POLITICAL ECONOMY RESEARCH INSTITUTE

PERI

University of Massachusetts Amherst

POLITICAL ECONOMY RESEARCH INSTITUTE

Creating International Credit Rules and the Multilateral Agreement on Investment: What are the Alternatives?

Elissa Braunstein
Gerald Epstein

1999

10th floor Thompson Hall
University of Massachusetts
Amherst, MA, 01003-7510
Telephone: (413) 545-6355
Facsimile: (413) 545-2921
Email:peri@econs.umass.edu
Website:
http://www.umass.edu/peri/

PUBLISHED STUDY

Creating International Credit Rules and the Multilateral Agreement on Investment: What are the Alternatives?[1]

by Elissa Braunstein and Gerald Epstein
Department of Economics and the Political Economy Research Institute (PERI)
University of Massachusetts, Amherst
Amherst, MA 01003

Forthcoming in Jonathan Michie and John Grieve Smith (eds.) *Global Instability and World Economic Governance*. London and New York: Routledge Press.

I. Introduction

International relations of production, mediated either by the market or through the internal transactions of multinational corporations (MNCs), are spreading rapidly to most parts of the world. This process of "globalization," though exaggerated by some analysts, should not, on the other hand, be dismissed as just more of the same.[2] While by some measures, international economic relations are no more extensive now than they were in 1913 (see the discussion and data below), this comparison is misleading. First of all, considering the standards of living and economic and political rights of workers and communities, 1913 can hardly be hailed as a reassuring benchmark. Second, the role of national governments and the welfare state in much of the world is fundamentally different and greater now than it was in 1913.[3] Hence, the world has never before experienced

---

[1] The authors thank James Burke and Trish Kelly for their significant contributions. They are not responsible for errors, however.

[2] See Hirst and Thompson (1996) and Sutcliffe and Glyn (1998).

[3] For more discussion of these points, see Baker, Epstein and Pollin (1998).

1913 levels of globalization with 1990's levels and types of government intervention. Are they compatible with each other? Are they sustainable?

These questions are at the heart of the analysis of international economic property relations and governance structures. For as globalization has proceeded, MNCs, financial institutions, and governments have accelerated the pace of constructing this architecture. The creation of the World Trade Organization (WTO), the European Monetary Union, and the North American Free Trade Agreement (NAFTA) are only three of the most important developments in these attempts. And over the last three years, negotiations have taken place at the Organization of Economic Cooperation and Development (OECD) to formulate the so-called Multilateral Agreement on Investment, establishing property rights and governance structures for international capital movements - foreign direct investment (FDI) as well as portfolio investment.

As was the case in the creation of capitalism, these international initiatives have been led by capitalists. In the current era, these capitalists are mostly large banks and businesses, which have attempted to create an edifice to their liking. And similarly, as with the establishment of national property relations and nation states, this process is hotly contested by different groups of capitalists and wealth owners. In the current case of the creation of international economic relations, these conflicts often take the form of disagreements among banks and corporations from different nations, and therefore among national governments, who, depending on the country's level of development and other aspects of their economic position, fight over the form of the international governance structure.

In a much weaker position in the construction of this new system are labor and communities. In many developing countries, workers and citizens have very little power because of the relatively authoritarian nature of their governments, and because the developing country governments themselves have been marginalized in the negotiating process. In the developed capitalist economies, workers are not without power. Since democratic governments are creating this new structure, labor and the citizenry have some

power to influence the position taken by governments. But, in this context, they are at a severe disadvantage in the sense that labor organizations have lost power vis-a-vis business in national politics over the last 25 years in virtually every major industrialized country. So citizens' power to organize the state to support their interests in these negotiations is weak. In the rise of national capitalism, labor formed organizations on the same geographical basis as capital to fight over the creation of property rights and the state. But now, the geographical context is more global, whereas labor organization is still primarily national.

Increasingly stepping into the breach are non-governmental organizations (NGOs), which have become organized internationally and are contesting the business-led creation of this new world governance structure. While these NGOs cannot match the wealth and power of the corporations, they have had some successes and are likely to have more.

In this chapter we analyze these issues of international governance with respect to capital flows, more particularly with an emphasis on MNC production and FDI; the concrete context for our discussion is the Multilateral Agreement on Investment (MAI). The chapter is organized as follows. In the next section we present some data on the evolution of globalization with special reference to FDI. In section III, we introduce the MAI and a framework for understanding the nature of the MAI. In section IV we consider its effects, and in section V we propose an alternative to the MAI. An appendix presents a simple economic model to help analyze the functions and effects of agreements like the MAI.

We first conclude that the MAI and similar initiatives have two main effects: 1) to create a new set of *international* property relations and governance structures, and 2) to fundamentally change *national* property relations and governance to the benefit of MNCs but at the expense of citizens, labor and communities. Because of its domestic policy intents and impacts, it is a mistake to see the MAI as simply a benign vehicle for structuring international economic relations.

Second, we conclude that unless labor, citizens and national governments want to dramatically reverse the level of international economic interaction, they will have to fight for an alternative set of international structures. Just strengthening the state will not suffice because of the already existing market power of global finance and MNCs.

Finally, however, we argue that promoting national, regional and/or international policies to expand aggregate demand and strengthen national controls over capital flows will also be a necessary part of any transition to citizens' governance over capital. Because without these, citizens and labor are less likely to get the political power they need to defend themselves against the political and economic attacks of business on a global scale.[4]

II. International Capital Flows: Some Stylized Facts

II.I The Context of Globalization

The term "globalization" has no common, widely agreed upon meaning.[5] We define it quite simply as follows: globalization is the widening and deepening of international economic interactions (Milberg, 1998). Note that this definition does not say these relations are necessarily international *market* relations. This is because it is a mistake to see globalization as synonymous with marketization and economic liberalization. Economic liberalization is one form globalization can take, and indeed, that is precisely its form in the current era - globalization is occurring in a neo-liberal regime. But one can imagine international economic relations that are not dominated by pure market relations, but, rather, are embedded in rich social structures of governance.[6] Indeed, as we will argue

---

[4] See Crotty and Epstein (1996) and Crotty, Epstein and Kelly (1998) for discussions of various aspects of these issues.

[5] See Hirst and Thompson (1996) and Baker, Epstein and Pollin (1998) for a discussion of various definitions of globalization.

