

**Working Paper Number 64**  
**Regulating Large International Firms**

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*This paper explores the existing arrangements for multilateral regulation of large firms, and makes the case for balancing strengthened global corporate property rights with more explicit and enforceable social obligations. In a democratic market-based society, investors have legally enforceable rights but must also obey laws designed to protect labour, consumers and the environment, while competition regulations are designed to counter market power and business taxes ensure the provision of public goods. Strengthened multilateral co-operation in three related areas - investment, tax and competition – is under way. Although progress is slow and contested, the distinct interests of host and home countries are clear and the 'development dimension' broadly recognised. In marked contrast, corporate conduct on labour and environmental issues is still almost exclusively regulated at the national level. Moreover, external standards of international corporate responsibility in developing countries are set by voluntary initiatives at best, with market incentives rather than legal requirements constituting the basis for compliance. A better approach would be a multilateral definition of the obligations of international firms that is explicitly linked to the guarantee of property rights. These obligations might reasonably include international taxation, competition rules and stakeholder issues such as employment conditions and environmental protection. The ongoing process of regional integration – particularly in Europe – could present an additional opportunity for such a definition.*

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## 1. Introduction

The process of globalisation has created an evident asymmetry in global factor markets: there is largely free movement of goods and capital; while services and labour remain largely confined within to national borders. Indeed, the value of the goods and services directly delivered by these firms in foreign countries now exceeds that of global exports.<sup>1</sup> This means not only that large international firms have become the effective bearers of economic globalisation, but also that the economic (and social) externalities of their business activities have become central to economic development. In the absence of international legal instruments to adequately deal with international firms, global intergovernmental institutions constrain governments which are then supposed to regulate firms which are located in their territories – whether headquarters or subsidiary. This creates a serious negotiating asymmetry between large firms and small countries, particularly if powerful home country governments support ‘their’ firms.

Developed countries see little reason in principle to treat international firms<sup>2</sup> differently from any large ‘domestic’ firm, who are (or potentially) multinationals in effect. Increasingly this is also true of developing countries themselves: not only the capital exporters such as Korea, Singapore and Taiwan; but also all middle-income countries have their own international firms. Low income countries too – from China and India on the one hand, the Ghana and Nicaragua on the other – have much of their capital abroad and domestically owned firms which operate across frontiers, and thereby can escape the regulators and – possibly more important – the tax authorities.<sup>3</sup> The case for international regulation of firms no longer rests, therefore, merely on the desire to curb the power of large multinational investors within developing countries; but from a wider agenda which includes large domestic firms and in principle places governments north and south in common cause.<sup>4</sup>

Modern market regulation has been built up at the national level from the interplay of two forces. First, the interests of the ‘firm’ (controlling shareholders and senior management) in the growth of asset value. Second, a combination of consumer pressures, stakeholder interests (employees, minority shareholders and local communities) and the objectives of the state itself. At the international level there are major complications. On the one hand, the weakness of the international political community is mirrored by the virtual absence of international commercial law.<sup>5</sup> It is far from clear – even in principle - how these conflicts are to be resolved, and by whom. On the other hand, the national governments involved are of unequal influence, and in particular large states such as the EU and the US (that naturally reflect the interests of their firms, stakeholders and consumers) effectively define both the agenda and the progress of negotiations.

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<sup>1</sup> See UNCTAD (2000a).

<sup>2</sup> Sometimes known as ‘foreign’, ‘international’, ‘multinational’ or ‘transnational’ firms – the point here being that they are domiciled in one jurisdiction and operate in another, and thus come under to distinct regulators.

<sup>3</sup> Indeed a case can be made for considering even poor households in developing countries as ‘transnational firms’ insofar as they have members abroad remitting funds.

<sup>4</sup> See DfID (2000).

<sup>5</sup> See Sauvart and Aranda (1994).

This paper examines four dimensions of current negotiations on the international regulation of international firms in order to throw some light on this problem: investment treaties; corporate taxation; competition law; and labour/environmental codes. As a whole they make up much of the equivalent 'matrix' to domestic regulatory structures, with the possible exception of consumer protection.<sup>6</sup> Section 2 looks at international investment negotiations, where the apparent conflict between 'north and 'south' has been most explicit, and the interest of 'multinationals' versus 'poor countries' (or even 'poor people') seems most apparent. Rather less advanced in terms of international negotiations, but none the less profoundly important for the future of international firm regulation, is international tax co-ordination, which is discussed in Section 3. Section 4 explores competition rules, which have recently been taken up by the EU as the solution to abuse of international market power –despite the lack of clarity as to principles and procedures. These three are being pursued on an intergovernmental basis and presume (at least in principle) a potential legal framework defining the rights and obligations of international firms.

The current approach to labour and environmental standards on the basis of voluntary codes is discussed in Section 5, where a contrast is drawn between the use of economic incentives and statutory powers to achieve a socially desirable outcome. Section 6 addresses the problem of how obligations on international firms might be introduced to match their claim for international property rights despite the political economy of the slow and uneven progress towards the international regulation of business in general, and their activities in developing countries in particular. Section 7 concludes.

## **2. International Investment Negotiations and Global Property Rights**

The lack of a clear international legal infrastructure for investor protection continues to hamper the establishment of a global market in long-term capital.<sup>7</sup> Investment issues are becoming a key element of commercial relations between states, now that the basic principles of free trade have been settled in the WTO, and the provision of services depends upon the commercial presence of an international firm in the host market. Among the advanced industrial countries, investment issues are settled under a number of (non-binding) OECD instruments. However, in the late 1960s, a number of European investor countries perceived a need to protect their assets in developing countries and started to negotiate bilateral investment treaties (BITs) with them.

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<sup>6</sup> Although it could be argued that international agencies such as the WHO (drugs), FAO (foods) and ICAO (air transport) do represent an embryonic form of global consumer protection.

