirty-nine groups of foreign investors have lodged compensation claims, some successfully, for revenues lost. Current outstanding claims are estimated at \$18bn.⁵⁵

Corporations don't always get large settlements. In the Bolivia water case, the investors launched a case arguing that the government had failed to protect their investment, thus violating the bilateral investment treaty. The international tribunal ruled in favour of the international investors, but only awarded them nominal compensation, arguing that although the claim should be upheld on the basis of commercial law, the government had so clearly acted in the public interest that a nominal settlement was appropriate

Is FDI Working for Development?

Under the right circumstances FDI can contribute to development by having a positive impact on the host economy and stimulating the local private sector through, creating jobs, buying inputs, and providing technology transfer and managerial skills. It can contribute in terms of net positive resource flows to a country and be a source for much needed foreign exchange which can be used to then finance critical imports.

The potential benefits of FDI stated above and listed at the beginning of the paper are very real but the mistake is to consider them to be automatic or universal. The evidence clearly points to benefits being critically dependent on the form and terms of FDI, the sector in which it occurs, initial conditions in the host country and the policy and regulatory environment.

There are a few examples, such as the investment that have gone into the sugar industry in Mozambique, of FDI working to make some of these positive contributions for development.

Box: the success of FDI in the sugar industry in Mozambique^{xliv}

The story of investment in the sugar sector in Mozambique shows some of the benefits that investment can deliver, and particularly how the right government policy can ensure that these

benefits go directly to poor people. The sector has attracted US\$350 million in investment, mainly from South African and Mauritian companies. Currently there are more than 20,000 people directly employed in the sugar mills, with wages guaranteed by the government's minimum wage policy. The impact on the local economies from increased demand for goods and services has been striking. This is particularly important, as sugar factories tend to be located in rural areas which have suffered the most from weak markets and lack of business opportunities. Mozambique also earns nearly US\$30 million a year from sugar exports.

As well as its wages policy, which ensures poor people get some of the benefits of increased sugar production, the government was prepared to intervene to compensate for international distortions in the sugar market.

A variable tariff on sugar imports protects local producers from unfair competition in domestic markets with subsidised producers in Europe. This was one of the factors attracting investment in Mozambique's sugar sector. When the IMF threatened to insist that the Mozambican government remove this tariff, investors joined with the government in lobbying the IMF to allow it to remain. One investor described the threat of removal as the "sword of Damocles" hanging over their heads, and asked, "What do you do? Do you turn to them [the factory workers] and say, sorry, because of the IMF there are no more jobs?"

However, it seems that on aggregate, FDI to developing countries has failed to live up to its promise and in a number of cases has even undermined rather than increased development.

A UN report – Economic Development in Africa shares the analysis that the development contribution of FDI is at best dubious and is undermined by the lack of tax revenues, significant profit repatriation, capital flight and a negative impact on local firms.

Box: FDI not working in Africa^{xlv}

The large inflow of foreign direct investment (FDI) into Africa since 2000 looks good on paper but is unlikely to deliver lasting benefits to Africans according to a United Nations report. The report, Economic Development in Africa, from the UN conference on trade and development (UNCTAD), warns African governments that policies aimed at attracting more FDI through a further push for rapid liberalisation and downsizing of the state "will not do the job".

When FDI had occurred it had not had the effect of encouraging local investment or increasing government revenues. "The inflow of capital from FDI may be a benefit but the resulting outflow of profits may be so high as to make it a substantial cost. Production of firms is a benefit but less so if it displaces local firms."

Multinationals often shield profits made in a developing country from that country's tax authorities, depriving it of key revenues. Mr Kozul-Wright said capital flight from Africa, either by rich people or multinationals, was a huge problem.

The other potential benefits of FDI, such as employment generation, technology transfer and locals skills build up are also not fulfilling their promise. This, combined with the real costs of FDI as discussed in the previous section, casts serious doubts on the logic of focussing policy primarily on attracting FDI.

Box: Employment created by FDI is rather limited

Employment generation is another widely touted benefit of FDI. However, even in rich countries such as Germany, MNCs (which are responsible for the vast majority of FDI in both rich and poor countries) account for a very small proportion of jobs. Most jobs are in fact created by the Small and Medium Enterprise sector.