[6] This is the point made by Block (1973) in his classic book on the international monetary system. See also the excellent book by Helleiner (1994) on the same subject.

below, many of the problems which appear to stem from globalization are really problems associated with globalization in the neo-liberal regime of deregulation and laissez-faire.

The paradox confronting many analyses of globalization is that while the changes upon us seem revolutionary, much of the data suggest that what we are experiencing is, in fact, not unprecedented. Table 1 presents some measures of international economic relations. As the table suggests, by some measures, globalization in 1913 was just as extensive as it is in the 1990s. The stock of FDI was nine percent of world output in 1913 and just a shade bit higher in the 1990s at 10.1 percent. The stock of overseas assets was 1.9 percent of world exports in 1913 and 2.1 percent in the 1990s. Yet some things have changed quite dramatically. Whereas manufacturing was primarily an occupation of the rich countries in the early twentieth century, by the late twentieth century manufacturing had become a large share of exports in many parts of the world, high wage and low wage. To take the most dramatic case: whereas in 1913 Asia exported 21.2 percent of its output, by the 1990s it was exporting 73.4 percent. This world competition in exports from poor countries is surely a key difference between globalization then and now. Second, recently there has been an acceleration in portfolio investment that is probably historically unparalleled. Funds raised on international financial markets were only 0.5 percent of world exports in 1950 and were up to 20 percent in the 1990s, and this is probably an underestimate, given that these data exclude financial options and other derivatives.

But it is the change in context for globalization that is most dramatic and most important. Since the 1940s, when the modern welfare state came into being, globalization and marketization on a world scale, which had been severely curtailed by depression and war, accelerated rapidly, as seen by comparing the table 1 data for 1950 and the 1990s. This acceleration is all the more dramatic when placed against the numbers of table 2. Table 2 shows that in 1870 and 1914, government spending was a very small fraction of national income, and of that small fraction, a quarter to one-half was spent on the military. In 1994, by contrast, central governments spent a much larger amount relative to the size of their

economies (by a factor of seven or eight), and most of that was being spent on programs other than the military, such as education and transfer payments. It is this context for globalization which is so new and so problematic: we have not seen 1913 levels of globalization with 1990's levels of the welfare state and social protection.

II.II Foreign Direct Investment and Multinational Corporations

In this chapter we focus on FDI and MNCs.[7] FDI has been growing in recent years far faster than world trade (see table 3). The bulk of the stock of FDI is among the world's wealthier countries ("the North"), but the amount going from the "North" to the "South" has been increasing in recent years (see table 4). The most astounding change is the rapid increase of flows to Asia, which increased its share of the world's stock of inward FDI from 10 to 17 percent between 1980 and 1996. Note the spectacular rise in China and Hong Kong, which has increased its share of the world's stock of inward FDI from 0.4 percent in 1980 to 5.5 percent in 1996.

More generally, a handful of developing countries in Asia and Latin America, and a number of countries in Eastern Europe and the former Soviet Union, are beginning to see rapid increases in FDI; but still, on the whole FDI predominately flows among the OECD countries. Hence, it is no accident that the major initiative to create a multilateral legal structure for FDI is being negotiated at the OECD.

III. The International Credit Regime and The Multilateral Agreement on Investment

The MAI is an international economic agreement designed to limit the power of governments to restrict and regulate foreign investment, both FDI and portfolio

---

[7] It is important to distinguish between FDI and MNCs because the latter engage in international production relations through means broader than FDI, for example, by joint ventures and outsourcing.

investment.[8] Its principles are based on those embodied in the investment provisions of the North American Free Trade Agreement, but the MAI amplifies these provisions and, unlike NAFTA, which only applies to the U.S., Mexico and Canada, would apply first to all OECD countries, and then to countries outside the OECD which could become signatories.

The key provisions of the agreement include:

1) *National Treatment*, which requires countries to treat foreign investors at least as well as domestic firms, but, in the words of the OECD, "[Countries] have no *obligation* to grant foreign investors more favourable treatment."[9]

2) *Most Favored Nation (MFN)* status, which requires governments to treat all foreign countries and all foreign investors the same with respect to regulatory laws.

3) *Limiting performance requirements*, which are any laws that require investors to invest in the local economy or to meet social or environmental goals in exchange for market access.

4) *Limiting the ability of governments to restrict the repatriation of profits and the movement of capital*, thus ensuring that corporations and individuals can move their assets more easily.

5) *Banning uncompensated expropriation of assets*. The MAI would require governments, when they deprive foreign investors of any portion of their property, to

---

[8] The following description of the MAI draws heavily on the work of the Preamble Center for Public Policy in Washington. See their web site [www.RTK.NET:80/preamble/mai/keyprovs.html]. Also see OECD (1996).

[9] (OECD, 1997, italics added.) On the question of whether countries can treat foreign investors better than domestic firms, calls to the OECD did not turn up anyone who would answer this question. After reviewing materials from their offices and the MAI itself, it seems that nowhere does the MAI bar countries from treating foreign investors better than locals.

compensate the investors immediately and in full. Expropriation would be defined not just as the outright seizure of a property but could also include governmental actions "tantamount to expropriation." Thus, certain forms of regulation could be argued to be expropriation, potentially requiring governments to compensate investors for lost revenue.

6) *"Roll-back" and "standstill" provisions* that require nations to eliminate laws violating MAI rules and to refrain from passing any such laws in the future. State and local, as well as federal laws, would likely be affected, though many existing laws specifically acknowledged by "reservations" to the agreement will be exempted.

7) *Investor-to-state dispute resolution* that would enable private investors and corporations to sue national governments and seek monetary compensation when they believe a law, practice or policy violates investors' rights as established in the agreement. This provision is a significant departure from most previous international agreements, save NAFTA, and is perhaps the most important aspect of the MAI. Previous agreements, such as the General Agreement on Tariffs and Trade, only allow governments to bring complaints against other governments, whereas this provision would allow corporations to sue governments over these issues.

It is important to note that the MAI does not include any binding language on the *responsibilities* of corporations or any mechanisms to enforce those responsibilities.

Negotiations on the MAI began in May 1995 and were originally scheduled to be completed by May 1997; the deadline was then extended for another year, and then extended again. As we discuss below, the major sticking point in the negotiations from the point of view of the negotiators is the question of access; some countries, including France, do not want to give foreign investors access to all sectors of their economies. If completed, the MAI will be presented to the governments of OECD countries for approval; developing nations will also be encouraged to join.