<sup>7</sup> For a succinct overview of the major developments in the history of international business regulation and investor protection, see Muchlinski (1999).

BITs focus solely on investment issues and make binding provisions on expropriation, the transfer of payments, and compensation for losses due to armed conflict or internal disorder. These benefits may be accorded on a national treatment (NT) or Most-Favoured-Nation (MFN) basis.<sup>8</sup> A broad definition of investment is used, covering direct investment, portfolio holdings and non-equity forms of investment. However, protection is only granted to investors with real links to one of the countries are parties to the agreement. BITs usually provide for the resolution of investor-state disputes in private institutions (such as the arbitration centres of the International Chamber of Commerce) or the International Centre for the Settlement of Investment Disputes (ICSID) of the World Bank. However, in contrast to their specificity with respect to investment protection, BITs usually make few commitments about liberalising investment restrictions. National treatment rarely extends to the pre-entry phase (i.e. the right of establishment in a particular sector) and few BITs contain provisions on investment restrictions such as performance requirements.<sup>9</sup>

Attempts to co-ordinate investment policies between larger groups of countries have a mixed record of success. They have been most successful where countries are highly interdependent in their trade and investment flows, the most notable example being the EU Treaty of Rome. In contrast, regional trade agreements among developing countries tend to contain only fairly rudimentary investment provisions, even in the case of ambitious integration agreements such as Mercosur. However, there are a growing number of preferential trade agreements between developed and developing countries that do incorporate investment provisions. These treaties usually include commitments on non-discriminatory treatment and disciplines on investment restrictions. The investment provisions in the North American Free Trade Agreement (NAFTA)<sup>10</sup> and the EU association agreements with countries in Central and Eastern Europe are binding and considered stringent. In contrast, the agreements between rather loose and diverse groupings such as ASEAN and APEC are weak and usually non-binding.

The ambitious investment protection provisions included in the NAFTA served as a blueprint for the OECD-based negotiations on a Multilateral Agreement on Investment (MAI).<sup>11</sup> The MAI talks were discontinued in October 1998 following opposition developing country governments, the failure of the US and EU to agree on a number of key issues – and widespread protests from labour and environmental groups. None the

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<sup>8</sup> NT involves firms being treated at least as well (in terms of investment licences and trade restrictions, for instance, but *not* taxation) as domestic firms, ‘under like circumstances’. MFN involves foreign firms in a particular country being accorded conditions at least as favourable as the best enjoyed by firms from any other country.

<sup>9</sup> Which typically oblige foreign firms to use a certain proportion of domestic inputs, or to export more than they import, for example.

<sup>10</sup> The Mexican government was required to liberalise its investment policies significantly in order to conform with the agreement, but has subsequently extended the substantive rights (in Chapter 11:A) to foreign investors from outside North America. However, as an OECD member since 1994 it would have had to do this in any case. There are also widespread exemptions from NAFTA disciplines, including energy and transport sectors (Mexico), cultural industries (Canada), maritime transport (US) and agriculture in all three countries. These exemptions have set important precedents for any future multilateral negotiations.

<sup>11</sup> See FitzGerald (1999).

less, US negotiators continue to use NAFTA as a benchmark for any future investment agreement negotiated at the multilateral level. Bilateral and regional investment treaties must in any case be consistent with the disciplines set out in the WTO agreements, including those on competition policy. The WTO agreements already contain important principles relating to the four main issues linked to investment (national treatment, transparency, investor protection and dispute settlement). There is therefore some logic in resuming multilateral investment negotiations within the WTO framework.

The existing WTO provisions on investment are scattered across a number of separate agreements. The National Treatment and Most Favoured Nation obligations imposed on governments by current WTO rules are worded in much the same way as the relevant clauses in existing investment accords.<sup>12</sup> The treatment of foreign firms can only be materially different from that of national firms if the situation of foreign firms is not comparable (as is the case in many service industries and above all where domestic firms are small and/or using traditional techniques). However, the next round of negotiations will have to decide whether to modify the existing WTO rules so that the national treatment obligation applies to the pre-entry phase (i.e. right of establishment), which would go well beyond most bilateral and regional investment agreements. Any future investment agreement would also need to contain provisions requiring host governments to make and enforce rules in a transparent way.<sup>13</sup> However, the right of national governments and central banks to intervene in pursuit of monetary and exchange rate stability is explicitly recognised under most bilateral investment treaties, and under the rules of the IMF. In a payments crisis, the WTO commitments to provide foreign exchange for firms to repatriate profits, pay royalties or service loans are not considered to be binding.

The new trade round is thus likely to consider investment issues, but WTO members are divided in their attitudes. The rudimentary WTO disciplines could be codified and strengthened, but the WTO's inability to hear disputes between states and private investors will remain a problem for the latter. Unlike the NAFTA (and the MAI draft) where firms can bring such cases, under bilateral agreements foreign investments may only be expropriated for a public purpose on a non-discriminatory basis and compensation must be prompt, adequate and effective. The draft MAI would have extended these safeguards (following the precedent set by NAFTA) to include measures taken by governments which have an 'equivalent effect' to outright expropriation. In US commercial law, this language has been interpreted to encompass government actions that have reduced the commercial value of investments. The inclusion of such broad language contributed to the failure of the MAI talks because in many jurisdictions it would have provided a higher level of protection to foreign investors than that available to their domestic counterparts. Environmentalists and labour rights activists argued that such terms would prevent national governments from taking any action to uphold or

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<sup>12</sup> For example, the clause on 'like circumstances' in GATS Article XVII is similar to that in NAFTA Article 1102.

<sup>13</sup> Article X of the General Agreement on Tariffs and Trade (GATT) requires governments to disclose all relevant provisions affecting investment. Article 6 of the Agreement on Trade-Related Investment Measures (TRIMS) and Article III of the GATS both contain notification requirements for investment rules.

introduce social and environmental safeguards if doing so would reduce the value of foreign investments.

