

New Institutional Economics (NIE): a possible theoretical  
foundation for the Multilateral Agreement on Investment (MAI)?

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## **Abstract**

The Multilateral Agreement on Investment (MAI) represented an attempt by the Organisation for Economic Cooperation and Development's (OECD) member countries to create a comprehensive multilateral legal framework governing foreign investment, particularly foreign direct investment. After a three-year effort, negotiations for the MAI collapsed in December 1998. Considerable support remains however, for creating global rules on foreign investment. The issues of possible loss of nation states' sovereignty in favour of the Transnational Corporations (TNCs) and the possible loss of developing states' sovereignty and flexibility in drawing their own development agenda as a result of the MAI's implementation are at the heart of the debates over the MAI.

The New Institutional Economics (NIE) represents an influential body of economic theory that tries to incorporate the study of institutions into mainstream neoclassical economics and to investigate the implications for economic development and reform. The development of NIE from a theory of firm and contracts (Williamson, 1996) to a theory of global development and reform (North, 1990a) extends the neoclassical orthodoxy and brings relevant theoretical insights for, the logic behind and the implications deriving from, the MAI. The theoretical underpinnings provided by NIE to international agreements, such as the MAI, have been generally neglected.

This thesis argues that the NIE is a possible theoretical foundation for the MAI. This is argued by looking at the commonalties in terms of NIE's and the MAI's development and policy implications and by analyzing NIE's contribution to the official discourse on development and reform. First, this thesis argues that the MAI and NIE did not develop in a vacuum. They developed as social and intellectual reactions for dealing with significant changes in the world

economy, particularly the increasing importance of TNCs and of FDI within the context of persistent disparities between countries' levels of economic development. Second, this thesis argues that the MAI's logic and policy implications directly relate to NIE's recommendation for development and reform. Third, this thesis argues that NIE has helped redesign the official discourse on development and reform with FDI and global rules on investment gaining an increasing developmental role.

This thesis contributes to the existing body of literature on the MAI and NIE in a number of ways. The contribution of this thesis to the MAI literature is in its insistence of (i) the need for clearer identification of the theoretical logic behind the MAI or future similar agreements; (ii) the relevance of any such agreement for developing countries; (iii) the need to oppose any such agreement not only by arguing that the outcomes will be undesirable but also that the underlying theory – in this case the NIE – is also flawed; and finally (iv) the need to analyze the MAI not just as an individual project that could determine the dynamics of the foreign investment transactions but as a fundamental part of an ongoing process of building a global institutional framework that determines the distribution of rights and power in the global economy. This thesis contributes to the NIE literature by (i) advancing the argument for a complementary Oliver Williamson – Douglass North framework and (ii) analysing the line of departure between NIE and neoclassical economics (NEO) in answering fundamental theoretical questions. Lastly, but not least, this thesis contributes to the theory and practice of international political economy by reinforcing the opinion that dominant social practices (MAI) are sustained and constituted by mainstream theoretical discourses (NIE).

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## **Glossary**

APEC	Asia Pacific Economic Cooperation
BITs	Bilateral Investment Treaties
FDI	Foreign Direct Investment
FTAA	Free Trade Agreement of the Americas
GATT	General Agreement for Trade and Tariffs
GATS	General Agreement on Trade in Services
ICSID	Convention on the Settlement of Investment Disputes between States and Nationals of other States
IMF	International Monetary Fund
NAFTA	North America Free Trade Agreement
NEO	Neoclassical Economics
NIE	New Institutional Economics
NT	National Treatment
M&A	Mergers and Acquisitions
MAI	Multilateral Agreement on Investment
MFN	Most Favoured Nation Treatment
OECD	Organisation for Economic Cooperation and Development
OIE	Old Institutional Economics
TNC	Transnational Corporation
TUAC	Trade Union Advisory Committee of the OECD
UNCTAD	United Nations Conference on Trade and Development
U.S.	United States
WDRs	World Development Reports
WTO	World Trade Organisation

## Chapter one: Introduction

### 1. Introduction

The objective of this thesis is to analyze New Institutional Economics (hereafter, NIE) as a possible theoretical foundation for the Multilateral Agreement on Investment (hereafter, MAI). The MAI represented an attempt by the Organization for Economic Cooperation and Development's (OECD) member countries to create a comprehensive multilateral legal framework governing foreign investment<sup>1</sup>, particularly foreign direct investment<sup>2</sup> (hereafter, FDI). The official negotiations within the OECD had begun in June 1995. The MAI was originally scheduled to be completed and signed by May 1996. However, as the complex negotiations lagged, the process was delayed. After a three-year effort, negotiations for the MAI collapsed in December 1998. The MAI is defined in this study as the 24 April 1998 draft encompassing the MAI text and the Commentary to the MAI text<sup>3</sup>.

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<sup>1</sup> Foreign investment usually refers to foreign private investment covering foreign direct investment, foreign portfolio investment and other foreign investments (for example, bank loans). Foreign direct investment refers to investment "reflecting the lasting interest of a resident entity in one economy (direct investor) in an entity resident in another economy (direct investment enterprise)" (IMF, 1995, p. xxxvi). It consists of the sum of: equity capital (new equity purchased or acquired by parent companies in overseas firms they are considered to control, including the establishment of new subsidiaries), reinvested earnings of controlled firms, and other intercompany transactions like loans from parent companies to controlled firms. Portfolio investment refers, in principle, to investment that provides financial capital to an enterprise in a country other than that of the investor, but does not involve any management control in the enterprise (UNCTAD, 1998).

<sup>2</sup> Most of the literature on MAI tends to use the concepts of foreign investment and foreign direct investment interchangeably when referring to MAI's coverage of investment. This ignores the importance of other foreign investment types covered by the MAI provisions but not considered FDI per se. The distinction is important in that portfolio investments, for example, present a much higher volatility than FDI and a much lower commitment to long-term development of the host economy. Hence, they are more susceptible to cause macroeconomic imbalances, particularly currency crises, and have been traditionally given different, more restrictive legal treatment than FDI.

<sup>3</sup> The MAI text consolidates the text of the agreement considered in the course of the last MAI negotiations. The commentary to the text was issued separately and it contains further clarifications on the content of the MAI text. Both documents are available at: <http://www.oecd.org//daf/cmms/mai/negtext.htm>

NIE represents an influential body of economic theory that tries to incorporate the study of institutions into mainstream neoclassical economics (hereafter, NEO)<sup>4</sup> and to investigate the implications for economic development and reform (North, 1995). It evolved on two main, relatively separate, theoretical branches (Williamson, 1996). The first branch applies a top-down macro-perspective to the study of institutions. It is concerned with the political and legal rules of the game and is usually associated with the works of Douglass North. The second branch applies a bottom-up micro-perspective to the study of institutions. It deals with firm and market modes of contract and organization and is usually associated with the works of Oliver Williamson. NIE is defined in this study as the comparative study of institutions resulting from the work of Williamson (1983,1987,1993,1996), North (1981,1989, 1990a, 1990b, 1995), North and Weingast R. Barry (1989) and Lance Davis and North (1971). Institutions are defined as either institutional environments or institutional arrangements where the crucial distinctions between them are that:

*the institutional environment* is the set of fundamental political, social and legal ground rules that establishes the basis for production, exchange and distribution. [...]An *institutional arrangement* is an arrangement between economic units that governs the ways in which these units can cooperate and/or compete. It ...[can] provide a structure within which its members can cooperate...or [it can] provide a mechanism that can effect a change in laws or property rights (Davis & North, 1971, pp. 6-7).