In the case of developing countries many of which are still primarily agrarian, FDI creates an even small proportion of jobs. For instance, it was estimated that total employment in developing country Export Processing Zones (EPZs), where a large part of FDI is concentrated is no more than 4 million^{xlvi}. Jobs in EPZs represent less than 5% of the total manufacturing jobs in developing countries^{xlvii}. Hence, while the jobs created by FDI are no doubt welcome in themselves, they are too few to have a real impact on the billions of people living in poverty in developing countries and their modest benefits need to be weighted against the very real and sometimes substantial costs associated with EPZs and FDI.

US companies investing in developing countries report the number of employees per \$1 million invested and these numbers are highly illustrative. The respective numbers for mining & extractive, manufacturing and services are 2.5, 23.8 & 2.3. (Source UNCTAD FDI/TNC database)

The case of the extractive sector in Africa – which dominates FDI in the continent – illustrates how things have not worked well. As highlighted below, FDI in mining and petroleum has accounted for few jobs, little integration with the local economy, an accrual of a less than fair share of the wealth to the local people, conflict and crowding out of investment in other sectors. It illustrates some of the pitfalls of relying on maximizing investment to deliver growth and poverty reduction.

Box: The dubious record of FDI in the extractive sector

Most FDI, especially in Africa is concentrated in the extractive sector. Twenty four African countries classified by the World Bank as mineral or oil dependent have received almost three quarters of the investment in Africa, over the last two decades. However, many of the countries richest in oil and minerals are also still the world's poorest, such as Nigeria, Chad, DRC, Sudan and Angola.

For these countries, investment in natural resource extraction has not brought poverty reduction, but instead they have been afflicted with a 'resource curse' in which mineral dependence has been shown to slow and even reduce economic growth in developing countries^{xlviii}. This can be part attributed to corruption (both by the domestic elite and MNCs), a less than proportionate share of the mineral wealth being extracted going to the country, and the tendency of FDI to crowd out local investment.

Investment in natural resources tends to be concentrated in 'enclaves', with little integration to the rest of the economy. This can mean limited linkages to the local economy, with very little sharing of technology, a good deal of imported technology and few jobs being generated. Mineral wealth can also distort economies, attracting the lion's share of support and investment and so stifling economic diversification and making it almost impossible for the basic manufacturing industries development to come into being^{xlix}.

Natural resource extraction can also bring direct costs to poor people. For example, Shell in Nigeria, is associated with oil spills, gas flaring, as well as local conflicts around oil fields. There is a lack of international controls of the behaviour of MNCs. For example in 2002 the UN presented a dossier listing 85 companies, many of them from OECD countries, investing in the DRC, and accused of perpetuating the conflict.

A combination of policies such as trade liberalisation, removal of barriers to and performance requirements (such as local content) on FDI, withdrawal of state supports, and privatisation programmes that did not lead to new resources or technology transfer were disastrous for the domestic private sector in developing countries. In SSA between 1980 and 1990, the share of manufacturing output in GDP dropped sharply in SSA before reaching a level in the 1990s below that reached in 1960^l.

Instead of having the field stacked in favour of domestic investors, the current mix of policies have tilted the field away from domestic investors in poor countries in favour of MNCs. The already substantial advantage that their size, market domination and international reach impart to MNCs is amplified by the new TRIPS (Trade Related Intellectual Property Rights) regime^{li}, by tax competition amongst developing countries trying to attract investment and by the use of aggressive tax avoidance and profits laundering strategies.

Box: The negative effect on the domestic private sector

In Zambia, this process led to a fall in manufacturing employment of 40 per cent in five years. In Ghana, employment in manufacturing fell by more than half. Both of these countries were enthusiastic liberalizers – a strategy that was a failure as far as domestic private sector development was concerned.

In most cases, these policies were imposed as the condition for receiving aid and loans from the international community. Most evidence from the history of successful private sector development points to the need to use some form of infant industry protection and incentives to the domestic private sector, currently denied to most developing countries under the WTO and by IFI conditionality. Such measures were successfully used in abundance by countries as diverse as the United States, S Korea, Malaysia and India to develop their vibrant private sector.