Any eventual WTO treaty on investment would thus be much less ambitious than the failed OECD-based multilateral agreement, but the negotiations are nonetheless likely to be difficult and prolonged. The aim of the negotiations would be to establish a common set of multilateral rules providing a simplified, secure and predictable legal environment for international investment. This is intended to be a binding multilateral framework encompassing existing bilateral agreements and practices; it would replace existing international agreements on investment issues. Negotiating an MFI is likely to be extremely complicated. The substantive provisions are unlikely to go beyond requiring national treatment for foreign investors and compensation for expropriated property.

The EU and Japan are keen to negotiate a WTO-based investment instrument, but the United States appears to be less so, as it does not feel as free to achieve its own interests (and those of US firms) through potential multilateral agreements as it already is through bilateral arrangements. Many developing countries remain opposed as the main effect would be to require developing and transition economies to liberalise their foreign investment regimes. However, any such agreement would need to be both flexible and gradual, as is already the case in the investment-related aspects in the GATS.<sup>14</sup> It would not prevent countries legislating in favour of certain domestic regions or targeting support for specific sectors or firm categories, provided it did not discriminate between domestic and foreign investors. In particular it does not limit government regulation on social, health and environmental issues.<sup>15</sup> In fact, most middle-income and small poor countries have already opened up radically in recent years. However, the two large low-income countries of most interest to investors (India and China) continue to maintain considerable controls on investment. Among the developed countries, Japan will also come under pressure (particularly from the United States) to open up its commercial and banking sectors.

The United States itself will also come under pressure during the negotiations to accept some disciplines on its use of investment rules to secure the extraterritorial application of US laws. The EU and Canada will presumably continue to oppose the extraterritorial application of US laws under the Cuban Liberty and Democratic Solidarity Act (the Helms-Burton law) and the Iran-Libya Sanctions Act (ILSA). EU and Canadian officials will be reluctant to conclude an investment agreement that leaves the US investments of their own companies liable to be expropriated for extraterritorial breaches of unilateral US trade embargoes. However, any multilateral investment treaty will have to be ratified by the US Senate, so the room for a compromise on extraterritoriality may be limited.<sup>16</sup>

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<sup>14</sup> General Agreement on Trade in Services at the WTO.

<sup>15</sup> For instance, it permits the over-riding of patent rights ('compulsory licensing') in order to provide generic drugs for HIV/AIDS treatment.

<sup>16</sup> Washington will probably also demand a blanket exemption for national security policies, as it did in the draft MAI.

### 3. International Taxation Co-operation

Current international capital income taxation arrangements pose particular problems for poor countries for three reasons. First, need for a fair share of potential fiscal resources generated by trans-border firms (both foreign and domestic) to service debt and supply basic social services. Second, the socially inefficient consequences of tax competition between developing countries in order to attract foreign investment, leading to declining rates and revenues. And third, difficulties in taxing income from overseas assets held by domestic residents, tax avoidance stimulating capital flight and loss of vital resources to poor countries. Developing countries also face the issue of how to balance between maximising their share of revenues and maintaining a climate that attracts inward investment (and retains their own investors). This involves implicit agreements on the sharing of revenues between host and home countries as well as explicit agreements on the methods to be adopted (including the definition of 'permanent establishment').<sup>17</sup>

Pressure for effective international co-operation to facilitate income tax collection is increasing. The increasing mobility of capital across national borders poses serious problems for national fiscal authorities committed to taxing income from wealth. Co-operation between tax officials could reduce some of these problems, but jurisdictional disputes and bank secrecy laws in tax havens have so far blocked it. For developing countries capturing tax revenue on the income of their own residents who have assets overseas is a major problem too. In consequence, closer international collaboration (even within the existing extensive network of double taxation treaties) by sharing information and permitting joint actions could increase the fiscal resources available to developing countries dramatically.<sup>18</sup> Further benefits would stem from this, including disincentives to capital flight, increased fiscal and macroeconomic stability, and greater resources available for poverty alleviation.

Standard theories of international taxation suggest that the tax burden should fall most heavily on those factors of production which are least mobile, in order to maximise the government's revenue. The process of globalisation has resulted in a significant liberalisation of cross-border capital flows over the last two decades, but there has not been a corresponding relaxation of the stringent rules covering the movement of natural persons. Capital has therefore become relatively more mobile and there has been a corresponding shift in the incidence of taxation from capital to labour as governments have tried to maintain their income levels.<sup>19</sup>

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<sup>17</sup> Reducing regulatory uncertainty is more important to investing firms than the particular concessions or incentives that a treaty may contain – which appear to be regarded as a 'windfall gain' rather than the basis for long-term investment decisions. See UNCTAD (1995).

<sup>18</sup> See Frenkel, Rain and Sadka (1991).

<sup>19</sup> As a result, corporate taxes account for only 8% of fiscal revenue in OECD member countries, equivalent to just 3% of GDP. The most recent data published by the US Department of Commerce show that the rate of income tax paid by the overseas subsidiaries of US corporations declined sharply between the mid-1980s and the mid-1990s. On a worldwide basis, the tax rate paid on gross corporate income declined from 42% to 28%. Since US overseas assets increased from 236 billion dollars in 1983 to 778 billion in 1996, the tax rate relative to these assets declined even more sharply from 13% to 6%. This trend has been common to all

There are two main principles that underlie the jurisdictional basis of national tax systems, although most countries employ a mixture of them. The source principle relates jurisdiction to the source of income or the site of economic activity. A country will tax all income earned from sources within its territory, whether it accrues to residents or non-residents. Income earned abroad by residents is not taxed. The residence principle relates jurisdiction to the residence or fiscal domicile of the earning entity. A country will tax the worldwide income of persons (natural or corporate) resident or domiciled in its territory. Income earned domestically by non-residents is not taxed.