Constitutions, laws, norms of conduct and ideologies are components of the institutional environment. Contracts, markets, firms, and polities are examples of institutional arrangements. Within the NIE literature, some align Williamson and North

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<sup>4</sup> Neoclassical economics refers in this study to the economic body of theory primordially based on the Walrasian equilibrium model. This model envisions the world as a perfect competitive market in which large number of autonomous, fully informed entities with profit-maximizing behavior voluntarily exchange homogenous goods and efficiently achieve the desired ends. Institutions are exogenous to this economic model and do not influence agents behavior or the economic outcomes.

under the same NIE perspective (Bardhan, 1989; Harriss-White, 1995; Stein, 1995; Williamson, 1996). Others distinguish between Williamson's and North's works treating them as separate perspectives (Nabli & Nugent, 1989; Groenewegen, Kerstholt and Nagelkerke, 1995; Hirsch & Lounsbury, 1996). In building a representative NIE theoretical framework, this thesis found it more useful to focus on the common logic and complementarity between North's and Williamson's works rather than on their differences. This approach does not necessarily dismiss the claims of differences between the two theoretical branches of the NIE, but it points out that, in some cases, the study of institutions can be better informed by a complementary Williamson–North NIE framework rather than by the individual theoretical work of its parts.

Although there has been a lot of attention accorded to both the MAI and NIE, a clear intellectual connection between them has not been spelled out. The controversial debates on the MAI and the NIE took place on relatively separate fronts. Two different but interconnected debates emerged within the MAI literature. The first debate (hereafter, the state/firm debate) refers to general opinions on the possibility of a loss of state sovereignty in favor of the modern transnational corporation<sup>5</sup> (hereafter, TNC) as a result of the MAI's implementation. For the MAI proponents, the potential loss of state sovereignty as a direct result of the MAI's implementation is overstated. National sovereignty represents an “outdated illusion” of voters unaware of the “degree to which their well-being is dependent on economic ties forged by investment from other countries” (Rashish, 1996). The MAI should be read as an efficient partnership between the OECD governments and the TNCs expected to enhance the efficient utilization of

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<sup>5</sup> A transnational corporation represents a firm which conducts its trade and production internationally, compound from a domestic parent firm and several affiliates.

economic resources, the creation of employment opportunities and the improvement of living standards. For the MAI's critics, this agreement would constrain governments' ability to impose obligations on TNCs to serve local economic, environmental or social needs related to their investment and hence would decrease the state's sovereignty. TNCs' activities could be contrary to social, cultural, environmental and local economic needs and hence incompatible with national sustainable development.

The second debate (hereafter, the state/state debate) refers to particular opinions on the possibility of loss of developing states' sovereignty and political flexibility in drawing their own development strategies, as a result of the implementation of an MAI-type agreement. For the MAI's proponents, the MAI represents a general set of fair play rules for governments regulating foreign investment transactions. It would not discriminate but rather help developing countries that lack credible political commitments to secure systems of property rights by reducing the uncertainty of foreign investors and thereby to attract FDI. For the MAI's critics, this agreement would affect developing countries' sovereignty and political flexibility in drawing their own development strategy, by locking them into one model of development.

The state/state debate has been relatively less explored by MAI analysts, with attention being focussed on the OECD negotiating countries. By drawing special attention to the possible implications of the MAI's for developing countries this study intends to contribute to filling this void. Although the MAI was originally conceived as an OECD initiative, it was clear that some developing countries were interested in unilaterally joining it and some had been given observer status. The way in which



bi/multilateral treaties are used as springboards for incorporation into WTO talks<sup>6</sup> also suggests that developing countries might also be involved at some point if the MAI or similar agreements do rise again.

This thesis looks at the NIE as a possible theoretical foundation for the MAI. With the award of a Nobel Prize in economics in 1991 to Professor Ronald Coase and then in 1993 to Professor Douglass C. North, two of the main scholars behind the NIE, the NIE emerged as an 'accepted' alternative paradigm to NEO. The NIE is supportive of NEO's framework but claims to introduce major modifications to NEO's initial theoretical assumptions and policy implications. The exact distinction between the two paradigms remains subject to debate. This study does not necessarily reject other theoretical contributions to the MAI but rather views as necessary a firmer grasp of the theoretical underpinnings of what exactly the NIE brings to the MAI debates that is overlooked by the NEO. By showing how the NIE is relevant here, I would hope that my work would be of use to those working at a higher level of abstraction. This is particularly important because the theoretical underpinnings provided by NIE to international agreements such as the MAI have been generally neglected.

This thesis argues that the NIE is a possible theoretical foundation for the MAI. This is argued by looking at the commonalties in terms of NIE's and the MAI's development and policy implications and by analyzing NIE's contribution to the "official discourse on development and reform"<sup>7</sup>. First, this thesis argues that the MAI and NIE

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<sup>6</sup> See for example the Information Technology Agreement in Asia Pacific Economic Cooperation (APEC) which formed the basis of the WTO text in Singapore in 1996.

<sup>7</sup> "The official discourse on development and reform" refers to the content of the 1987, 1994, 1997, 1998/1999 and 1999/2000 World Development Reports (WDRs) published by the World Bank. In their role as the World Bank's annual intellectual flagship publication, the WDRs have, for more than 20 years, reflected the official mainstream discourse on development and reform. The WDRs have been previously



did not develop in a vacuum. They developed as social and intellectual reactions for dealing with significant changes in the world economy, particularly the increasing importance of TNCs and of FDI within the context of persistent disparities between countries' levels of economic development. Second, this thesis argues that MAI's logic and policy implications directly relate to NIE's recommendation for development and reform. Third, this thesis argues that NIE has helped redesign the official discourse on development and reform with FDI and global rules on investment gaining an increasing developmental role.

## **2. Outline of thesis**

This thesis is divided into four chapters. The purpose of this first chapter is to introduce the objective, concepts and methodological framework of this thesis. The purpose of this chapter is also to show that the MAI and NIE did not develop in a vacuum and that a possible intellectual relation is relevant in the current empirical, theoretical and international legal developments in the field of FDI.

The purpose of the second chapter is to present an overview of the MAI text, together with the main debates about its possible implications, the state/state and the state/firm debates. A detailed presentation of the MAI content is justified by the large number of controversies in the interpretation of the text. Without claims for an exhaustive analysis of all the possible implications emerging from the implementation of the agreement, an analysis of the main elements of the last negotiated draft is attempted. As

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used as an indicator of the intellectual relation between development theories and the official discourse on development and reform by Colin Leys (1996), in his account of "The Rise and Fall of Development Theory".

previously mentioned, there are strong reasons to expect that any future MAI-type agreement would directly concern both developed and developing countries. Hence, the focus of this chapter is on the main themes of concern for both developed and developing countries.

The purpose of the third chapter is twofold. First, this chapter advances a complementary Williamson-North NIE framework. This theoretical framework will be used for analyzing NIE's theoretical underpinnings of the MAI in chapter four. Second, this chapter explores NIE's position vis-à-vis NEO. The choice of examining NIE in contrast to NEO throughout this chapter is based on two reasons. First, by showing here how NIE differs from NEO in terms of practical implications and how this relates to the MAI debates, I intend to underline the importance of analyzing NIE's theoretical underpinnings to the MAI as opposed to a more general NEO approach. Second, the line of departure of NIE from NEO in answering fundamental theoretical questions is, I believe, the place where the seeds of the NIE's theoretical contribution to the MAI reside. By drawing this line in chapter three, I am building the logical grounds for my next arguments in chapter four.