How Regulatory Changes are Reducing Policy Space

Especially since the early 1990s, efforts to attract increasing amounts of Foreign Direct Investment have formed an ever more important part of developing country industrial and development policy. This has been due a number of factors. The most important ones are

- The IMF and the World Bank have actively pushed for privatizations, a dismantling of capital controls and a liberalization of investment regimes through the use of structural adjustment agreements and loan conditionality.
- Research concluding that FDI was the most stable forms of private capital flow (especially in the aftermath of the SE Asian crisis) was also highly influential in

establishing the image of FDI to a “good inflow” which developing countries needed to try and maximise.

- FDI inflows can provide short term balance of payments support which can help shore up the finances of a country which is experiencing problems so developing countries often try and attract FDI to relive balance of payment problems
- Multilateral agreements such as the TRIMS and TRIPS negotiated under the WTO and the GATS agreements on services have acted as ratchets for a more liberal investment regime since they skew the regulatory landscape in favour of foreign investors. These are often used as starting points in bilateral negotiations (see next point) which typically push for a more liberal investment regime
- An extensive and proliferating network of Bilateral Investment Treaties (BITs), Free Trade Agreements (FTAs) and International Investment Agreements (IIAs) is being negotiated mainly at the initiative of the US and EU and now China and India which smoothen the flow of FDI by opening up new areas for investment, dismantling regulatory restrictions and increasing the profit potential from foreign investment.

The depth, pace and scope liberalizing changes seem compatible on with the belief that “FDI will save the day” – something the analysis in this report has shown to be at best flawed and at worst a complete perversion of the underlying data.

Item	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Number of countries that introduced changes	43	56	49	63	66	76	60	65	70	71	72	82	103	93	93
Number of regulatory changes	77	100	110	112	114	150	145	139	150	207	246	242	270	205	184
More favorable to FDI	77	99	108	106	98	134	136	130	147	193	234	218	234	164	147
Less favorable to FDI	0	1	2	6	16	16	9	9	3	14	12	24	36	41	37

Source: UNCTAD database on national laws and regulations.

Figure 4: Source UNCTAD

The table above lists the changes in FDI regulatory regimes undertaken by various countries and the bias towards increased liberalization is clear.

For example, in the year 2006, of the 184 changes identified, 109 took place in developing countries and most of these were favourable to FDI. Some typical changes that were enacted in 2006 include

- A reduction in corporate tax rates in Egypt (from 40% to 20%) and Ghana (from 28% to 25%)
- Creation of new special economic zones offering tax holidays and other incentives such as in India
- Opening up of new sectors to FDI such as telecommunications in Botswana and Kenya, banking in Egypt and Nigeria, real estate in Morocco and Insurance in Swaziland

The total number of International Investment Agreements (IIAs) is now close to 5,500 which include 2,573 Bilateral Investment Treaties (BITs), 2,651 Double Taxation Treaties (DTTs) and 241 other agreements such a regional trade agreements with investment provisions^{lii}.

The United States has signed Free Trade Agreements (FTAs) with 11 countries and is currently negotiating 10 more. Most of the US agreements contain GATS plus commitment on services especially in areas such as financial services, delivery, and distribution^{liii}. Some even contain provisions prohibiting the implementation of capital controls^{liv}. Meanwhile the EU has signed 10 FTAs, is negotiating 23 more and has Economic Partnership Agreements EPAs with over 60 former colonies.

Least developed countries (LDCs), while host to less than 1% of global inward FDI stock, had nevertheless concluded 16% of all BITs, 7% of all DTTs and 15% of other IIAs by the end of 2006.

This overlapping and layered complex treaty universe undermines the multilateral framework which though far from being perfect is far less onerous for developing countries with limited capacity. Some of the issues that need to be considered as a result of these developments are

- Reduced efficiency
- Capacity constraints
- Uneven negotiating and bargaining power
- Limiting policy space for developing countries
- How development friendly such agreements are

This complex landscape leads to a maze of competing rules that divert trade, reduce investment efficiency and increase administrative burdens.