Developed countries tend to adopt the residence principle, since they usually have a net positive foreign asset position and the residence principle maximises their tax take. Developing countries typically favour the source principle because they host significant amounts of FDI; although a number of emerging markets such as Mexico and Argentina have moved from source to residence taxation in an attempt to stimulate foreign investment and capture income from their residents' overseas assets. The resulting clash of jurisdictions and principles leads to severe problems for multinational corporations operating in more than one jurisdiction, since they may be taxed more than once on the same income.

Double taxation treaties attempt to counter this problem by allocating tax rights between the country in which an individual or corporation is resident and the country which is the source of their income or capital gains. Most double taxation treaties are modelled on either the OECD Draft Taxation Convention/Model Tax Convention or the United Nations Model Double Taxation Convention between Developed and Developing Countries.<sup>20</sup> The model conventions are broadly similar, the main difference being that the OECD convention favours residence taxation while the United Nations one gives more weight to source taxation. The number of double taxation agreements (DTTs) has increased rapidly and there are now some 1,700 such treaties in existence. DTTs were originally between developed countries, but the recent expansion, clearly following the course of bilateral investment treaties, is both with and between developing countries: a third of all DDTs are between developed and developing countries, and a further sixth between developing countries.

From the point of view of developing country revenue authorities, DTTs are the only way to cover intra-firm transactions and thus overcome the problem of transfer pricing.<sup>21</sup> These, however, become ineffective if offshore centres are used as transfer pricing points as well as for tax avoidance. In consequence, short of a comprehensive multilateral tax agreement, reconsideration of tax credits<sup>22</sup> within existing DTTs would be desirable; as would the application of the US 'pass-through' principle to tax havens. Indeed, a number

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firms. The tax rate on income declined from 40% to 29% among the industrialised countries of the OECD, while the rate in developing and transition economies declined from 45% to 27%. See FitzGerald (2001).

<sup>20</sup> See OECD (1997) and UN (1980) respectively.

<sup>21</sup> See Plasschaert (1994).

<sup>22</sup> Corporation tax paid overseas can be credited against a firm's domestic tax bill if there is a DTT in place. The higher the proportion credited, the greater the incentive to pay tax overseas. This system thus has an important potential for generating fiscal support to developing countries.

of developing countries play a key 'offshore' role in the international investment process where tax avoidance is of particular importance. No system of international tax administration - whether multilateral or bilateral - has much meaning unless these offshore centres are included.

Either the source or the residence principle could provide a basis for an effective system of international tax co-operation, if it were applied uniformly. However, many of the advanced industrial countries operate 'world-wide' taxation systems that combine elements of both principles. An international taxation system where each jurisdiction applied a single principle (source from the point of view of most developing countries) and tax rates were equal would be simpler for both tax administrators and multinational firms, requiring less information and avoiding double tax problems. However, it is difficult to see how such a solution could be implemented in practice. The United States is unlikely to change its own tax system simply to increase the tax take of other countries. Prospects for reform are somewhat greater in the EU as a result of current efforts to harmonise corporate tax rules within the single market and the emerging agreement on the prevention of tax competition and tax evasion between member states - though even these efforts do not provide much of a basis for international tax reform.

The most promising prospect for reforming tax administration may be provided by the drive for better co-ordination among national tax authorities to tackle organised crime and money laundering. Both banks and regulators have come under strong pressure to share information on financial transactions as part of this crime-fighting effort and, in the process, divulge the overseas assets of residents in a particular tax jurisdiction. The problem of tax evasion (in the sense of the failure to declare taxable income) through the use of tax havens will not be fully eliminated until the legislative status of these havens is reformed (especially their strongly defended secrecy rules). Most tax havens are vulnerable to political pressure from their larger 'guarantor' states. The OECD is already generating such momentum by pressure for the enactment of 'black lists' of tax havens, which fail to meet basic disclosure and co-operation requirements vis-à-vis, other tax and criminal jurisdictions. Investors reporting trade or financial transactions through blacklisted jurisdictions would be required to produce detailed information and satisfy other requirements for other tax authorities.<sup>23</sup>

A multilateral tax agreement would not only improve the fiscal revenue position of developing countries and reduce the attractiveness of tax incentives to foreign investors. It would also strengthen the effort to combat money laundering and financial fraud. However, the likelihood of an agreement on a comprehensive system of multilateral tax administration is low. Thus the application of DTTs in support of developing countries (possibly as a joint EU initiative) and the extension of agreed OECD principles to non-members (such as those on administrative assistance or harmful tax competition) are probably the only viable basis for investment-related tax co-operation.

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<sup>23</sup> See OECD (1998).

#### 4. New Proposals for Competition Rules

In a globalising world where single companies may have a very large market share in certain sectors, there is a clear need for more effective national and international arrangements to reinforce competition.<sup>24</sup> Regional laws and framework agreements on competition policy can be an important option for smaller states, both in terms of administrative cost and the economic circumstances. Small countries may only be able to sustain one firm in a sector or even in large areas of economic activity, and thus rely on external competition to ensure a competitive domestic market.