Immediately, the question arises: why is such a treaty being negotiated? Since foreign investment is a market phenomenon, why can't the market simply operate on its own

without governments getting involved? There are three answers: 1) access 2) enforcement and 3) rolling back the state.

III.I Access

By signing on to the MAI, countries would agree to open up virtually all sectors of their economies to FDI. Countries now limit foreign investment in various economic sectors for a variety of reasons: to protect domestic ownership of militarily sensitive production, or to protect the viability of certain forms of indigenous production, for example the French film industry. In this sense, access involves many of the same issues as are involved in trade agreements, such as how much to protect domestic industry, and therefore reflects competition among rival capitalists.

It has a further dimension, however. Open access might also force governments to open up government-owned sectors to foreign investment. Whether this is a good thing depends on a large number of factors including how "socially" efficient the industries are currently run, and how they would be run if they were turned over to private ownership. In many cases, to be sure, social control over production in some sectors of the economy is likely to be curtailed by the agreement.

These issues of access constitute some of the most contentious from the point of view of the negotiators, and help to account for some of the continuing delays in reaching agreement. However, apart from the issue of government-controlled sectors, these conflicts are primarily inter-capitalist rivalry. Of far more concern to workers and citizens generally are the other two aspects of the MAI: enforcement and rolling back the state.

III.II Enforcement

All relations of authority, including property relations, need some kind of enforcement mechanism to operate. Walrasian economics, the dominant version of mainstream economics until the last decade or so, was built on the idea that enforcement was unproblematic. For Marx, as for modern post-Marxian and so-called analytical institutional economics, one of the central problems of economics is to get others to behave in ways that

aren't always in their best interest: to labor when the boss isn't watching; to not expropriate or excessively tax or regulate foreign investment; or to not be excessively risky with borrowed money (Bowles and Gintis, 1990). Legal structures and courts provide *exogenous enforcement* of transactions in cases where transactions (or contracts) are relatively transparent. But since you can't always know which future contingencies might arise, or even what the other contracting party is up to all of the time, contracts often require *endogenous enforcement* mechanisms as well. Endogenous enforcement results in things like paying workers high wages so they don't want to lose their jobs and thus work harder (employment rents). Without sufficient exogenous or endogenous enforcement, many types of economic relations will not function well, and can even cease to exist. The more powerful the mechanisms of exogenous enforcement, the less costly and necessary are endogenous forms.

These considerations are especially important in credit relations where it is difficult to monitor the use to which credit is put and where, because of the fungible nature of credit, it is easy to divert credit from its presumed use. Collateral is a central mechanism of endogenous enforcement in credit relations.

Enforcement is much more problematic in the realm of international investment than in that of domestic investment, because although there are powerful court enforcement mechanisms at the national level, such legal structures are absent at the international level. Moreover, seizing collateral from a sovereign nation is fraught with the same problems of force and enforcement entailed in the international lending to begin with. How, then, can international lenders and investors be assured that there will be a sufficient likelihood that they will be repaid? Without such mechanisms of enforcement, international lending and investment will be relatively low or nonexistent.

Building on the seminal work of Lipson (1986), Epstein and Gintis (1992) develop the idea of an International Credit Regime (ICR): an international institutional structure that provides the enforcement investors need to make foreign investment. This ICR consists of

an Enforcement Structure and a Repayment Structure. The former is the set of institutions that creditors use to enforce repayment, such as the IMF and the U.S. government; the latter is the set of arrangements or policies that debtor countries use to convince creditors that they will not interfere with investments, such as an outward-oriented trade policy that makes debtors vulnerable to trade sanctions. Agreements such as the MAI can be interpreted as elements of an ICR, enabling creditors to sanction recalcitrant debtors, and providing structures for debtors to make themselves vulnerable to such sanctions in order to convince creditors that they, the debtors, will not interfere with creditors' investments.

The North American Free Trade Agreement, while one of the most significant multilateral treaties offering investment protection, is by no means the only such recent agreement. The number of bilateral investment treaties (BITs) for the protection and promotion of international investment has increased extremely rapidly in recent years. In 1960, there were 75 such treaties in existence; by the end of the 1980s, the number had jumped to 386. By January 1, 1997, there were 1330 BITs in existence, involving 162 countries (UNCTAD, 1997b:19).

Countries have been interested in entering into such agreements for many reasons. Perhaps the most important, the disintegration of the Soviet Union and the evident discrediting of its economic model, along with decades of attempted sabotage of alternative development models by the U.S. and international organizations, dramatically enhanced the TINA view prevalent among today's governments: there is no alternative to integration into the world economy. Hence, there has been a large increase in both developed and developing countries' openness to MNCs, and increased willingness on the part of developing countries to enter into treaties to protect foreign investment.[10]

The MAI strengthens the BITs and reinforces pressures for liberalization. The key difference between the MAI and the BITs is the investor-to-state-resolution provisions of

---

[10] This section draws on Crotty, Epstein and Kelly (1998).

the MAI. These allow corporations to sue governments at any level if they think that the agreement has been violated, whereas in BITs, only governments can seek redress. This provision of the MAI provides a gargantuan increase in the international enforcement power of MNCs. With their deep pockets, they would be able to intimidate governments by simply threatening to take them to court over real or perceived interference with their prerogatives.

III.III Rolling Back the State

The ability of MNCs to sue states for imposing regulations and performance requirements could provide them with a powerful tool to fight government controls and regulations, a tool they could never have expected to wield through their national and local governments alone. In this sense, the MAI provides a Trojan horse, having nothing to do with international investment per se, by which domestic and foreign corporations can get leverage over national policies and fight against the ability of democratic governments to regulate the prerogatives of property owners. The issue is different from that portrayed by some populist opponents: it's not that foreigners are usurping national sovereignty. Rather, through the use of an international treaty, it is capital, both domestic and foreign, usurping the rights of citizens and workers in their attempts to influence government policy.[11]

IV. Analyzing the MAI

IV.I The Benefits of MAI

What about the positive benefits that MAI proponents argue might accrue to citizens from more investment, jobs and technology transfer? The MAI will be beneficial to the extent that it increases the quantity or quality of real investment, so for purposes of discussion it is helpful to ask whether the rules are: 1) investment-creating, 2) investment-

---

[11] On these points, see the excellent information being put out on the MAI by NGOs such as the Preamble Center for Public Policy, and Public Citizen's Global Trade Watch.

enhancing, and/or 3) income (or rent) redistributing. We begin by considering investment within the OECD, and then extend the analysis to developing countries.