Already in the negotiation of multilateral agreements, the resource and capacity constraints of many LDCs are clearly visible. More than 20 countries, for example, do not have even a single full time representative in Geneva to follow the WTO processes. With several other treaties and agreements especially those which are bilateral in nature, the very limited capacity the LDCs do have is put under excessive amounts of strain. It is not very clear, how under such strains, the representatives of LDCs are able to negotiate in the best interest of their countries.

This capacity constraint worsens an already weak negotiating and bargaining position. Moreover, most investment flows into LDCs are driven by US or EU MNCs and increasingly those from emerging Asia. If an LDC gets 40% of its investment from the US but in turn accounts only for 0.2% of US outward investment, it is clear who will have the upper hand in the negotiation of a bilateral investment treaty. That is why, a multilateral framework such as the WTO, though far from perfect, is much better for small and poor developing countries where they can have strength in numbers and team up with behemoths such as the BRIC developing countries.

The development friendliness of an agreement can be gauged on a number of parameters of which some important ones are

- A cost benefit analysis of the concessions that developing countries make vs. the concessions they are able to secure in the negotiation process
- Whether such agreements increase or decrease policy space
- Whether these agreements mean that the development policy tools used by rich countries in the past are now made available or withdrawn
- Whether these help or hinder the negotiation power of the country in other forums such as the WTO which are key from a development perspective

The current spate of bilateral agreements being negotiated fail on most of these tests.

Current trends on further liberalization

Rich countries are aggressively pushing for an opening up of the service sector to foreign investment. The most aggressively pursued sectors are banking and financial services and the distribution sector. The spread of the ongoing financial crisis especially to territories such as Eastern Europe where banking systems had been liberalized and opened to foreign investment means that the momentum for such wholesale liberalization will (hopefully) slow down and even reverse.

The financial sector, for example, lies at the heart of the allocation of resources within a country. Promises of lower interest rates, better access to credit and more efficiency which were made to press the case for liberalization in the sector, have sadly not turned out to be true. The financial sector of Mexico, liberalized in 1993 under NAFTA, is a case in point. Foreign ownership of the sector had increased from nearly zero to 85% in 2000 and was accompanied by a reduction in bank credit to domestic businesses from 10% of GDP to a mere 0.3%^{lv}. Amongst the rural poor, the number of small farms with access to credit halved and when finance was available, the interest rates were exorbitant^{lvi}

Distribution services, which include the retail sector, are critical for the livelihoods of poor people in developing countries. In India, for example, the retail sector contributes to 10% of the GDP and employs 6-7% of the workforce. It also serves as an interface between producers and consumers creates jobs for the poor.

The restricted policy space available to developing countries is being eroded further

As discussed above, the investment chapters of FTAs together with separately negotiated bilateral investment treaties (BITs) and unilateral measures being introduced by developing countries in a bid to attract FDI all mean that there are fewer and fewer restrictions on the activities of foreign investors in developing countries. What is more, many of these provide for a powerful system of international arbitration to ensure that these expanded rights of foreign investors are vigorously enforced. This reduces the scope for policy action by developing countries.

During the 1990s, industrialised countries pushed hard to introduce binding investment rules through the Organisation for Economic Co-operation and Development, advocating the creation of a Multilateral Agreement on Investment. When this effort collapsed in 1998 due to internal disputes, attention shifted to the WTO where the EU in particular tried to insert talks on investment into the Doha Round of negotiations. Developing countries successfully opposed this initiative^{lvii}.

However the bilateral agreements being pursued mean that many of the investment provisions originally being pushed by developed countries now have the force of law. A growing number of bilateral treaties allow investors to sue governments in international commercial courts for compensation because of regulatory changes, even when these are in the public interest.

Some developing countries are entering new agreements in the expectation that FDI will increase as a result, but there is no evidence that this is the case. African countries have between them signed over 1000 bilateral investment treaties, but receive less than four per cent of global FDI. Brazil, one of the largest recipients of FDI has not signed even one.

The East Asian miracle economies as well as other OECD countries such as Finland, the UK and even the United States for years screened foreign investors, only allowing entry to those that met the developmental needs of their economies. They also required them to fulfil 'performance requirements', to enter joint partnerships with local firms, transfer technology, upgrade the skills of employees, and buy intermediate inputs from local suppliers, stimulating production in the wider economy. They were able to develop industries that are now world leaders, creating jobs and contributing to rapid poverty reduction^{lviii}.