A multilateral framework agreement on competition principles could help reinforce effective competition by increasing predictability and strengthening confidence in the stability and fairness of the market system. There is a growing consensus that these issues need to be addressed in an international context.<sup>25</sup> The EU and many other governments believe that the WTO is the most appropriate forum for negotiation of an agreement which could identify principles and modalities for co-operation on cross-border and international matters, in particular on international cartels and restrictive practices by multinational enterprises. The interaction between inward investment and market structure was recognised in the services negotiations of the Uruguay Round.<sup>26</sup>

However, the Marrakech Agreement establishing the World Trade Organisation and the associated agreements, understandings and declarations do not provide any generally applicable rules for national competition policies; although a number of WTO accords make reference to competition policy and related issues in specific contexts.<sup>27</sup> The EU has proposed that negotiations on competition policy should form part of any new round of multilateral trade talks. However, this suggestion was strongly resisted by US officials at the WTO Third Ministerial Conference in Seattle, on the grounds that the market inefficiencies which a competition policy agreement might solve are not yet well defined. The existence of hard-core international cartels could, in principle, provide the foundation for a WTO agreement on competition issues. However, discussions of this subject in the WTO Working Group on the Interaction Between Trade and Competition Policy have been notably short of concrete examples and, when real examples are produced, they tend to be based on actions against international cartels launched by *national* competition authorities.

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<sup>24</sup> See Graham and Richardson (1997).

<sup>25</sup> See OECD (1999).

<sup>26</sup> Article VIII of the General Agreement on Trade in Services (GATS) stipulates that monopolies and exclusive service providers must not act in a manner inconsistent with WTO member obligations under the agreement. Article IX of the GATS provides for consultations over restrictive business practices. The Agreement on Basic Telecommunications Services implemented these GATS safeguards in the telecommunications sector when WTO members undertook specific commitments with respect to competition policy.

<sup>27</sup> See WTO (1997a).

The United States and the EU established a bilateral agreement on the application of competition law in 1991. However, the EU-US bilateral agreement does not provide a hopeful precedent for an effective WTO-based system. Only its procedural provisions are binding, not the substantive ones. It does not contain binding rules on jurisdiction and it does not preclude extra-territorial action.<sup>28</sup> The EU has sought to negotiate binding rules in these areas, but its proposals have been rejected by the United States.

In the event of a merger, multinational corporations often need to obtain clearance in several different jurisdictions. The companies would prefer to deal with one authority rather than several.<sup>29</sup> There is arguably a good case for an arrangement among national competition authorities that would allow multinational firms to seek worldwide clearance from just one, which would then be recognised by others. Initially, a plurilateral accord might cover only a few major economies, but other WTO members would be free to join if they are able to do so and see advantages in it for themselves. However, this is not what the EU is proposing: the European Commission wants a fully multilateral agreement, which all WTO members would be obliged to sign.

About half of the WTO member countries, mainly developing countries, do not have any competition law at present.<sup>30</sup> The EU believes that many of these countries would benefit from the adoption of competition disciplines, helping them attract foreign investment and improve the allocation of domestic resources. A fully multilateral agreement would require them to introduce and enforce effective competition policies. In this sense, the European view is that a multilateral pact would force developing countries to act in their own best interests. However, this confuses the case for persuasion with the case for compulsion.

The provisions of the WTO Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) would seem to be a fairly effective mechanism for ensuring compliance with current and future competition decisions. Where a complaint is made and the respondent fails to comply with the recommendations of a dispute settlement panel, the complainant may be authorised to withdraw a commensurate amount of concessions from the respondent. The prospect of cross-retaliation (and the possibility that several aggrieved WTO members would take action in concert) would be a very effective sanction against non-compliant behaviour if international investment rules were brought within the WTO system. However, the WTO could not offer dispute resolution in investor-state as opposed to state-state disputes - unlike NAFTA. WTO provisions are only binding on governments, which are the only parties with legal standing in dispute settlement proceedings. Even though private rights of litigation might be desirable in extreme circumstances, it is unlikely that WTO proceedings would or could be altered to accommodate this.

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<sup>28</sup> Where the United States acts against alleged breaches of US antitrust law even though the breach occurs outside the United States and all the relevant parties are foreign.

<sup>29</sup> The so-called 'one-stop shop' approach – see WTO (1997b).

<sup>30</sup> See UNCTAD (1999b).

The EU proposals go far beyond the restraint of extraterritorial action (principally by the United States) in holding that all WTO members should adopt a comprehensive competition law. There would be common approaches on anticompetitive practices with a significant effect on international trade and investment – such as ‘hard-core’ cartels, criteria for assessment of ‘vertical restrictions’ on suppliers or distributors, or abuses of dominant market positions; principles for co-operation of export cartels and international mergers. There would also be provisions on notification, consultation and surveillance in relation to anti-competitive practices with an international dimension as well as exchanges of non-confidential information. The WTO dispute settlement provisions would be used to ensure that domestic competition law and enforcement structures are in accordance with the provisions agreed multilaterally.

Japan and a number of developing countries (mostly in East Asia) support the EU position, but the countries in this group may have very different reasons for supporting competition negotiations. Moreover, US officials remain deeply hostile. The US Department of Justice fears that a multilateral compromise would take a lowest-common-denominator approach, diluting its own rigorous stance towards antitrust enforcement. In contrast, the US Department of Commerce and the Office of the United States Trade Representative are opposed to the idea of multilateral negotiations on competition policy because they believe that Japan and several other Asian countries would use the talks to re-open the related issue of anti-dumping law, which has been extensively used by the US to protect its own industries from international competition. The United States will try to ensure that this subject is kept off the agenda of any new round of negotiations.

## 5. Codes of Corporate Conduct

In the 1960s and 1970s, most of the pressure to regulate the business practices of firms with global operations came from developing countries. However, the current corporate responsibility movement and the renewed popularity of codes of conduct and other voluntary arrangements are being driven by constituencies in the advanced economies.<sup>31</sup> International norms and declarations aimed at protecting the human and labour rights and the environment include the Universal Declaration on Human Rights, various protocols drawn up by the UN and the International Labour Organisation (ILO)<sup>32</sup>, and the OECD Guidelines for Multinational Enterprises. However, none of these instruments is directly binding on companies.<sup>33</sup> They do impose binding obligations on governments in some instances, but few governments have tried to enforce these undertakings on private firms.

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<sup>31</sup> See Fatouros (1994).

<sup>32</sup> See UN (1988) and ILO (1991).