The fourth chapter builds on all previous chapters by pooling together the core argument of the thesis. It starts by analyzing the commonalties between NIE's and MAI's possible practical implications for development and reform. The state/firm and state/state debates summarized in chapter two are reexamined here through the lens of the NIE framework developed in chapter three. The chapter continues by tracing the contribution of the same NIE framework to the official discourse on development and reform. This analysis brings additional support for the hypothesis that NIE represents a possible

theoretical foundation for the MAI. The fourth chapter concludes by reviewing the hypothesis, results and implications of this theoretical exercise for the study of the MAI and future global treaties on foreign investment. As a final point, the limitations of this study are discussed and areas for future related research are proposed.

### **3. FDI and NIE: an historical perspective**

#### **3.1. The changing face of the world economy and the role of the FDI**

One way to think about the world economy is from the point of view of the totality of exchange transactions undertaken in the world for production or trade purposes. The decisions underlying these transactions with a bearing on economic growth and competitiveness – such as decisions to invest and innovate – have traditionally been discussed as the product of national firms under the auspices of their national states (UNCTAD, 1994). With the significant growth of cross-border transactions registered in the post-war period, these perceptions began to change.

Official estimates show that total world trade in 1997 represented 14 times the level of world trade in 1950. Further, while between 1948 and 1997 world output grew at an annual average per year of 3.8 per cent, merchandise exports grew at a 6 per cent rate (WTO, 1998, p. 1). These developments, particularly the fact that trade has grown faster than output, represent for some the extent of increased international economic integration of the world economy, due to the internationalization of production and the increase in cross-border transactions.

Of the different types of transactions the flows of FDI have particularly increased, surpassing the growth in trade or domestic production. During the period 1983-89, FDI

outflows “have increased at the unprecedented rate of growth of 29 per cent a year, three times faster than that of the growth of exports and four times that of the growth of the world output” (UNCTAD, 1991, p. 3). Other official reports estimate that over the 1973-1995 period, the value of annual foreign investment outflows multiplied more than twelve times (from \$25 billion to \$315 billion), while the value of merchandise exports multiplied approximately eight and a half times (from \$575 billion to \$4900 billion) (Drabek, 1998, p. 4). In 1997, the ratio of inward plus outward FDI stocks to world Gross Domestic Product (GDP) grew twice as fast as the ratio of world imports and exports to world GDP (UNCTAD, 1998, p. xvii), suggesting that the FDI continued to deepen the integration of the world economy.

The increasing role of FDI has important implications for the state of the world economy. This is mainly because of four factors. First, as opposed to international trade (the import and export of goods and service), FDI covers any cross border transaction aimed at acquiring or expanding corporate control of productive assets (Froot, 1993). Hence, it usually implies an exchange of domestic for foreign control of production capacities. This means that what characterizes today’s world economy is an increased internationalization of the control of previously domestically controlled factors of production.

Second, over 90 per cent of the outward stocks and flows of FDI are conducted by Transnational Corporations (UNCTAD, 1995, p.7). Even within the TNCs’ universe the control over FDI transactions is highly concentrated. The world's largest 100 TNCs (not including those in banking and finance) were estimated by the United Nations Conference of Trade and Development (UNCTAD), (1995, p. 19) to account in 1993 for

about one-third of the combined outward FDI of their countries of origin. The source of FDI and respectively the home for the parent firms of these 100 TNC as well as most other TNCs, is the developed world. The United States remains the main source and destination of FDI in the world. Japan and the European Union (EU) represent the other main foreign direct investors. The destination of FDI, initially concentrated within the developed world, began to shift at an increasing rate towards the developing world. In 1997, developing countries' level of FDI inflows was twice the level they received in 1993 and tenfold the level in 1985 (UNCTAD, 1998, p. 16). The targeted developing countries are the ones that recently liberalized FDI and implemented privatization programs open to foreign participation. This implies that the current transfer of control of productive assets is taking place within the developed world but increasingly shifting from the developing to the developed world. It also implies that the process is led by a few large transnational corporations that take advantage of the new opportunities for profitable investment in both developed and developing countries as countries open up their economies to foreign investment.

Third, during the post Second World War period, a different but interrelated type of international transactions, namely intra-firm cross-border transactions, started nesting within FDI transactions at an increasing rate. These represent the transactions undertaken by a TNC in organizing under unified governance - between the parent firm and its foreign affiliates – its processes of production and trade. The TNCs' intra-firm transactions can take the form of cross-border intra-firm trade, cooperative intra-firm agreements, non-equity forms of TNC involvement (licensing, turnkey agreements, franchising, management contracts) or subcontracting (UNCTAD, 1994). In 1992, for



example, only about one-third of the world's international transactions were not associated with TNC's intra-firm transactions (UNCTAD, 1995, p. 39). Analyzing the 1992 data, the 1995 World Investment Report remarked that "in the case of the United States, whose firms are among the leaders in the internationalization process (and for which better data are available) ...[...].four out of five dollars received for goods and services sold abroad by United States firms are actually earned from goods and services produced by their foreign affiliates or sold to them"(Ibid., p. 39). This means that another characteristic of today's world economy is the process of "internalization" of transactions within the TNC or the removal of the transactions from the realm of the market to the realm of the corporate firm. This leads to a further increase in the overall control of TNCs over the process of production and trade in the world economy.

Fourth, if in the past greenfield investment was the rule, today the vast majority of FDI is done through mergers and acquisitions (Froot, 1993, UNCTAD, 1995, 1998). The value of majority purchase cross-border mergers and acquisitions<sup>8</sup> (hereafter, M&A) in relation to total FDI inflows rose from 49 per cent in 1996 to 58 per cent in 1997, representing the highest share attained in the 1990s (UNCTAD, 1998, p. 19). Most of the increase in the value of M&A was due to large-scale cross-border M&A deals. These mega deals (worth more than \$ 1 billion each) accounted for about a half of global M&A transactions values in 1997, compared to one quarter in 1995 (ibid. p. 20). Within the developed countries, which account for about 90 per cent of cross-border majority purchases, U.S. firms continue to account for the single largest share of the mega deals. The large-scale M&A are concentrated in the banking and insurance, chemical and

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<sup>8</sup> Majority purchases are "transactions in which the foreign investor acquires more than half the voting securities of resulting business" (UNCTAD, 1998, p. 20).

pharmaceutical, and telecommunication and media industries (ibid. p. 20). These data show that a characteristic of today's world economy is not an increase in the overall stock of capital through the construction of new facilities (greenfield investment) but mainly an increased redistribution (via acquisitions and takeovers) and centralization (via mergers) of the previously existent world capital stock.

### **3.2. Theoretical trends in FDI and the role of the NIE**

As the 1994 World Investment Report points out (UNCTAD, 1994), accommodating the steady growth of cross-border economic activity has produced considerable disagreement among economists, the debate being polarized mainly around two different theoretical schools. The first is the 'international trade school' based on neoclassical economics. The second is the 'industrial organization school', a less clearly unified paradigm. Michael Twomey (1993), Edward Graham and Paul Krugman (1993) and John Dunning (1995) acknowledged the influence of Ronald Coase's and Williamson's theoretical insights on the formation of the industrial organization school.