However, many of the recent agreements, especially those signed by US and Japan, eliminate the possibilities for poor countries to use these same policies. This is done through providing for 'pre-establishment rights' that prohibit governments from screening foreign investors^{lix}. In addition, a growing number of investment chapters and treaties prevent governments from regulating foreign investment once it enters the economy, by banning the use of all 'performance requirements' in all sectors including mining, manufacturing, and services^{lx}.

More than 170 countries have now signed international investment agreements that provide foreign investors with the right to turn immediately to international investor–state arbitration to settle disputes, without first trying to resolve the matter in national courts^{lxi}. Such arbitration fails to consider the public interest, basing decisions exclusively on commercial law.

Foreign investors including equity holders can sue even when the government is acting in the public interest. The cost can be extremely high. Current outstanding claims against Argentina are estimated to be \$18bn^{lxii}. Some of the pending cases include legal action against governments for increasing value-added taxes, re-zoning land from agricultural to commercial use, and regulating hazardous waste facilities.

The actions are based on the grounds that these actions had adverse consequences on profits of foreign investors. If the government loses taxpayers must foot the bill for damages to investors' profits, including anticipated future profits. Investors' automatic recourse to international arbitration, enshrined in BITs and FTAs is also undermining national legal systems.

Not only is the legal basis for investment arbitration decisions loaded against public interest, but so are the proceedings^{lxiii}. Despite the fact that many arbitration panels are hosted at the World Bank and United Nations, two institutions with a public commitment to accountability, the investment arbitration system is shrouded in secrecy. It is virtually impossible to find out what cases are being heard, let alone the outcome or rationale for decisions^{lxiv}.

What can be done?

FDI is not a panacea

The first important thing that needs to be done is to recognize that FDI is not a panacea even though it may often be portrayed as one. While FDI volumes are no doubt substantial, the numbers disguise significant points of concern. The real stock of FDI (which governs the potential of outflows) is likely to be a multiple of currently reported numbers. FDI profits, which generate outflows when they are repatriated, are already very high and increasing and are also likely to be significantly under-reported.

Moreover, the increase in FDI has is heavily concentrated in the emerging market economies and is skewed away from the poorest countries. Also, evidence points to FDI following growth and development rather than leading it. Disturbingly, FDI in the poorest countries is heavily concentrated in the extractive sector where it has contributed to substantial problems such as

crowding out investment in other sectors and fuelling conflict etc. The examples of FDI that has contributed to development are few and far between.

While the case for FDI may look good on paper, in reality most of the benefits have not been borne out though the costs have been very real. Aggressive tax competition to attract FDI, the increasing use of intra-subsidiary financial transfers and transfer pricing to avoid taxes in poor countries, the use of exaggerated royalty payments have all contributed to depressed tax revenues for host country governments and the flight of capital and scarce resources from poor countries. Factoring in the very high profits levels on FDI, the accelerating increase in stocks and the use of profits laundering means that FDI has a very high likelihood of becoming a channel for capital flight and a net leakage of scarce resources from poor countries without generating enough compensating indirect spill-over effects.

There is also increasing evidence that the regime of increasing liberalization of investments driven by the IFIs, the WTO and bilateral trade and investment agreements, together with aggressive tax avoidance strategies being used by MNCs, is undermining the domestic private sector, which is crucial to long term development. There is an urgent need to reevaluate the current FDI policies being pushed by rich countries and being pursued by poor countries as they are not bearing fruit by contributing to development.

FDI, while useful sometimes, can have serious drawbacks and any policy oriented primarily towards attracting FDI as a means to finance development is doomed to failure. Quality of FDI is more important than quantity.

There is thus a need for a clear distinction between maximising the volume of FDI flows and maximising its contribution to sustainable development. There is hence a need for

- A more differentiated and qualitative approach to FDI which distinguishes between FDI in the productive sectors and non-productive sectors, green field investment and mergers & acquisitions etc
- There is a need for a much stronger policy focus on maximising the development spill-overs of FDI and minimising negative spill-overs and not just a focus on maximising inflows
- In formulating appropriate FDI policies, it is critical to distinguish between host countries taking into account their levels of development, skills, size, absorption capacity and factor endowments
- It is important to look at the interplay between the trade and investment regimes given that there is an increasing degree of overlap between the two. For example, an ever increasing percentage of world trade is controlled by MNCs with more than half being intra-firm trade. Moreover treaty regimes such as the WTO and FTA (many of which have investment provisions) as well as institution such as the IMF and World Bank influence both trade and investment regimes.