<sup>33</sup> An exception is the US legislation on bribes paid abroad to public officials by US corporations, although the enforcement mechanism seems to be fiscal in nature insofar as ‘agency fees’ may not be set against tax.

Moreover, the social and environmental dimensions of international investment have become intensely controversial in recent years, mainly owing to the activities of non-governmental organisations in campaigning against the alleged abuses of multinational corporations.<sup>34</sup> It is a relatively uncontroversial proposition that transitional and developing countries should not use the relaxation of labour and environmental standards to attract or retain foreign investment. However, it remains far from clear how to make obligations relating to labour and green standards binding, or subject to dispute settlement procedures. Many countries have also expressed concerns about WTO intrusiveness into the affairs of sovereign governments, particularly in the environmental and health and safety areas. Nonetheless, in both the United States and to a lesser extent in the EU, there is strong pressure from domestic legislators and labour unions to ensure that any future agreement contains some form of safeguards in these areas.

In contrast, developing countries are determined to resist any linkage between trade liberalisation and social issues, for both good and bad reasons. On the one hand, small firms (which provide the bulk of employment) in developing countries would find international standards too expensive and close down, while many poor households rely on child labour to make ends meet. On the other hand, large firms and employers' associations in developing countries have a clear financial interest in not applying modern labour and environmental standards even if they could afford them, and are eager to cite developmental reasons in their support. They will press to keep labour and environmental issues outside any multilateral investment agreement. WTO agreements that will have a substantial impact on the internal economies and regulatory policies of member countries therefore need a strong justification - either in terms of their benefits to the trading system or in terms of gains that they will create for members which could not be obtained unilaterally.

Developed-country governments have encouraged self-regulation by the private sector as part of a broader effort to reduce state intervention in the economy and cut the burden of regulation on business. Officials are also keen on private sector initiatives as a means of countering a political backlash against globalisation and deflecting pressure to advance social and moral agendas more forcefully through international institutions with proven enforcement powers - notably the WTO dispute settlement mechanism. For the business sector, voluntary undertakings to improve environmental and social practices are not so much proactive measures as a defensive move to forestall emerging demands from social groups for governments to step in with mandatory regulation.<sup>35</sup>

The OECD has recently completed a revised version of its 1991 *Guidelines for Multinational Enterprises*, which contain standards and principles of good conduct for international businesses.<sup>36</sup> The 1976 Declaration by the Governments of OECD Member Countries on International Investment and Multinational Enterprises was intended to

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<sup>34</sup> See UNCTAD (1999a).

<sup>35</sup> Corporations often feel compelled to offer voluntary commitments in the wake of accidents, scandals and other negative publicity, such as the accidental release of toxic chemicals from a Union Carbide subsidiary plant in Bhopal (India) in 1984, the massive Exxon Valdez oil spill in 1989, and allegations that Shell Oil was complicit in environmental and human rights abuses in Nigeria.

<sup>36</sup> OECD (2000).

improve the climate for inward investment. It also sought to encourage multinational enterprises to make a positive contribution to the countries in which they operate. All OECD members, as well as some non- OECD countries and the EU have subscribed to the declaration. It consists of four elements each underpinned by an OECD Council decision. The Guidelines for Multinational Enterprises are one of these elements (others deal with the treatment of foreign enterprises by governments and the avoidance of conflicting requirements on multinational firms).

However, observance is voluntary and not legally enforceable. The 2000 guidelines cover a range of issues, including employment and industrial relations, disclosure of information, science and technology, and environmental protection. The relationship between business and the environment received only limited attention in the 1991 version of the guidelines, which were drawn up at a time when the nature of the relationship was not thought to be particularly problematic. Enterprises were simply advised to ‘take due account of the need to protect the environment and avoid creating environmentally related health problems’.

The 2000 version illustrates just how far the business and environment debate has moved in the last ten years. The proposals have been influenced by international negotiations, growing public concern about the environment and possible future environmental problems. The second draft emphasises the importance of sustainable development, in both the general introduction and the specific section on the environment. The guidelines argue that multinational enterprises have a vital role to play in achieving this goal: they are encouraged to adopt an environmental management system (EMS), reflecting the growing interest throughout the 1990s in EMS standards such as ISO14001. The overall message is that environmental responsibility is good business practice and makes financial sense, so that there is no fundamental conflict between the activities of multinational enterprises and environmental protection.

However, a more detailed reading of the guidelines reveals major problems. The OECD commitment to the interests of multinational enterprises is clear in the draft guidelines, and although consultation is endorsed, a wider agenda of participation is not. It is clear that in this area the OECD has not engaged with those campaigners who have been arguing that companies should involve a wider variety of stakeholders meaningfully in decision-making. The draft is equally cautious in the area of scientific and technological risks. It suggests that decision-making should be based on ‘foreseeable’ impacts and a ‘scientific and technological understanding of risks’. Where there are potential risks it argues that multinational enterprises should ‘not use the lack of full scientific certainty as a reason for postponing cost-effective measures to prevent or reduce such damage’. This is a very weak version of the precautionary principle.

The damage to a firm's reputation, the need to improve community relations in host countries and the prospect of more stringent government regulation can all provide companies with a powerful incentive to overhaul their business practices.<sup>37</sup> Nevertheless,

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<sup>37</sup> For example, the International Federation of Football Associations (FIFA) negotiated a code of conduct with the International Textiles, Garment and Leather Workers' Federation covering contractors and

businesses hope that such commitments will reduce the pressure on governments to regulate industry directly, or use trade sanctions, enforced by the WTO, to underpin labour and environmental rights. Corporations with international operations remain strongly opposed to attempts to make international trade conditional on the observance of minimum standards of environmental protection and labour rights. Voluntary codes are not considered to be a substitute for legislation at the national level, but may be attractive to large international firms at the international level in order to reduce pressure from international activists. The main incentive appears to be the protection of brand value.