Investment creation: It is an important empirical question as to how much new real investment will be generated as a result of the MAI within the OECD. There is already a substantial amount of FDI within the OECD from other OECD countries. It seems unlikely that changing the rules along the lines of the MAI would generate a great deal of new investment. Even if it did, the domestic investment forgone would have to be netted out. This effect is likely to be large because of the relatively closed nature of the OECD countries as a group with respect to FDI: if a U.K. company invests in Germany, it is probably not investing in the U.K. or Ireland. So, truly new investment would only be forthcoming if the MAI raised the profitability of investment per se, and not simply made one location more profitable than another. It is likely that the MAI would succeed in doing so only to the extent that it would shift rents from other activities (point three below) or eliminate truly socially wasteful rules and regulations. The burden of proof must surely be on the promoters of the MAI to demonstrate that it would have that effect, but most of the promotional literature is so vague that the question has not even been properly posed.

Investment-enhancing: The MAI could yield benefits if, by eliminating inefficient rules and regulations, it could improve the quality of investment, either by improving access to more profitable sectors, or by allowing more effective use among already targeted sectors. Those who believe that the MAI will promote privatization of inefficient government sectors, or will eliminate socially inefficient performance requirements, are banking on this positive effect. Again, there has been very little in the way of a rigorous attempt to estimate these effects.

Rent (or Income) Redistributing: By altering the distribution of power between workers and citizens on the one hand, and corporations on the other, the MAI could simply redistribute income from workers and citizens to firms, either of this generation, or, by harming the environment, from future generations. By enhancing the bargaining power of

firms relative to citizens, the MAI makes it more likely that firms will capture what gains there are to be had from any increase in investment that occurs. We suspect that, at least within the OECD, this will be the major impact of the MAI.

If the MAI were extended to less developed countries, the analysis of potential benefits is more complicated.[12] The case for the MAI leading to new investment in developing countries is stronger than that made for increased investment within OECD countries, but under the terms of the MAI, which outlaw performance requirements and other government regulation, this may be a phyrric victory. Under the rules of the MAI, even if financial flows arrive, they may not benefit the domestic economy.

For FDI to enhance economic development, it must fit within the overall development strategy (Dunning 1994). But liberalization itself, and the investment treaties that accompany it, often make it more difficult for developing economies to utilize FDI to their best advantage. The early and more recent experiences of the East Asian NICs suggest the flaws in this liberalization approach. Education, infrastructure and other public services played a central role in their development strategies and contributed to decades of success by fostering environments favorable to both domestic and foreign investment. Moreover, this region attracted FDI despite the presence of some of the most restrictive investment regimes in the world. It has only been in the recent context of the liberalization of financial flows in East Asia that crises have emerged, indicating the potential costs to developing countries that the liberalized atmosphere specified in the MAI might bring.

To the extent that the MAI increases or enhances foreign investment in developing countries, we argue constraints imposed on developing country governments make it extremely difficult to capture the benefits of increased FDI and portfolio investment, and are likely to result in merely a re-distribution of what benefits are created away from host countries to multinational investors.

---

[12] This section benefited from the contributions of Trish Kelly.

IV.II What is the Evidence? Capital Mobility and State Tax Competition[13]

If the goal of the MAI and other similar treaties is to dramatically reduce enforcement costs and create a relatively seamless market for foreign investment, if it is successful, what will the effect be? One way to consider this question is to study regional interactions in the United States, a vast market with separate jurisdictions. Here we focus on tax and subsidy competition for corporate investment.

Sometimes called the "War Among the States," the competition among U.S. states for investment and jobs may well be a microcosm of what is emerging in the global arena. With the increased mobility of capital across geographic regions has come heightened competition among U.S. states to attract and retain corporate investment. This competition is obvious in the rush of deals offering multi-million dollar tax breaks and incentives to large corporations in return for in-state investments, as well as in the proliferation of state tax credit programs for firms looking for new production sites. Notable among the numerous large incentive packages offered, the state of Indiana provided $300 million in incentives to United Airlines, South Carolina doled out $135 million in incentives to BMW, Alabama agreed to a $253 million dollar incentives package for the Daimler-Benz Corporation, and Kentucky gave the Defasco Company (a steel producer) $140 million. Some of these high priced deals have aimed not at attracting investment, but simply at keeping corporations from leaving the state; for instance, Sears Roebuck received almost a quarter of a billion dollars in grants and tax breaks from the state of Illinois in 1986 when that corporation threatened to move out of the state.[14]

States have also increasingly written business incentive programs into their tax codes to attract footloose firms. According to Mancon Inc., a firm that tracks business incentive programs, the number of individual state programs across the U.S. offering tax breaks in

---

[13] Our thanks to James Burke, who contributed most of this section on state tax competition.

[14] The figures for these incentive deals are from the *Washington Post*, August 20, 1995, p. A1.

the form of investment tax credits, jobs creation tax credits and property tax abatements has grown from 450 to over 700 in just the last two years.[15] States have also expanded their activities to market these tax breaks to mobile corporations. The average budget of state development agencies (which oversee efforts to attract companies with these incentive packages) has grown from about $18 million in 1986 to about $35 million in 1994.[16]

Although exact figures are difficult to attain, the corporate tax credits and other financial incentives with which states compete for new investment result in billions of dollars in foregone state revenues each year, certainly playing a significant role in the dramatic fall in the rate at which states have collected taxes from corporations in the 1980s and 1990s. The effective state tax rate on corporate income has fallen from 7.5 percent in 1980 to 4.7 percent in 1994. This decline has not come about because of a lowering of the states' statutory rates (which have actually risen on average between 1982 and 1994), but from tax rule changes, including the expansion of corporate tax credits proffered by the states.[17]

The fall in corporate tax collections put additional pressure on state governments, which have cut public services while struggling to balance budgets in the 1980s and 1990s. If corporations were paying at the 1980 effective tax rate in 1994, the states would have received sixty percent more in corporate taxes that year, or another $15 billion in revenues. With the decline in revenues from corporate tax dollars has come a shift of the tax burden to individuals. Between 1980 and 1994 the share of total state revenues coming from corporate income taxes fell by almost three percent (from 9.7 percent to 6.8 percent), while the share coming from personal income taxes rose by 4.4 percent (from 27.1 percent to 31.5 percent).