The international trade school explains the dynamics of international trade and investment by focusing on countries' different endowments of factors of production. International investment reflects the movement of internationally mobile capital from the abundant to the scarce country, attracted by higher profit rates in the receiving country. In this account, both trade and international investment are simply aspects of perfect competition among atomistic firms, all enjoying equal access to technology and markets, with none large enough to influence prices of inputs or outputs. By assuming a world of complete markets and perfect competition (the key assumptions of NEO), this approach

explores the benefits of global economic integration in the absence of TNCs and FDI, where the choice between flows of factors and flows of goods is essentially arbitrary (UNCTAD, 1994).

As the industrial organization theorists pointed out, “the standard neoclassical theory has little to say about the very large firms that carry out much of the world’s production and even more of the world’s trade, nor about the ongoing process of entry and exit that characterizes most international markets”(McCulloch, 1993, p. 39). It cannot explain the emergence and purpose of TNCs, or the increasing role of FDI in the world economy as presented above. In an attempt to answer these questions, the international organization theorists

have assumed a world where firms must constantly choose between trade and FDI in their drive to expand activities across borders, and ...[economic integration]... reflects the strategic decision of firms to a world of cross-border market failures with significant transaction costs, in which the control over assets located in different countries certainly matters (UNCTAD, 1994, p. 119).

The main ideas behind this logic were initially advanced by scholars from the field of law and economics (Coase, 1937) and the field of industrial organization (Williamson, 1975) in their concern with creating a theory of the firm and of contract. They criticized some neoclassical assumptions, particularly the assumptions of perfect market and perfect competition, arguing that there are significant transaction costs, like measurement, enforcement, or management costs, underlying any exchange. The birth and growth of the firm, and through extrapolation, the growing importance of TNCs, is to be explained as an efficient solution engineered by economic entrepreneurs to deal with uncertainty and market imperfections and to minimize the transaction costs. In this sense, FDI represents an alternative mode of organizing exchange employed by TNCs in an effort to internalize certain transactions from the realm of the market within firms for



transaction minimization efficiency purposes. In the last two decades, there was an explosion of theories derived from the logic presented above. What came to be known as the “New Institutional Economics” represents the embodiment of these particular insights in the field of economics.

### **3.3. Origins and development of the NIE**

It is commonly said that NIE began with Coase’s seminal article on “The Nature of the Firm” (1937), with its explicit introduction of transaction costs into economic analysis (Coase, 1998). A significant puzzle for mainstream economic orthodoxy was how to explain the existence of firms or other institutions in the economy. More generally, neoclassical economics failed to explain efficient or inefficient collective outcomes in terms of choices made by rational individuals. Coase (1937) attempted to solve this puzzle. His main argument was that there are costs underlying any transaction<sup>9</sup> and that firms, contracts, property rights and other institutions emerged as social devices to economize on these transaction costs. Williamson (1973, 1983, 1987, 1993, 1996) continued the implementation of this theoretical program at the micro-level of firms, contracts and organizations. He attempted to construct a theory of the firm and explain the diversity of different modes of economic organization. North (1981, 1989, 1990a, 1990b, 1995) extended the logic of transaction cost economics at the macro-level of nation state, constitutions, cultural and ideological norms. He attempted to construct a theory of institutional development and to explain the diversity in the economic performance registered across time and space.

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<sup>9</sup> As opposed to neoclassical economics that assumed zero transaction costs.

The phrase “the new institutional economics” was coined by Williamson with the intention of differentiating the subject from the “old institutional economics” (hereafter, OIE) as developed in the work of John R. Commons, Wesley Mitchell, and those associated with them (Coase, 1998). Exactly what kind of theory NIE is proposing and how different this is in respect to the main theoretical schools it draws upon (NEO and OIE) is subject to debate.

NIE gives credit to OIE for its focus on the importance of institutions and institutional change in economic development and on transactions as the basic unit of analysis. Williamson (1996) finds particular affinities between his work and the work of John R. Commons. Other scholars (Hirsch & Lounsbury, 1996; Groenewegen, et al., 1995) also consider that striking parallels may be drawn between North’s later works and that of John Commons.

However, both the NIE and its critics – mostly from the OIE school – were concerned with clearly delimiting NIE from OIE. For the NIE critics, this body of knowledge differs from OIE in regard to both the epistemology (Ramstad, 1996; Dugger 1990, 1996) and methodology (Dugger, 1990; Rutherford, 1995; Collard, 1995; Pratten, 1997) applied when analyzing institutions. For the NIE school, “the OIE may be presented as descriptive, holistic and behaviorist and the NIE as formalist and reductionist. In ideological terms, the former can be depicted as collectivist and lacking technical rigour, the latter as anti-interventionist and excessively devoted to highly mathematical rational choice modelling” (Harris, Hunter and Lewis, 1996, p. 4)<sup>10</sup>.

Within economics, NIE is broadly conceived as being consistent with, and supportive of, the orthodox mainstream perspective that is neoclassical economics. NIE

shares with NEO the basis of the choice-theoretic approach that underlies microeconomics and hence the neoclassical axioms of methodological individualism. One can conclude then, that what links NIE and NEO is a shared essential method (Pratten, 1997). However, as it will be shown in chapter three, the claims of major modifications to the neoclassical paradigm require further investigation.

#### **4. The need for global rules on foreign investment: Echoing an NIE perspective?**

In this empirical and theoretical setting, a predominant consensus between the representatives of international business, government officials in the developed world, academics and international development organizations emerged.

There is now a predominant opinion that we are experiencing a new stage of global economic integration that affects the characteristics of the world economy and its underlying governance structure. There are claims that FDI has become the most important channel/instrument of growth and the TNCs have become the major agents for delivering growth (UNCTAD, 1994, 1995, 1996). There are claims that these developments are underlying the formation of an integrated global economy in which nation states are forced to reconsider their role in the process of development (World Bank, 1997). Nation states, particularly the developing countries, should recognize the importance and role of FDI in the development process by providing the needed legal transparency, predictability, and legal security required by foreign investors for investing in their economies.

The dramatic proliferation of various international agreements on FDI during the 1990s was a positive sign in this direction. At the bilateral level, the total number of

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<sup>10</sup> For a detailed description of each of these differences between OIE and NIE see Rutherford (1994).

bilateral investment treaties (BITs) was 1,513 by the end of the 1997, of which about three-quarters were signed during the 1990s (UNCTAD, 1998, p. xix). At the regional level, prior to 1995, the North American Free Trade Agreement (NAFTA) between Canada, United States and Mexico provided the most important framework dealing with FDI issues.

It was argued that there are several problems with the existing bilateral or regional agreements. Bilateral agreements appear to play a relatively insignificant role in attracting FDI for individual countries. Moreover, with their rapid proliferation since 1990, they seem to have lost the capacity of signaling credible commitments for foreign investors (UNCTAD, 1998). Regional agreements usually focus on trade liberalization provisions and deal only additionally with FDI issues. They contribute – by increasing the market access of foreign investments - but do not address directly the policy framework for the treatment of foreign investment. They lack explicit provisions on the movement of factors of production, particularly FDI capital, and do not signal credible commitments for foreign investors due to loose dispute settlement and enforcement procedures (*ibid.*).

In summary, the lack of policy coherence and the presence of multiple agreements might increase the uncertainty, confusion, and hence the costs of doing business internationally (WTO, 1996). The “business transaction costs [...] arise directly from inadequacies of information, asymmetries in doing business in different countries, the heterogeneity of administrative procedures, and differences in business support measures” (UNCTAD, 1998, p. 123). Also, the fact that national laws and their enforcement may differ between the host and home country requires an internationally

efficient mechanism for dispute settlement. The argument seems particularly relevant in the case of developing and transitional countries. In these countries the content and the enforcement mechanism of domestic legislation concerning FDI is considered to be no alternative to internationally binding standards. Hence, the need for a binding multilateral agreement on FDI that would increase the credibility of government commitments by preventing backsliding as well as containing mechanisms for continuous liberalization and market oriented reforms (WTO, 1996; UNCTAD, 1998).