However, until companies that make commitments to socially responsible production can point to more tangible rewards, the business community's attitude towards such commitments will remain somewhat ambivalent. Private approaches to social regulation try to work through the market mechanism by providing companies with a financial incentive to improve working and environmental conditions in developing countries. The assumption is that if demand and consumption patterns can be changed in favour of goods produced or sourced in a socially responsible way, the marketplace will induce manufacturers to provide what consumers want. The actual impact which private regulation initiatives (such as labelling schemes) have on the market depends thus on the general level of issue awareness among consumers and investors, and their willingness to make respect for human rights, labour standards and environmental protection relevant criteria in their purchasing decisions.

Activism by non-governmental organisations, calls for product boycotts by consumer associations and media coverage of corporate misbehaviour have all contributed to a higher level of consumer awareness and helped mobilise the public to use its purchasing power in favour of socially responsible conduct. Activists have also begun to use sanctions against companies that have subscribed to social and environmental principles and then failed to implement them in practice. In addition to generating negative publicity and organising consumer boycotts, activists have forced the exclusion of member companies from trade associations and even instituted legal proceedings under laws protecting consumers from false advertising. Nonetheless, this activism has had much less market impact than the mass consumer reaction to concerns about the safety of genetically modified organisms, which has had a major adverse impact on the sales of companies that produce GM foods or retailers that put GM produce on their shelves.

There is only limited empirical data comparing the performance of socially responsible companies with their more conventional counterparts. Empirical studies suggest that socially responsible behaviour can be translated into a competitive advantage more readily in countries where there is a generally high level of awareness among the population about social and environmental issues. In countries like Sweden, where there is strong support for environmental protection, products carrying an environmental label seem to have gained market share at the expense of unlabelled ones. Labels presumably

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subcontractors in the soccer industry, after the sports body was confronted with evidence that children under the age of 14 were being employed in Pakistan to stitch soccer balls. Adidas, Mattel and other well-known producers of toys, apparel and sporting goods have made enhanced commitments about labour standards after being implicated in child labour and sweatshop scandals in developing countries.

help companies capitalise on their environmental responsibility and turn it into market share because they allow consumers to identify and recognise environmentally friendly products quickly and easily. However, in some countries, labelling schemes have not had any discernible effect on market share. Even in countries where labelling schemes have a significant effect, eco-labelled products still have only have a niche position.<sup>38</sup>

A small but rapidly growing number of US investment funds now screen companies for their corporate environmental practices and how they treat their employees worldwide (a practice usually referred to as ethical or social screening).<sup>39</sup> Socially responsible investing has also attracted attention in Canada, the United Kingdom and other European countries. Funds that pick companies on ecological and other ethical criteria have generally performed well, but they seldom show higher returns than unspecialised ones. Shareholders have become more active in demanding greater transparency and accountability about labour and environmental practices. However, there is no sign that ethical investors have reached the critical mass and level of organisation that would enable them to influence equity prices, either by forcing down the stock prices of companies with poor practices, or rewarding socially responsible companies with a higher market valuation.

## 6. The Prospects for Change

In sum, codes of conduct (and by implication all voluntary initiatives) have two weaknesses. First they should cover the entire sector to be effective, in order to prevent the ‘free rider’ problem, and this must contain an element of compulsion. Second, there must exist some plausible penalty for breaking rules – these can only be applied by governments or by legislation that empowers civil organisations such as trade associations to apply such penalties. In other words, there is a need for international standards on labour and environment to be supported by intergovernmental agreements – as property rights, tax liability and competition rules are (however imperfectly) – if they are to be effective. Reliance on the presumed effect on asset (brand) value of consumer awareness of production conditions in developing countries is hardly sufficient.

There is thus no doubt that some form of international regulation of international business is necessary. However the process of constructing a global regulatory system is slow and lopsided. The interests of corporations are backed by major states, which are also under pressure also from their own consumers, unions and NGOs. Any progress will be the

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<sup>38</sup> The market share for ‘fairly traded’ goods (usually commodities and craft items carrying a logo certifying that they are sourced directly from poor producers in developing countries) is also relatively limited. In Europe a small market share has been established, but is mainly based on solidarity rather than quality; while in North America, these products are only slowly making their way into supermarkets.

<sup>39</sup> In the United States, the inflow into ethical investment funds has risen by more than 80% since 1997: about 20% (some US\$ 2 trillion) of all investment fund assets took this form in 1999. In Japan, the first investment trust specialising in firms with high environmental management standards was introduced in August 1999, and attracted more than 100 trillion yen in just three months.

result of conflictive negotiations between the US and the EU, with developing country interests (particularly those of smaller poor countries) being marginal. Developing countries' voice could be stronger with a clearer view and united front, although they too respond to domestic conflicts between business and other interests.

Property rights are likely to be strengthened through future WTO rules, although these are unlikely to include the right to establishment or the right to appeal directly to international tribunals. A reasonable basis for approaching this topic is that if property rights are to be guaranteed internationally, then so should 'property obligations' as well. The EU initiative to include investment in the Millennium Round with an explicit 'development dimension' thus presents a vital opportunity to define what would be in effect a 'global social contract', rather than merely negotiating a set of concessions on transition arrangements for developing country accession to agreed investment disciplines.<sup>40</sup> The linkage to the accepted need for co-operation on tax and competition issues should be made explicit. However, the logical step of establishing multinational corporations as judicial persons under international law is still a long way off, despite the institutional reality of the global economy.<sup>41</sup>

The danger, of course, is that not only are these property rights not balanced by obligations as they are at the national level, but also that some of these rights may in fact be undermining social, labour or environmental standards – that is rights claimed by other groups in society.