---

[15] Telephone conversation with Anthony Misino at Mancon.

[16] *Wall Street Journal*, March 8, 1995, p. A2.

[17] Statutory tax rates for the states can be found in the *Directory of Incentives for Business Investment and Development in the U.S.* and in *American Business Climate and Economic Profiles*.

Competitive business incentive policies by the states have a natural propensity to expand. As one state institutes a new tax break or subsidy, other states feel compelled to expand their incentive packages. The frantic competition among the states rewards firms for being mobile as the gains from relocating become ever higher. In this way, the growth of incentives may even further encourage the capital mobility that has driven the proliferation of these competitive programs in the first place.

In fact, past studies have shown that tax incentives have generally been either ineffective or relatively unimportant in determining the location decisions of firms (Carlton, 1983; Waits and Heffernon, 1994). A study by Head, Ries and Swenson (1994) suggests that these kinds of state incentive programs have now become so widespread that they basically offset each other in attracting new investment. Thus, the last decade's proliferation of "beggar thy neighbor" incentive programs may not have actually generated any significant change in the distribution of production among states. For many states, the end result has likely been a "race to the bottom," with little gain in jobs, less corporate tax revenues for the states, and fewer public services and higher taxes for the public.[18]

Ending this competitive downward spiral would allow states to use the billions of dollars in funds now being siphoned off by special incentives to mobile corporations on the promotion of sound economic development - good physical infrastructure, high quality education and a well-trained workforce. A cooperative regime in which states competed with each other on the basis of these factors - rather than low corporate taxes or wages - could be key to putting states on the path of a high wage "climb to the top" as they confront a new world of rising corporate mobility.

---

[18] A report by the Federal Reserve Bank of Minneapolis, entitled *Congress Should End the Economic War Among the States* (1994), decried the tax competition among U.S. states and locales for investment by large companies. The Bank argued that competition lowers domestic tax revenues below desired levels and may distort the location of domestic investment (see also Holmes, 1995).

This type of competitive bidding for mobile capital is a practice that extends well beyond the United States, and with similar consequences. Hence a *global* treaty, rather than purely national policies or agreements within specific regions, is of central importance for any alternative international governance structure.

V. Alternatives to Neo-Liberal Governance of FDI

If we are correct, that the type of globalization represented by the MAI is on balance harmful to the majority of workers and citizens, then what are the alternatives to the MAI and similar attempts to construct an International Credit Regime?

One alternative is to roll back globalization. Countries could put up various protective barriers to trade, FDI and portfolio flows. Is this a feasible and desirable strategy? We think the answer is yes and no. Certain forms of globalization have very negative effects such as speculative, short-term capital inflows and outflows; these transactions can and should be restricted. International trade in general can often have very strong net benefits. FDI is much more of a mixed bag, and ought to be regulated more on a case by case basis, but international competition for investment may undermine a country's ability to regulate FDI in this way. As a result, international arrangements which can underpin a leveling up, rather than a race to the bottom or a rolling back of the state, are necessary to the proper regulation of FDI and capital flows generally.

What would such an alternative set of arrangements look like? Using the framework outlined in section III above, the goals of such arrangements would be two-fold: 1) to reduce the conflict between the needs of workers and citizens and the incentives facing corporations, and 2) to reduce the power bias currently in favor of corporations relative to citizens and workers so that corporations will not be able to ratchet down legitimate and desirable social protections. There are two other goals which we have not discussed explicitly but which are important to keep in mind: 3) environmental protection (in addition to social protection) - reminding us that the goal is not to maximize foreign investment but to optimize it by taking into account true social costs, and 4) contributing to or at least not

interfering with poverty reduction in the poorer countries of the world. Social protection in industrialized countries should not unduly interfere with productive and efficient transfers of resources to poorer countries that will actually benefit those at the lower rungs of the world income distribution.

We see the architectural layout for reaching these goals as a structure akin to a building, complete with *floors, windows, meeting rooms*, and *elevators*; and every building needs good *insurance*.

Floors To prevent the leveling down process, international floors on key variables and policies are required. These should include:

international tax floors: This floor would outlaw tax and subsidy bidding for FDI to stave off a race to the bottom. Special dispensations could be made for particularly poor or disadvantaged regions where lower productivity levels need to be offset beyond what lower wage rates can provide.

regulation floors: Similarly, any offer of substantial regulatory reduction ought to be approved by a commission, housed in an appropriate international institution such as the ILO, UNCTAD or the WTO. These would include labor and environmental regulations.

minimum wage floors: A set of international minimum wages that apply to MNCs ought to be negotiated among countries. These minima should be high enough to contribute to poor workers' living standards, but should not be so high as to unnecessarily choke off investment.[19]

To make these floors operate properly, two other parts of the building are necessary: *windows* and *meeting rooms*.

Windows Rules are required to make MNC and government operations more transparent. Today, it is extremely difficult to grapple with tax, regulatory and subsidy abuse because many of these policies are kept secret. Firms and governments should be

---

[19] See Pollin and Luce (1998) on "living wage legislation"; this can be extended to the international level.

required to reveal all tax, subsidy and regulatory treatment given to a corporation. This information should be easily accessible to the public.

Meeting rooms To create, administer, and alter these floors, international governing bodies must be democratically organized. They should represent not only national governments, but have members of labor unions and NGOs on their bodies, making it more likely that there will be true representation of citizens.[20] As it is, the only groups besides governments that sit around the negotiating table are corporations.

Elevators These rules of the game will not be sufficient to reduce the pressure for leveling down without elevators. Elevators are policies and institutions that maintain sufficient levels of aggregate demand, providing more security and employment for workers and citizens. Without adequate demand, temptations to violate floors out of desperation will become overwhelming, and workers will lose the bargaining power that comes with low levels of unemployment. Policies to maintain aggregate demand can be implemented at both the international and domestic levels. They include expansionary monetary policy at the domestic and regional levels, with circuit breakers such as short-term capital controls to prevent excessive exchange rate instability.[21]

Insurance In exchange for abiding by these principles, an international body could be established to insure corporations against expropriation. This insurance would be the carrot that would help convince corporations to abide by these rules. It could also provide a worker friendly Enforcement Regime that would underpin an adequate flow of FDI.