How to move forward^{lxv}?

The economic challenge for countries hosting FDI is three fold

- How to attract foreign investors?
- How to add value through the activities of foreign investors?
- How to capture that value locally?

There are likely to be short term trade-offs between policy measures, such as performance requirements, which increase the development impact of a given level of FDI and the aggregate level of FDI. However, in the long term, since development itself provides a more conducive environment for foreign investment, there may be greater synergy between the interests of investors and those of the populations of developing countries.

At the global level, in order to turn the tide and put investment at the service of development, investment rules, whether multilateral, regional, or bilateral, should^{lxvi}:

- Recognise the special and differential treatment that developing countries require in order to move up the development ladder.
- Enable developing countries to adopt flexible intellectual-property legislation to ensure the primacy of public health and agricultural livelihoods and protect traditional knowledge and biodiversity.
- Exclude essential public services such as education, health, water and sanitation from liberalisation commitments.
- Recognise the right of governments to regulate the entry of foreign investors to promote development and the creation of decent employment, and include commitments to enforce core labour standards for all workers.
- Ensure mechanisms for extensive participation of all stakeholders in the negotiating process, with full disclosure of information to the public, including the findings of independent impact assessments.

This suggests a need for a focus on policy measures at the national and international levels which will encourage FDI of the forms, in the sectors, and in conditions which will provide the greatest developmental benefit.

Internationally, the critical objective is the preservation of the policy space available to developing country governments to pursue appropriate policies to maximise the developmental benefits of FDI, including the avoidance of a competitive process which could undermine the scope for such policies. There is a need for, for example,

- mechanisms to control tax competition, in order to avoid the provision of unwarranted concessions in terms of tax treatment of, or direct or indirect subsidies to, foreign affiliates, and downward pressure on corporate taxation more generally (including through “export-processing zones”);
- mechanisms to control transfer price manipulation by transnational companies, including the adoption of a country-by country reporting international accounting standard;
- legal measures requiring comprehensive disclosure of ownership of foreign affiliates, providing total transparency of beneficial ownership, including free public access to offshore corporate registries;
- mechanisms to ensure greater transparency in contractual terms for foreign (and domestic) investment in extractive industries;
- a comprehensive review of existing international agreements and instruments in terms of their potential implications for the developmental benefits of FDI, and their revision to minimise adverse effects.
- A move away from the growing bilateral investment treaty network towards a specifically development friendly multilateral investment regime

Nationally, appropriate measures will vary critically according to the particular circumstances of the country concerned. Many such measures may also be dependent upon measures at the international level to relieve constraints on their implementation. The central *objectives* of national policies should include:

- ensuring that the form, nature and sectoral composition of FDI is such as to optimise its potential development benefits, given the national context, as part of a coherent industrial policy;
- maximising backward linkages with the domestic economy, both through fostering the creation of new linkages, and actions aimed at strengthening and intensifying existing linkages^{lxvii}, in order to strengthen the contribution of FDI both to employment and to technology transfer;
- increasing the potential for backward linkages, by promoting locally-owned businesses, and particularly small and medium enterprises;
- increasing the absorptive capacity of the economy for the potential benefits of FDI, particularly in terms of technology transfer, for example by increasing access to and quality of educational, particularly at higher levels;
- maximising the contribution of affiliates to public revenues, by ensuring the rigorous application of appropriate taxes, avoiding systematic and one-off tax concessions and direct and indirect subsidies to attract foreign investment, and acting to ensure that tax revenues are not artificially reduced through transfer price manipulation;
- ensuring that foreign affiliates comply with applicable environmental and social standards, including health and safety provisions, and raising such standards to appropriate levels in a non-discriminatory manner;
- preserving future policy space, by avoiding international commitments (eg international investment agreements and mode 3 commitments under the GATS Agreement) which may limit their ability to pursue policies conducive to improving the development effects of FDI, and seeking agreement for appropriate revisions to existing obligations where necessary;
- representing their interests strongly, in collaboration with similarly placed countries, in multilateral trade and other negotiations on proposals which may have a similar effect; and
- promoting international measures such as those described above in appropriate international fora.