Tax co-operation is driven by the need of OECD states to maintain their fiscal base on the one hand, and the desire to combat international crime on the other. However, developing countries have much to gain from a multilateral system, in terms of both greater income from multinational firms and the effective taxation of their own capital base. The negotiating problem here is how to adapt a developed country initiative to a development objective. In the longer term, international tax rules would help to regulate transnational firms, through both the collection and exchange of information and the potential for the design of potential developmental incentives. Here again, the process of fiscal harmonisation and co-operation *within* the EU has led to both the political initiative and the administrative model for wider international tax co-ordination, from which developing countries could benefit substantially.

International competition rules are at an early stage, although they are clearly needed for highly concentrated global sectors such as telecommunications, airlines or even banking. The interest of developing countries (particularly the larger ones) is not entirely clear, as competition rules would expose their own companies to more competition. None the less, such rules would provide a sound basis for regulating large international firms in an effective monopoly situation in smaller economies. Again, the dynamic for such rules is provided by negotiations between the USA and the EU, with key developing country players such as India and China still taking a bilateral rather than multilateral approach to the issue.

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<sup>40</sup> As was the case in the Uruguay Round.

<sup>41</sup> Not least because international private law does not exist, of course.

In this light, the present ‘voluntary’ approach to codes of conduct on labour and environmental issues is somewhat anomalous. The fear of loss of asset value may be an effective constraint on companies with significant brand image and a large consumer base in the US or the EU, but it cannot be used as a general principle. In particular, this does not seem to be an appropriate basis for regulating large national firms in developing countries. Moreover, relying on consumers in northern markets to ensure the compliance of all international firms in the south would mean that the pattern of enforcement would be variable over time and inconsistent between sectors and countries.

Voluntary approaches even *within* developed countries have a number of drawbacks from a public policy perspective. The most significant problem with using voluntary instruments is that it is not possible to guarantee the desired outcomes. For this reason, voluntary instruments are unlikely to be used in situations that involve serious public health issues or where urgent action is needed and targets must be reached quickly. Moreover, free-riding firms that benefit from the scheme without bearing its costs can undermine the integrity of most voluntary instruments. Covenants between industry sectors and public authorities may thus only be useful where there is a strong trade association that can deliver the involvement and compliance of its members, or where a sector comprises a small number of large firms and peer pressure can achieve the same objective.

An alternative to multilateral regulation of firms that is often proposed by activists is that *domestic* legislation in OECD countries should be introduced in order to require multinational firms headquartered there to observe certain standards of conduct.<sup>42</sup> The only advantage of this approach would be that local lobbying might produce results in the short term. However, there are at least three serious disadvantages to this approach. First, this would lead to different legislation in each home OECD country, and thus varying standards applied by the corresponding foreign forms in any one host developing country. Second, multinational firms could easily avoid such domestic legislation by moving their legal head office offshore. This problem underlines the need for fiscal action against offshore centres discussed above. Third, there seems no reason to apply high standards to the affiliates of multinational firms in developing countries, but not to apply them to domestic firms of similar size which usually have much more impact on local stakeholders – and often apply even lower standards. In sum, the logical approach would be to adopt multilateral legislation, and then to exempt small firms on a national basis under the ‘like circumstances’ principle where appropriate.

The necessary linkage between private property rights with social obligations to both the state (ie taxation to provide public goods) and local stakeholders (workforce and local community) is recognised and applied in all modern democratic market economies.<sup>43</sup> Construction of a similar international linkage is still a long way off in the future and would have to overcome the hurdle of recognising the existence of firms as juridical

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<sup>42</sup> See, for instance, Mayne (1999).

<sup>43</sup> Indeed, under the feudal system ownership of land was conditional upon the provision of military service to the crown and of justice to the local population.

persons in international law. None the less, there are some signs of progress in the recognition of international firms as subjects of international law. This is most apparent in the area of corruption and narcotics, where extraterritorial legislation implies the recognition of foreign firms. There is also a precedent in the access of firms to intergovernmental dispute procedures in a number of plurilateral treaties. Finally, some elements of international customary law also place obligations on corporations in areas such as the abuse of human rights.

The importance of the EU to this debate is that these issues have to be defined explicitly *between* member countries as economic, social and policy integration proceeds and even accelerates. There is then a presumption that these international principles should be applied more widely, to the benefit of developing countries. In the coming decade, the economic recovery of the EU and Japan relative to the US on the one hand, and the increasing regional co-operation with Europe, Asia and the Americas on the other, should both create an opportunity for this type of discussion.

## 7. Conclusions

It is clearly incorrect to regard large international firms as effectively ‘unbridled’. There already exist strong measures between OECD countries to regulate these firms in the fields of investment rights, tax burdens and competition rules. The problem is these systems have not yet been extended to cover developing countries in a way that supports development. There is thus an urgent need to define what a desirable regulatory regime might look like from the point of view of both middle-income and low-income developing countries.

There are sufficient elements already in place to support a practical argument for a comprehensive multilateral approach to the regulation of international firms. This would balance the interest of large international firms in the protection of property rights and simpler merger procedures on the one hand, with those of governments in tax and competition policy, and those of local stakeholders in labour and environmental standards on the other. This would be of particular benefit to the least developed countries that are still effectively excluded from international investment flows.<sup>44</sup>

In terms of the international political economy of change, much depends upon the response of the major powers to globalisation itself. The EU in particular has had to work out the cross-border regulatory rules (‘mutual recognition agreements’) and social obligations (the ‘*aquis*’) that affect corporations within the Single Market, and is thus in the best position to take this issue forward – albeit slowly. Meanwhile, thinking about what type of international business regulation would be in the interest of developing countries in general and poor households in particular is a worthwhile exercise. The

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<sup>44</sup> See UNCTAD (2000b).

ability to draw on ongoing progress in the three fields of global regulation based on international law would provide a far more realistic basis for debate than voluntary initiatives based on business ethics and brand image.

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