These efficiency arguments with a clear NIE flavor are in line with the need for supranational institutions like the General Agreement for Trade and Tariffs (GATT) and its main successor the World Trade Organization (WTO) that for the last 50 years have been laboring to code an international legal framework for trade. The increasing role of FDI which started surpassing trade, calls for a multilateral framework governing investment as a fundamental piece in coding the constitution of the global economy based on similar efficiency arguments (Ruggerio, 1998).

The beginning of negotiations in June 1995 for a multilateral agreement on investment by the twenty-five (now twenty-nine) member states of the Organization for Economic Cooperation and Development (OECD) confirmed that “their governments were not satisfied with the state of international law regarding foreign direct investment” and that “the time has come to negotiate a more comprehensive regime to govern foreign direct investment” (Hart, 1996, p. 4). The intention of the MAI negotiations was to establish a broad-based, comprehensive agreement that would serve as a benchmark for any further agreements on FDI. As Hoekman (1996) explained, the efficiency arguments reviewed above did not explain why negotiations began at the OECD and not

at the WTO. If the MAI was supposed to represent a global framework for governing foreign investment, the exclusion of developing countries from the agreement by conducting negotiations at OECD was not justified.

The United States was at the forefront for starting negotiations at the OECD as opposed to negotiations at the WTO or at the United Nations Center for Trade and Development (UNCTAD), and justified this choice for two reasons. First, the OECD was considered a better intermediate venue because of fears that the developing country members of WTO or UNCTAD would impede the speed and content of negotiations for such a far reaching agreement (Hart, 1996). As Ambassador Eizenstat (1996), Under Secretary for International Trade, U.S. Department of Commerce explained, it was important to

keep in mind that there are a number of developing countries that are adamantly opposed to initiating any WTO work on investment (e.g. Indonesia, Malaysia and India), and most of the developing countries that indicated support for WTO investment work want the mandate to remain educative in nature. [As a result] negotiations in other fora such as the WTO or UNCTAD would lead not only to substandard agreements but might also have the effect of taking momentum from negotiations in the OECD (Eizenstat, 1996, p. 19).

The creation of a global treaty on investment was supposed to be a two-stage process with the MAI being the intermediate phase. As Donnelly (1996), Deputy Assistant Secretary for Trade Policy and Programs, U.S. Department of State explained when stating the U.S. position on the MAI negotiations:

The Clinton Administration attaches top priority to America's economic security as a goal of our foreign policy. NAFTA, the Uruguay Round of the GATT, APEC and the Summit of Americas, to name a few of the economic achievements of the last three years, have made the United States an integral part of an increasingly open global trading system... With completion of the Uruguay Round negotiation of the GATT, our attention has turned to the need to develop comprehensive international rules governing investment... We believe the more sensible course is to complete negotiations of the MAI in the OECD, where we can be better assured of obtaining a high-standard agreement and allow it to serve as a benchmark for later negotiations in the WTO when there is greater acceptance of the need for such an agreement (Donnelly, 1996, p. 30).



The second reason was that there were still disagreements between the U.S. and the other OECD member states on the exact disciplines and coverage of a general agreement on investment. As Donnelly explained again:

...The United States has stated consistently that only a state-of-art agreement in the OECD, meeting or exceeding the standards of our Bilateral Investment Treaties (BITs), would be of interest to [the US]. This can be achieved by eliminating foreign government screening of inward investment in those few OECD countries where it still exists; providing national treatment for foreign investors when countries privatize state enterprises and open monopolized sectors of their economy to competition; and opening protected sectors to foreign investment. [The US does] not believe it is appropriate to a high-standard, multilateral investment agreement to carve out from its coverage either broad sectors of the economy, such as culture, or broad exceptions to the most favored nation commitments, such as for regional economic integration organizations. (Donnelly, 1996, p. 31)

After three years of deliberations the negotiations on the MAI collapsed. As the U.S. representatives feared, the OECD governments proposed a large number of exceptions from the general rules including restrictions on foreign investment in the agriculture sector (European Union), the provision of subsidies and the carving out of the culture sector (France and Canada). In addition to disagreements among governments, the MAI found strong opposition from non-governmental organizations, in particular environmental and labor groups. Despite these difficulties there remains considerable support for global rules on foreign investment. FDI provisions resembling many of the MAI commitments<sup>11</sup> continued to be negotiated in different regional or multilateral fora. The most important regional attempts after 1995 are: the negotiations for an investment chapter of the Free Trade Agreement of the Americas (FTAA) started in June 1998 and expected to be concluded by 2005, the Trade and Investment Cooperation Arrangement

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<sup>11</sup> The 1998 World Investment Report (UNCTAD, 1998) reviews the main regional and multilateral FDI related agreements and their relation to past, and possible future work on an extensive MAI type multilateral framework for investment. See particularly pp. 59-74 and pp. 117-133.

signed between MERCOSUR and Canada on 17 June 1998, the work on an ASEAN Investment Area framework agreement started in 1995, and the Energy Charter Treaty entered into force on 16 April 1998 and ratified by 38 countries by the end of June 1998 together with its Supplementary Treaty regarding investment. The most important multilateral attempts are: the FDI related agreements for the telecommunication service industries (the Fourth Protocol to the General Agreement on Trade in Services (GATS) on Basic Telecommunication Services) and for the financial service sectors (the Fifth Protocol to the GATS on Financial Services) concluded at WTO in 1997.

Further proposals have been considered by some countries to incorporate certain aspects of the MAI negotiations into the negotiating round expected to begin with the November 1999 WTO Ministerial meeting<sup>12</sup>. At the OECD Ministerial Council meeting in 1998, the Ministers of Member countries stated that “they support the current work program on investment in the WTO and once the work program has been completed will seek the support of all their partners for next steps towards creation of investment rules in the WTO” (OECD, 1999, p. 1). The OECD work program relating to international investment will continue under the Committee on International Investment and Multilateral Enterprises in cooperation with other OECD committees, the WTO, UNCTAD, World Bank and the IMF in dialogue with developing countries, and representatives of civil society (ibid.).

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<sup>12</sup> Switzerland, the European Communities, Japan, China and Korea have submitted communication documents regarding negotiations on trade and investment to the General Council of WTO in preparation for the 1999 Ministerial Conference (WTO, <http://www.wto.org>). In the case of China, Korea and the European Communities there is a clear recognition of the need to differentiate between FDI and other short-term capital of portfolio investment (MAI has lumped these elements together) and focus exclusively on the FDI negotiations. There is also a clear recognition of the importance of labor and environmental related issues for any FDI negotiations. In the case of Japan (<http://www.miti.go.jp/report-e/gIT1102e.html>), the proposal for WTO negotiations of FDI resembles almost entirely the last MAI draft.



“The collapse of negotiations on a multilateral investment agreement in 1998 suggests that a global treaty on investment rules is still some way off” (World Bank, 1999, p. 82). However, “international mobile capital is here to stay” (ibid, p. 85). These institutional legal developments together with the theoretical developments of NIE underlines the scope and importance of this study.