VI. Conclusion

More citizen and labor friendly rules of the game are both feasible and necessary to reduce and even reverse “race to the bottom” pressures emanating from globalization.

---

[20] These representatives should be drawn from both the developed and developing world so that outcomes are the result of an inclusive negotiating process.

[21] See Pollin (1998).

Those pressures stem both from the external economic forces that result from globalization, and also from attempts by corporations to use the new political and legal architecture being created to undermine national and local democratic rights.

While there are likely to be genuine and even significant benefits from some aspects of globalization, proponents of the MAI and other international agreements fail to demonstrate such benefits, often simply falling back on ideological or tautological claims. In fact, the economic effects of the currently negotiated MAI are likely to be negative, in both the developed and developing world. Much further research is necessary, however, before the costs and benefits of such agreements can be known with any certainty.

The most hopeful aspect of the newly emerging globalization is the ways in which citizens and labor groups in many parts of the world are mobilizing and joining forces to criticize, oppose and develop new alternatives to the neo-liberal architecture being constructed by corporate-influenced governments. These efforts, for the most part, are taking what we believe to be the appropriate steps of not simply trying to retreat behind the walls of nation states, a strategy which we argue is likely to fail, but proposing new international structures for regulating international economic interactions. At the same time, more control of short-term capital and other aspects of globalization is needed at the national level to enhance the power of these global coalitions to influence the emerging rules of the game.

Table 1
Measures of Globalization, 1913-1996

	1913	1950	1990s
World exports/GDP (%)	8.7	7.0	13.5
Manufacturing exports as percentage of total exports			
Asia	21.2	25.3	73.4
Latin America	3.2	2.3	48.7
FDI (stock) relative to world output	9.0	4.4	10.1
World overseas assets/ exports (%)*	1.9	NA	2.1
Funds raised on international financial markets as percentage of world exports	NA	0.5	20.0

Source: Baker, Epstein and Pollin (1998).
*World overseas assets/world exports: 1885: 2.2; 1938: 1.6.

Table 2
Central Government Expenditures as a Share of National Income (C) and Military Expenditure as a Share of Central Government Expenditure (M), 1870-1994 (Percent)

	1870		1914		1950		1994	
	C	M	C	M	C	M	C	M
France	15.0	34.3	11.8	28.8	33.2	42.5	47.2	5.6
Germany	5.5	…	7.0	…	…	23.7	34.0	5.9
Great Britain	5.0	…	8.0	25.0	39.2	13.1	42.7	10.1
Sweden	5.3	…	7.5	…	21.3	20.0	51.0	5.3
U.S.	4.7	32.6	2.4	69.1	17.3	50.2	22.0	18.0

Source: Authors’ calculations, Woytinsky and Woytinsky; U.N. (1997).

Table 3
Indicators of Growth of International Economic Activity, 1964-1994
(average annual percentage change)

Period	World export volume	World FDI Flows	International bank loans	World real GDP
1964-1973	9.2	…	34.0	4.6
1973-1980	4.6	14.8	26.7	3.6
1980-1985	2.4	4.9	12.0	2.6
1985-1994	6.7	14.3	12.0	3.2

Source: Crotty, Epstein and Kelly (1998); UNCTAD (1997a: Table 24, p. 71).

Table 4
Regional Distribution of the Stock of Inward FDI, 1980 and 1996

Inward stock of FDI as a percent of the total:	**1980**	**1996**
Developed	78	70
U.S.	17	20
European Union	39	38
Developing	22	28
Latin America	10	10
Asia	10	17
Hong Kong and China	0.4	5.5

Source: UNCTAD (1997b: Annex table B.3 and authors' calculations).

References

Baker, Dean, Gerald Epstein and Robert Pollin. 1998. "Introduction," in Dean Baker, Gerald Epstein and Robert Pollin, eds. *Globalization and Progressive Economic Policy: What are the Real Constraints and Options?* Cambridge, UK: Cambridge University Press.

Barnet, Richard and John Cavanaugh. 1994. *Global Dreams; Imperial Corporations and the New World Order*. New York: Simon and Schuster.

Block, Fred. 1973. *The Origin of International Monetary Disorder*. Berkeley: University of California Press.

Bowles, Samuel and Herbert Gintis. 1990. "Contested Exchange: New Micro-Foundations for the Political Economy of Capitalism," *Politics and Society* 18(2): 165-222.

Carlton, Dennis. 1983. "The Location and Employment Choices of New Firms: An Econometric Model With Discrete and Continuous Endogenous Variables," *Journal of Economics and Statistics* 65: 440-449.

Crotty, James and Gerald Epstein. 1996. "In Defense of Capital Controls," *Socialist Register*: 118-149.

Crotty, James, Gerald Epstein and Trish Kelly. 1998. "Multinational Corporations and the Neo-Liberal Regime," in Dean Baker, Gerald Epstein and Robert Pollin, eds. *Globalization and Progressive Economic Policy: What are the Real Constraints and Options?* Cambridge, UK: Cambridge University Press.

Dunning, John H. 1994. "Re-evaluating the Benefits of Foreign Direct Investment," *Transnational Corporations* 3(1): 23-51.

Epstein, Gerald and Herbert Gintis. 1992. "International Capital Markets and the Limits of National Economic Policy," in Tariq Banuri and Juliet Schor, eds. *Financial Openness and National Autonomy*. Oxford: Clarendon Press.

Federal Reserve Bank of Minneapolis. 1994. "Congress Should End the Economic War Among the States," *Annual Report*. Minneapolis: Federal Reserve Bank of Minneapolis.

Head, C. Keith, John C. Ries and Deborah L. Swenson. 1994. "The Attraction of Foreign Manufacturing Investments: Investment Promotion and Agglomeration Economies," NBER Paper No. 4878.

Helleiner, Eric. 1994. *States and the Resurgence of Global Finance*. Ithaca: Cornell University Press.

Hirst, Paul and Grahame Thompson. 1996. *Globalization in Question*. Cambridge: Polity Press.

Holmes, Thomas J. 1995. "Analyzing a Proposal to Ban State Tax Breaks to Businesses," *Federal Reserve Bank of Minneapolis Quarterly Review*: 29-39.

Lipson, Charles. 1986. *Standing Guard*. Berkeley: University of California Press.