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- ⁱ Speech entitled “Growth and Poverty Reduction – Creating More and Better Jobs in Poor Countries” delivered at the New Economics Foundation, 19th Jan 2006
- ⁱⁱ All the data is from World Bank Global Development Finance
- ⁱⁱⁱ *ibid*
- ^{iv} UNCTAD online FDI database
- ^v Note: This only refers to the net direct financial impact of FDI. If for example, FDI generates significant export revenues, it can still make an overall positive contribution to the balance of payments of a country
- ^{vi} Rethinking the Role of Foreign Direct Investment, UNCTAD 2005
- ^{vii} *ibid*
- ^{viii} www.unctad.org
- ^{ix} Federal Reserve Bank of Dallas (2002) ‘Beyond the Border: Financial Globalization Manna or Menace’.
- ^x Authors Calculations based on the World Investment Report, UNCTAD 2005
- ^{xi} *ibid*
- ^{xii} Is FDI good for the poor? A review and stocktake, Development in Practice, Volume 15, June 2005, Andrew Summer
- ^{xiii} *ibid*
- ^{xiv} Should countries promote Foreign Direct Investment?, Hanson, Gordon H, G-24 Discussion Paper, UNCTAD
- ^{xv} This section draws heavily on Financing for Development and Foreign Direct Investment: a Critical Assessment, David Woodward, United Nations (unpublished) February 2008
- ^{xvi} UNCTAD (2004)
- ^{xvii} Aykut, D., and Sayek, S. (2005) “The Role of the Sectoral Composition of Foreign Direct Investment on Growth”; [http://www.fscpo.unict.it/catania_workshop2005/pdf/Sayek&Aykurt\(paper\).pdf.pdf](http://www.fscpo.unict.it/catania_workshop2005/pdf/Sayek&Aykurt(paper).pdf.pdf); UNCTAD (2007) *loc. cit.*
- ^{xviii} UNCTAD (2007) *loc. cit.*
- ^{xix} Woodward (2001) *loc. cit.*
- ^{xx} Has US Investment Abroad Become more Sensitive to Tax Rates?, NBER Working Paper No. 6383, R Altschuler, H Grubert and S Newton, 1998
- ^{xxi} For example “the single most important thing a developing country can do to benefit from the trade and investment opportunities thrown up by globalisation is to get their investment climate right”
Hilary Benn, the UK development minister in ‘Growth and poverty reduction’, a speech to New Economics Foundation, 19 January 2006
- ^{xxii} <http://www.guardian.co.uk/business/2007/nov/06/19>
- ^{xxiii} <http://www.guardian.co.uk/flash/page/0,,2201916,00.html>
- ^{xxiv} ‘The Next Crisis? Direct and Equity Investment in Developing Countries’, David Woodward, Zed Books, 2001
- ^{xxv} *Ibid*
- ^{xxvi} <http://www.comstockfunds.com/files/NLPP00000%5C030.pdf>
- ^{xxvii} Christian Aid written evidence on the Private Sector submitted to the International Development Committee of the Houses of UK parliament drafted by Sharon McClenaghan, 2006
- ^{xxviii} UNCTAD (2003) FDI Policies for development: national and International perspectives
- ^{xxix} Christian Aid *ibid*
- ^{xxx} Derrick Hindery, ‘Social and Environmental Impacts of World Bank/IMF-funded Economic Restructuring in Bolivia’, *Singapore Journal of Tropical Geography*, 25 (3), 2004, p. 281-303.
- ^{xxxi} C Vilegas Quiroga, *Privatizacion de la Industria Petrolera en Bolivia*, 2002, CIDES-UMESA /CEDLA /FOBOMADE /DIAGONIA.
- ^{xxxii} Derrick Hindery, *ibid*
- ^{xxxiii} SE de Pabon and T Kruse, *La Industria Manufacturera Boliviana en los Noventa, Serie: Avances de Investigacion*, No 25, CEDLA.
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- ^{xxxv} UNCTAD (2005) Economic development in Africa: Rethinking the role of Foreign Direct Investment
- ^{xxxvi} UNRISD, The Pay Your Taxes Debate – Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry by M Riesco, G Lagos and M Lima
- ^{xxxvii} A proposal for unitary taxes on the profits of transnational corporations, Andrew Mold, CEPAL Review 82, April 2004
- ^{xxxviii} See *The McKinsey Quarterly 2004 - 1*, McKinsey and Company, 2004. Research by McKinsey highlights the ineffectiveness of incentives, including tax breaks, in attracting foreign investment.
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^{xxxix} A proposal for unitary taxes on the profits of transnational corporations, Andrew Mold, CEPAL Review 82, April 2004