## **Chapter two: The MAI: content and analysis**

### **1. Introduction**

This chapter presents an overview and analysis of the Multilateral Agreement on Investment (MAI) draft. For the purpose of this thesis, the contents of the last MAI text, as of 24 April 1998, can be grouped under four main parts: preamble, scope, obligations and dispute settlement provisions. Sections 2 to 5 below present the summary and analysis of these four main components of the agreement. Section 6 concludes by summarizing the main debates on the possible implications of the MAI and by explaining the need for a theoretical analysis of the logic behind the agreement.

### **2. Preamble**

The preamble to the MAI encompasses four statements: (1) the circumstances shaping the context of, and the need for, the MAI; (2) the scope of the MAI; (3) the relation of MAI to international standards for environmental law and labor practices; and (4) the nature of the MAI as a free-standing agreement. The circumstances shaping the context of and the need for MAI include the belief of the contracting parties that international investment assumes a great importance in the world economy and the belief that the MAI will enhance the efficient utilization of economic resources, the creation of employment opportunities and the improvement of living standards. The scope of the MAI is the establishment of multilateral rules for foreign investment with high standards for the liberalization of investment regimes and investment protection and with effective dispute settlement that would complement and benefit the world trading system. The third statement expresses contracting parties' desire to implement

this agreement in a manner consistent with sustainable development and international environmental law (as reflected in the Rio Declaration on Environment and Development and Agenda 21). It also recognizes their commitment to core labor standards<sup>1</sup> by referring to the OECD Guidelines for Multinational Enterprises - whose non-binding legal nature is expressly highlighted. The fourth statement represents a declaration on the nature of MAI as a free-standing agreement open to accession by all countries.

The preamble to the MAI text reflects the assumption that economic development will arise as a positive externality from the implementation of the agreement. This condition, however, is neither a binding interpretation of the agreement nor a directly specified objective of the MAI itself. As a result, the MAI provisions would prevail, even in the cases when they would be inconsistent with effective developmental policies followed by a signatory country (Fitzgerald, Cubero-Brealey & Lehmann, 1998). For the MAI proponents, the international environmental standards reflected in the Rio Declaration represent the standards which the MAI will meet upon implementation (ibid.). For the MAI opponents (Sforza & Vallianatos, 1997; Clarke and Barlow, 1997; Swenarchuk, 1998), the MAI's provisions are in conflict with the provisions of the Rio Declaration and hence might represent a niche for escaping previous international environmental commitments. This position was also expressed in a joint "NGO Statement On The MAI"<sup>2</sup> which was a result of the October 1997 NGOs/OECD consultations and endorsed by 565 organizations in 68 countries. The labor standards provided by the OECD Guidelines for Multinational Enterprises are non-binding. The Trade Union Advisory Committee

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<sup>1</sup> Noting that the International Labor Organization is the competent body to create and oversee these standards.

<sup>2</sup> Text available in Jackson and Sanger, 1998, p. 319.

of the OECD<sup>3</sup> (TUAC, 1997) does not anticipate the voluntary compliance of corporations with the OECD Guidelines and argues for the necessity of introducing direct references to binding labor standards in the MAI text. Over the years, TUAC criticized the lack of attention paid by both TNCs and governments to the implementation of the OECD Guidelines (Jones, 1998). The OECD's monitoring of the impact of these guidelines on TNCs' activities in developing countries was particularly low (OECD, 1996).

### 3. Scope

The agreement's scope and application section establishes how broadly or narrowly the agreement is to be interpreted. In this section two key terms, "investor" and "investment", are defined. The MAI defines an investor as either a natural person (whether a national or a permanent resident) or an enterprise. An enterprise is defined as a "legal person or any other entity organized under the applicable law of the contracting party, whether or not for profit, and whether or not government owned or controlled" (OECD, 1998a, p. 11). The MAI is built upon a broad, asset-based definition of 'investment', which includes not only foreign direct investment as such but also the direct or indirect ownership or control of any other asset. The agreed approach in the last MAI draft is to provide broad coverage of all forms of investment coming from the MAI investors (Witherell, 1997). Non-traditional forms of foreign investment such as indirect investment, intellectual property, public debt, real estate, financial services, and short-term investments are included in the definition of investment under the MAI.

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<sup>3</sup> TUAC has consultative status with the OECD and, based on 1998 data (Jones, 1998) represents 70 million workers in 55 affiliated trade union national centers in the 29 OECD countries.

Notwithstanding the introduction of prudential measures and temporary derogation provisions with respect to financial capital flows<sup>4</sup> under the last MAI draft, most foreign investment transactions are considered to be legitimate investments. The implications of this broad definition of investment which includes short-term investments are important in that short-term capital flows are more likely to cause macroeconomic imbalances, particularly currency crises and have been traditionally given different, more restrictive treatment. It has been argued that MAI provisions will apply to all speculative investments including those types that have caused currency chaos in the Asian countries (Dobbin, 1998). It could also apply to the repatriation of assets and profits by foreign investors. Sudden capital outflows of these types, unrestricted by government controls were considered by some to be the main destabilizing factor that contributed to the Mexican peso crash in late 1994 (Vallianatos, 1997). Because of the broad definition of investment which encompasses any kind of asset owned or controlled directly or indirectly by an investor, it has been argued that any government or private action that affects any of the assets could be challenged under the MAI (Durbin, 1997).

The MAI aims to apply to all economic sectors. As the critics remarked, “the MAI takes a top down rather than a bottom up approach to liberalization. In other words, a sector is covered by the Agreement unless it is specifically excluded” (Chapman, 1997, p. 12). The MAI also intends to apply to all levels of government. In the Canadian context, this raised concerns about the decline in the sovereignty and in the bargaining power of provincial governments in favor of federal governments and transnational corporations. The ability of minority and native groups to rely on self-governance and control of local development could also be decreased (Mercredi, 1998). Acceptance of this provision of the MAI would also lead to *de jure* or *de facto*

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<sup>4</sup> See the financial servicees obligation under Section 4 of this chapter.

amendments of existing national constitutions, for example in Canada, where such a transfer of power from provincial to federal government is argued to be unconstitutional (Robinson, 1998).

#### 4. Obligations

Contracting Parties' obligations regarding the treatment of foreign investors are reflected in the MAI text under two types of standards. "Relative standards" of treatment - such as *non-discrimination* - are standards for the treatment of foreign investors that refer to other already existing bodies of rules in the recipient country. As opposed to these, there are "absolute standards" of treatment - such as *general treatment* - that are not contingent on host countries' legislation but on international law (OECD, 1998b, p.29). The principle of *non-discrimination* is established by means of the relative standards of *national treatment* (NT) and *most favored nation treatment* (MFN). This provides that Contracting Parties shall accord to foreign investors and investments treatment no less favorable than that accorded to its own national investors and investments (NT) or to investments from any other country, whether or not party to the MAI (MFN); and in any case, shall accord to them the more favorable of NT and MFN, "with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment, and sale or other disposition of investments" (OECD, 1998a, p. 13). Discrimination in the agreement includes both "de jure" (formally discriminatory) and "de facto" (discriminatory in effect) discrimination (OECD, 1998a, p.28). The *General Treatment* principle states that each Contracting Party shall accord to investments in its territory of investors of another Contracting Party "fair and equitable treatment and full and constant protection and security" (OECD, 1998a, p. 57), and in no case less favorable than that required by international law.