Milberg, William. 1998. "Technological Change, Social Policy and International Competitiveness," working paper on Globalization, Labor Markets and Social Policy. New School for Social Research, New York.

OECD. 1997. "The Multilateral Agreement on Investment," OECD Policy Brief No. 2-1997.

_______. 1996. *Towards Multilateral Investment Rules*. Paris: OECD.

Rodrik, Dani. 1997. "Has International Economic Integration Gone Too Far?" Washington, D.C.: Institute for International Economics.

Sutcliffe, Bob and Andrew Glyn. 1998. "Still underwhelmed: Indicators of globalization and their misinterpretation," *Boston Review*, forthcoming.

Pollin, Robert. 1998. "Can Domestic Expansionary Policies Succeed in a Globally Integrated Environment? A Consideration of Alternatives," in Dean Baker, Gerald Epstein and Robert Pollin, eds. *Globalization and Progressive Economic Policy: What are the Real Constraints and Options?* Cambridge, UK: Cambridge University Press.

Pollin, Robert and Stephanie Luce. 1998. *The Living Wage: What It Is and Why We Need It*. New York: The New Press.

United Nations. 1997. *Human Development Report*. New York: United Nations.

UNCTAD. 1997a. *Trade and Development Report*. New York: United Nations.

_______. 1997b. *World Investment Report*. New York: United Nations.

Waits, Mary Jo and Rick Heffernon. 1994. "Business Incentives: How to Get What the Public Pays For," *Spectrum*, Summer: 34-40.

Appendix: A Simple Model of the Effects of the MAI on Social Welfare

In this section we develop a simple (and indeed, a simplistic) model to illustrate the impact of the MAI. The model uses as its framework the basic idea that as globalization increases, there will be two opposing tendencies operating on the policy structures of domestic economies. On the one hand, there will be pressures toward a "race to the bottom," that is pressures for cutting the role of the government, including the social protections of the welfare state, in order to allow firms to be more competitive and to help the country compete as a site for foreign investment (Barnet and Cavanaugh, 1994). On the other hand, there will be pressures for the government to take on more responsibilities as globalization creates losers as well as winners, and as it generates more insecurity by accelerating the pace of change. These pressures will tend to enlarge the size of the state and the amount of social protection (Rodrik, 1997).

These opposite pressures can operate simultaneously: the demand for more social protection, a la Rodrik, and the race to the bottom, or the declining willingness of capital to supply protection as openness increases. Figure 1 illustrates these in a simple diagram, the supply and demand for social protection. The "demand for social protection" is upward sloping, reflecting the fact that as openness to the international economy increases, citizens and workers will need more social protection to protect them from the vagaries of the market. The "supply of social protection" represents firms' willingness to pay taxes to support government social protections, as well as the willingness firms have to provide these at the firm level, including the toleration of unions, the payment of health benefits, and other firm level benefits. The line G represents the exogenously given level of globalization, reflecting firms' exit options as well as the pressure on firms coming from trade competition.

A shift out in G represents an exogenous increase in the level of globalization, that is, an enhancement in the exit options available to firms, as well as an increase in the international competition facing domestic firms. As G shifts out, a wedge develops

between the social protection that citizens and workers need, and that which capital wants to provide (figure 1). This sets up a power struggle for institutional change which could take place at the level of the state or the level of the firm or both. Where the economy will end up depends on the relative power of the two groups, the institutional structures in place, and significantly, the level of globalization itself. Figure 2 illustrates this relationship between globalization and the outcome of the bargaining process over social protection in the case where the higher the level of globalization, the closer the outcome will be to those desired by capital (the "supply" curve). This outcome is illustrated by the "contract curve," which represents the locus of bargains settled on as globalization increases. By enhancing the exit options of firms, globalization enhances their power relative to citizens, workers and the state. This allows firms to win a better deal in the struggle for social protection represented (see Crotty and Epstein, 1996; and Crotty, Epstein and Kelly, 1998).

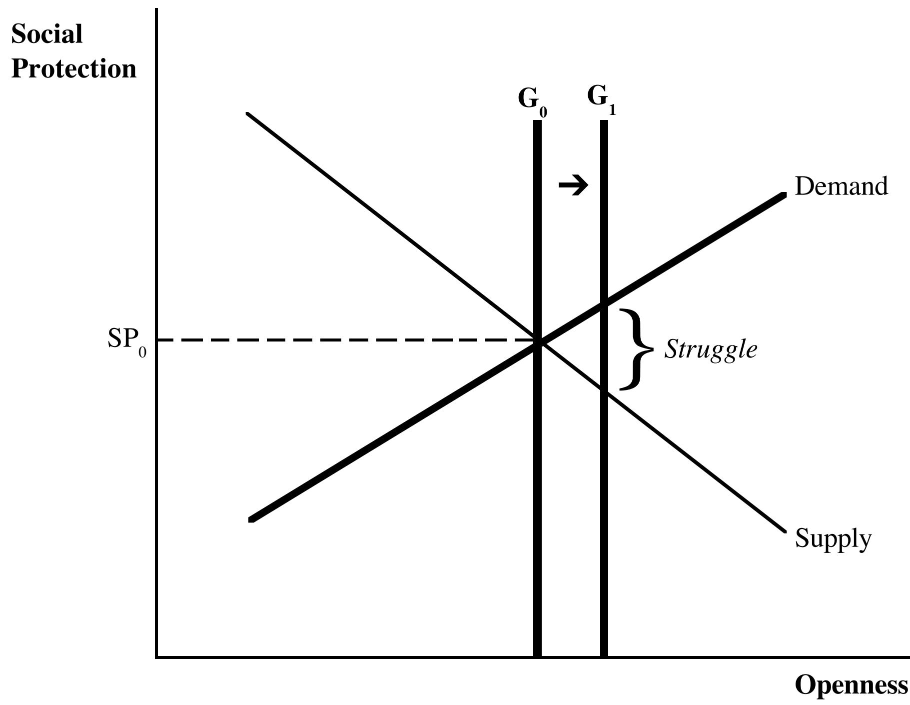
We can use this simple apparatus to illustrate the effects of the MAI. By increasing the power of the international enforcement structure, the MAI will cause a shift out in the G line, the exogenous level of globalization, hence widening the gap between the needs of citizens and that of firms. This is the enforcement effect. But the MAI will also have a second effect (see figure 3). By reducing the power of central and local governments, it will reduce the effective demand for social protection that citizens can generate and therefore will lower the level of social protections that they will receive. This is illustrated by a shift downward of the demand for social protection curve. This is the "Trojan horse" effect.