^{xl}The Economist, March 25 2004

^{xli} UNRISD, The Pay Your Taxes Debate – Perspectives on Corporate Taxation and Social Responsibility in the Chilean Mining Industry by M Riesco, G Lagos and M Lima

^{xlii} http://www.finfacts.com/irelandbusinessnews/publish/article_10005150.shtml

^{xliii} ‘Coffee giants ruse denies aid to farmers by Antony Barnett in The Observer, June 13, 2004

^{xliv} Written evidence submitted by Christian Aid to the UK Parliament’s International Development Committee available at

<http://www.publications.parliament.uk/pa/cm200506/cmselect/cmintdev/921/921we13.htm#note22> and P de Robillard in Poor People, Free Trade and Trade Justice, Christian Aid, 2004

^{xlv} “Foreign Investment not Doing the Job” September 14, 2005 in the Guardian by Ashley Seager

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^{xlvii} Madeley, J. (1999): *Big Business, Poor Peoples: The Impact of Transnational Corporations on the World’s Poor*, London, Zed Books.

^{xlviii} Sachs, J and Warner, A (2003) J. Natural Resource Abundance and Economic Growth

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And

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^{xlix} Christian Aid written evidence on the Private Sector submitted to the International Development Committee of the Houses of UK parliament drafted by Sharon McClenaghan, 2006

^l FDI Policies for development: national and International perspectives, UNCTAD, 2003

^{li} OECD country MNCs and other entities hold over 95% of patents and an overwhelming number of copyrights etc which are protected under TRIPS. So this reinforces their advantage over developing country public and private sector and enhances their rent seeking capacity

^{lii} World Investment Report, UNCTAD 2006

^{liii} Roy, M., Marchetti, J and Lim, H. (2006) ‘Services Liberalization in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS?’, WTO Staff Working, Paper Economic Research and Statistics Division, http://www.wto.org/english/res_e/reser_e/ersd200607_e.pdf

^{liv} <http://www.aprnet.org/index.php/journals-a-policy-papers/volume-15-june-2007/293-new-developments-on-services-and-investment-in-ftas.html>

^{lv} ‘How NAFTA Failed Mexico,’ *The American Prospect*, 1 July 2003, <http://www.prospect.org/print/V14/7/faux-j.html>, last accessed 3 February 2007 and Federal Reserve Bank of Dallas (2002) ‘Beyond the Border: Financial Globalization Manna or Menace’.

^{lvi} J. J. Audley, D. G. Papademetriou, S. Polaski, and S. Vaughan (2004) ‘NAFTA’s Promise And Reality – lessons from Mexico for the hemisphere’, Carnegie Foundation.

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^{lx} This trend started with Article 1106 of the Investment Chapter of NAFTA in 1994, and since then, the vast majority of US and EU investment agreements have followed suit. As stated in “Signing Away the Future” Oxfam Briefing Paper 2007

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^{lxiv} See for example ‘NAFTA’s Powerful Little Secret: Obscure Tribunals Settle Disputes, But Go Too Far, Critics Say’, *New York Times*, 11 March 2003; CIEL ‘Secretive Bank Tribunal Bans Public and Media Participation in Bechtel Lawsuit Over Access to Water’, 12 February 2003; and ‘Will UNCITRAL Become Even More Secretive?’, *Investment Treaty News*, 3 September 2006.

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