Under the MAI's *National reservation* provision contracting parties are allowed to lodge reservations to the NT and MFN principles by listing all the non-conforming measures maintained at the time of signing or acceding to the MAI. The schedule is supposed to list all the non-conforming measures which the country intends to maintain, as well as future amendments to them with the obligation that the amendments would not increase the non-conformity of the measures (OECD, 1998a). The content of Annex A of the Agreement resembles the *standstill* principle of the MAI (the prohibition of newer or more restrictive exceptions) as explicitly mentioned in the Commentary text to the MAI draft. The 24 April 1998 MAI draft, differs from the May 1997 MAI draft in that the *roll-back* principle of the MAI (the liberalization process by which the reduction and eventual elimination of non-conforming measures will take place) appears in the agreement as a voluntary commitment and not as an explicit obligation. However, nothing else besides this and the shift of the explanatory provisions on the roll-back principle from the MAI text to the Commentary text section has been changed. The roll-back principle is still acknowledged as a fundamental principle of the MAI negotiations that would be effective on the Contracting Parties through strong peer pressure and/or exchange of concessions in subsequent rounds of negotiations<sup>5</sup>.

The national reservations provision allows contracting parties to maintain some protectionist leverage in key sectors of the economy like culture, education, health and social services. However, consistency with the principles of standstill and roll-back requires the intention for future opening up of these sectors to foreign investment. France's attempts at the end of 1998, to obtain a definite exemption of its cultural sector met with strong opposition from the U.S. delegation and led to the withdrawal of France from the MAI negotiations. The obligation to accord to foreign investors treatment no less favorable than for domestic firms

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<sup>5</sup> See for example page 60 in OECD, 1998b.

eliminates governments options of screening foreign investment applications against certain criteria in line with national goals and objectives. Notwithstanding the provision of the national reservations' option, the standstill and roll-back principles underline the central commitment of the Agreement to identify and eliminate over time all sectoral or regional protections that contravene the principle of non-discrimination (NT and MFN). Further, as many critics have pointed out, the Agreement provides for non-discrimination of foreign investors in respect to domestic ones but does not prohibit a better treatment of the former than the latter (Khor, 1998; Dobbin, 1998; Durbin, 1997; FitzGerald, et al., 1998). This provides further incentives for governments to decrease the protection of the domestic industry by shifting performance requirements from the foreign to the domestic investors' responsibility. The inclusion of de facto discrimination under the MAI jurisdiction means that "if it can be proved that a measure has the effect of harming a foreign investment even if that harm was incidental or unintended, it could be challenged" (Dobbin, 1998, p. 19).

The specific obligation provisions provided by the treaty include: transparency on administrative and judicial government rulings and regulations; granting of temporary entry and work permits to foreign investors, employees and their families; restrictions on the imposition of performance requirements; the obligation to treat foreign investors in a non-discriminatory way in respect to privatization, monopolies, concessions and investment incentives; as well as specific financial services provisions, expropriation and compensation provisions and withdrawal provisions. The most important specific obligation provisions are analyzed below.

*Performance requirements* – The type of performance requirements that Contracting Parties are prohibited to impose, enforce, or maintain as a condition for the establishment,



acquisition, expansion or disposition of an investment, were effectively summarized by Anthony Chapman as follows:

a) to export a certain level of goods; b) to achieve a given level or percentage of domestic content; c) to favor the purchase of domestically produced goods; d) to relate the amount of imports to the amount of exports or to the amount of foreign exchange from an investment; e) to restrict the domestic sale of goods or services by foreign enterprises to the level of exports or foreign exchange; f) to transfer technology, a production process or other proprietary knowledge except when imposed as part of a ruling respecting national competition laws or to transfer intellectual property rights; g) to locate a headquarters in the Contracting Party; h) to provide an exclusive product mandate for the world or for a certain region; i) to achieve a certain level of investment, production, sales, employment, research or development in a Contracting Party; j) to hire a given level of local personnel; k) to establish a joint venture; or l) to achieve a minimum level of local equity participation (Chapman, 1997, pp. 28-29)<sup>6</sup>.

The MAI's provisions regarding the treatment of performance requirements represent some of the most controversial provisions in the MAI debates. Performance requirements are policy tools extensively applied by governments, particularly in developing countries, to use foreign investment to harness the development of local communities in which these corporations invest, or to fulfill overall sectoral or macroeconomic strategic development objectives. The MAI prohibits the imposition or enforcement upon a foreign investor of any type of conditionality on the source and use of its factors of production or on the management of its production, sales, profits, research and reinvestments which are not also required of domestic firms. Requirements to use local suppliers or to hire a minimum number of local employees as well as requirements for a specific location of headquarters, transfer of technology, ratio of exports to total sales, research and development or reinvestment within the area or host country, are the most relevant conditionalities now forbidden under the MAI. The ban on performance requirements listed from f) through l) would not apply with respect to the "receipt of an advantage" (OECD, 1998a, p. 22)

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<sup>6</sup> The requirements listed from a) through e) can be applied with respect to: export promotion policies (for example, export processing zones), foreign aid programs, the production, processing and trade of agricultural products, advantages related to trade in services, custom duties or exceptions from such duties and preferential tariffs or quotas.

which is investment incentives granted by the receiving country. This provision might coerce governments to offer incentives in the forms of preferential taxes, subsidies or access to resources, including better treatment than offered to domestic firms, in order to obtain certain performance requirements from foreign investors.

*Privatisation* – Under this provision contracting parties are obligated to accord NT and MFN in relation to all kinds of privatisation, irrespective of their method, or rules regarding subsequent disposal of a privatised asset<sup>7</sup>. The privatization provision could affect particularly developing countries and those in transition from centrally planned to a market economy which are still involved in massive privatization programs. It could also affect developed and developing countries that intend to privatize infrastructure services in areas like transportation, telecommunication, banking and insurance, health or education.

*Monopolies, state enterprises and concessions*<sup>8</sup> - This provision refers to Contracting Parties' obligation to act in a non-discriminatory manner (to accord to foreign investors the best treatment of NT and MFN) when creating, maintaining or eliminating monopolies, either state or privately owned, as well as state enterprises. The same principle extends over the granting of concessions, authorizations for the exploration and production of minerals and over transparency measures (the notification on the creation or elimination of monopoly).

The prohibition of Contracting Parties to impose minimum or maximum levels of equity participation, as well as the provisions regarding privatization, the treatment of monopolies and

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<sup>7</sup> The compatibility of different methods of privatisation with the NT and MFN is not clearly determined in the last MAI draft. The text includes alternative proposals from different delegations regarding this issue. However, a compromise seems to have been reached which declares special share arrangements contrary to the obligations of NT and MFN if they discriminate *de jure* or *de facto* against foreign investors (see OECD, 1998a, pp. 27-30, specially footnote to paragraph 1, p. 28).

<sup>8</sup> The flexibility to lodge reservations to the agreement after the entry into force of the MAI, regarding this issue is not explicitly granted in the text.

the offering of government concessions represent limitations on government policies to protect specific sectors of the economy from foreign competition or ownership takeover. Governments, particularly in developing countries, maintain state or privately owned monopolies in key sectors of the economy like culture, education, health and social services and national defense. The MAI draft excludes from the areas subjected to the principles of the agreement just the defense sector. These arguments are particularly relevant in the light of current trends of FDI (see chapter one, p. 11) which show that the vast majority of FDI represents majority purchases cross-border mergers and acquisitions mega-deals.