Note that the supply of social protection may be upward sloping. Through agglomeration effects and economies of scale, more openness may be associated with greater demands for infrastructure, education, and high performance work structures on the part of firms (see Milberg, 1998). By generating a "climb to the top" these effects may moderate or even eliminate the negative impacts of globalization. But as long as the need for social protection increases at a faster rate than the supply (the slope of the demand curve

is higher than that of the supply curve), the same dilemma, though quantitatively smaller, will still exist.

This framework is also useful for illustrating how alternatives to the MAI might work. "Elevators" such as increases in aggregate demand would shift (or rotate) down the demand for social protection curve because the greater availability of jobs would increase security; increases in aggregate demand would also shift up (rotate up) the supply curve because by increasing export markets, it would reduce the pressure on firms and governments to cut jobs. (See figure 4.) Both effects reduce the scope of social struggle and bar against the leveling down process that might come with globalization. "Floors" rotate the demand for social protection curve down, as citizens require less social protection for any given level of openness. They can also have bargaining power effects, moving the contract curve of figure 2 closer to the needs of citizens rather than firms.

Figure 1
Demand for and Supply of Social Protection



Demand: workers and citizens from firms and the state
Supply: capital supplies at firm level and to the state
G: exogenous level of globalization

Figure 2
Effects of globalization on social protection when it favors capital's bargaining power

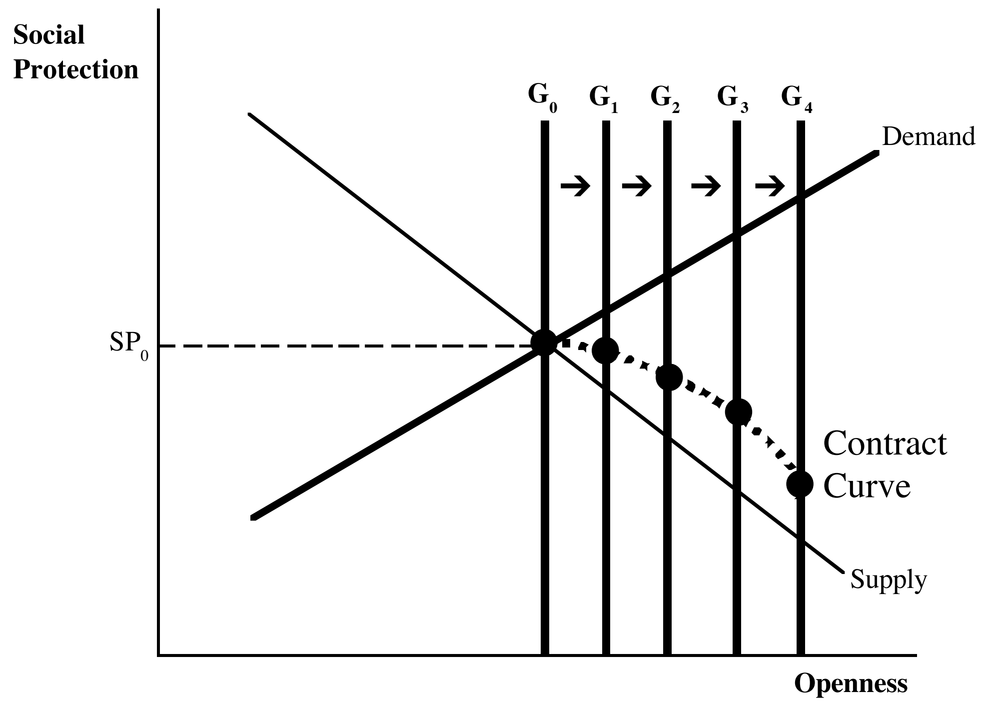
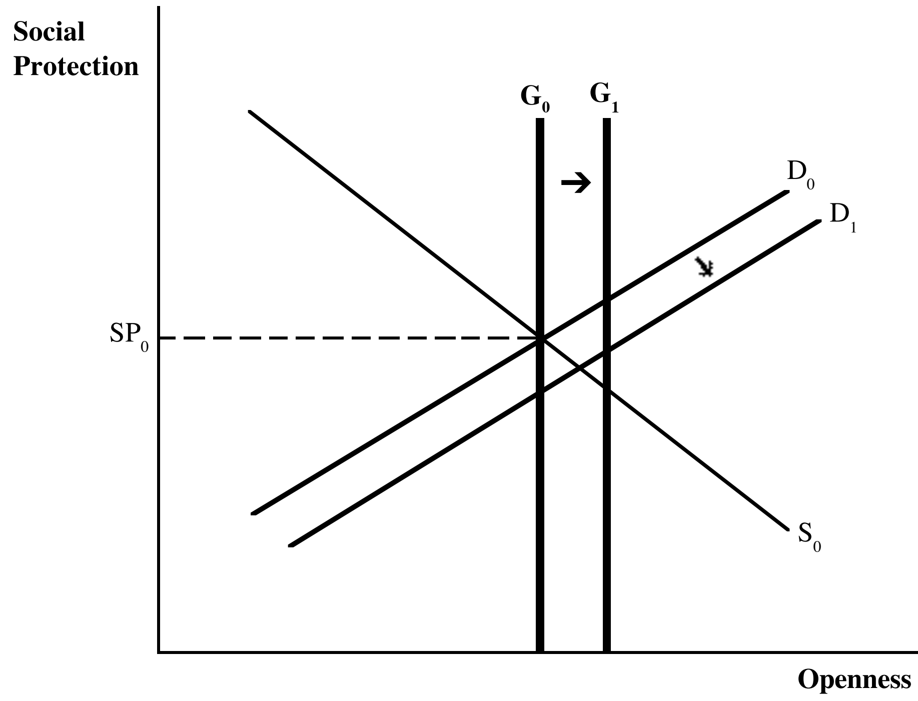


Figure 3
The Effects of the MAI



$G_0 \rightarrow G_1$: Enforcement effect
$D_0 \rightarrow D_1$: Trojan horse effect

Figure 4
The Effect of Increases in Aggregate Demand on Social Protection