*Incentives* - Any investment incentive measure is subject to the principle of non-discrimination. The compatibility of performance requirements related incentives with the NT and MFN is not explicitly determined<sup>9</sup>. The obligation to extend any government subsidy to foreign investors could enable foreign commercial providers to claim equal access to public subsidies for health and social services including the ones targeted towards specific organizations such as community-based non-profit agencies (Sanger, 1998). Although the MAI's proponents (FitzGerald, et al., 1998) disagree, the inclusion of preferential treatment and subsidies to domestic investors under the MAI treatment could decrease tremendously developing countries' latitude in drafting their own development strategy. The extension of government subsidies to foreign investors represents a costly, and in many cases unrealistic option, for countries that might have a lower annual national budget than the value of the annual sales of a major transnational corporation. Being unable to extend its subsidies to all investors, these governments might choose to cut or eliminate such subsidies. Together with the other pressures towards

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<sup>9</sup> The proposed text calls for further negotiations after the signature of the agreement regarding additional MAI disciplines for avoiding and minimizing the distorting effects of investment incentives on the flow of capital and investment decisions.

liberalization resulting from the privatization and monopoly provisions, this might cause a further crowding out of domestic investment in favor of foreign producers.

*Financial services*<sup>10</sup> – Within the financial service provisions, the most important one is the recognition that financial services are subject to the MAI principles. The agreement allows for exceptions from the application of the MAI as “prudential measures” necessary for investor protection or ensuring the stability of the financial system as long as they do not constitute “means of avoiding the Contracting Party's commitments or obligations under the Agreement” (OECD, 1998a, p. 81). This means that any prudential measure undertaken by a host government for ensuring the stability of its domestic financial system can be subject to dispute settlement if considered inconsistent with the MAI provisions by a foreign investor. The Agreement also allows for “temporary derogations” from the *NT* article relating to cross-border capital transactions in the event of “serious balance-of-payments” or “serious difficulties for macroeconomic management, in particular monetary and exchange rate policies” (ibid., p. 79). These non-conforming measures, however, shall be consistent with the Articles of Agreement of the International Monetary Fund (IMF), shall be temporary and subject to review and approval every six months by the IMF and shall be eliminated as soon as conditions permit. It results from the text that the IMF would be the institutional body that would decide which of the temporary derogations are consistent or not with this article of the Agreement. Further, based on the “text proposed by the IMF and supported by most of the delegations” (ibid., p. 80, footnote 7), any such assessment by the IMF shall be accepted by the Dispute Settlement Panel (see Dispute Settlement section below). There are concerns about possible loss of state sovereignty in the

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<sup>10</sup> The MAI contains specific financial service provisions covering: prudential measures, recognition arrangements, authorization procedures, transparency, information transfer and data processing, membership of self-regulatory bodies and associations, payment and clearing systems/lender of last resort, and dispute settlement.

conduct of monetary and exchange rate policy, IMF decisions having precedence over the Dispute Settlement Panel and over national governments' decisions on what constitutes appropriate monetary stabilization policies. These concerns are particularly relevant to the developing countries that suffer from chronic balance of payment problems and inflation, and where governments' control of volatile capital flows is a major policy tool in stabilization. The inclusion of significant capital account transactions – such as short-term capital flows – and of financial services under the definition of investment does not imply a direct obligation of parties to completely liberalize their capital accounts. These provisions do however, constrain governments' option to control capital account transactions by making any government policy in this area subject to the dispute settlement provision. Even in cases of monetary crises (like the ones recently experienced by the Asian countries) the IMF, as opposed to the national government, will decide which temporary measures of capital account control a country can use. As most developing countries experience currency instability they would be the most affected by these provisions.

*Expropriation and compensation* - The MAI text bans any direct or indirect expropriation, nationalization and “any measures having equivalent effect”<sup>11</sup> (OECD, 1998a, p.57) except if implemented in the public interest<sup>12</sup>, on a non-discriminatory basis, in accordance with the law and subject to prompt, fully convertible and transferable compensation at “fair market value” (ibid.). The host party for the investment has the obligation to pay interest rate payments or exchange loss adjustments when applicable. The expropriation and compensation provisions do not include a clear definition of expropriation. Similar to NAFTA's provisions, the

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<sup>11</sup> A taxation measure, for example, is subject to the expropriation and dispute settlement provisions if it exceeds “the bounds of internationally recognized tax policies and practices” (OECD, 1998a, p. 87, footnote 3b).

<sup>12</sup> The proposed text provides signatories with a general exemption from the obligations under the *expropriation and compensation* articles for reasons of national security, public law and order, and maintenance of international peace.



text refers to direct expropriation, indirect expropriation and to measures having equivalent effect. Therefore, expropriation can be by default defined by legal precedents in international or U.S. disputes, particularly the ones arising out of NAFTA (Dobbin, 1998). The best assessment of the possible effects of these provisions can be determined by looking at the use of similar provisions under NAFTA. Of the seven known challenges using NAFTA's investor right-to-sue-governments provisions, six involve U.S. corporations suing federal or state-level environmental measures in Canada and Mexico (Global Trade Watch, 1998). The most cited example by the MAI critics is the 1998 case Ethyl Corporation vs. Government of Canada. The Canadian Parliament acted to ban the import and interprovincial transport of an Ethyl product – the gasoline additive MMT - when public health officials determined that it may be a dangerous toxin. The U.S. based Ethyl Corporation responded by filing a lawsuit against the Canadian Government under NAFTA (Sforza & Vallianatos, 1997). The Ethyl Corporation demanded \$251 million in compensation for expropriation of property, including expected future profits from sales, and further threatened to increase its demanded compensations for the Canadian government's damage to the company's reputation should further deliberations by the Canadian Parliament be undertaken. "Faced with the growing likelihood it could lose the suit, Canada agreed to repeal the ban and pay Ethyl \$13 million in damages for lost profits to-date. Canada further agreed to pronounce MMT safe - without scientific evidence and in direct contradiction to the views of the nation's environmental protection agency" (Global Trade Watch, 1998, p. 1). This example shows that the expropriation and compensation provisions can seriously influence governments' capability to undertake environmental, health, or for that matter, any policy decision that can be challenged by a foreign investor under the MAI provisions.

*Withdrawal* –Finally, the MAI requires at least a five-year period before notice to withdraw from the agreement can be given, followed by the requirement to honor existing obligations to existing foreign investors and companies for another 15 years. “Effective locking-in is thereby guaranteed” for 20 years after signing onto the MAI (FitzGerald, et al., 1998, p. 22). One can argue that this provision, together with the standstill and roll-back provisions, can restrict signatory countries to one particular model of development by binding several future governments or Parliaments to the core provisions of the MAI. Together they provide for an effective mechanism for the continual liberalization of trade and investment and for the harmonization of national legislation with the more liberal ones.

## **5. Dispute Settlement**

The MAI text provides two mechanisms for resolving disputes regarding an alleged breach of the Agreement: *state-state arbitration* and *investor-state arbitration*. The main elements of these two types of dispute settlement and the differences between them are presented below.

*State-state arbitration* - This type of dispute settlement is a mechanism for Contracting Parties to address disputes regarding the interpretation or application of the Agreement. The mechanism includes several levels. First, the Parties must attempt to resolve the dispute through consultations, mediation or conciliation. If these consultations fail to reach an agreement the issue may be submitted to an arbitration tribunal. The tribunal would consist of either three or five members (if either Party chooses so). The tribunal members would be appointed by the Secretary General of the International Center for the Settlement of the Investment Disputes (ICSID) from within a roster maintained for this purpose. The tribunal might request reports on



any scientific or technical matter elaborated by a technical review board or an expert. Possible remedies that a tribunal could award are: a declaration that an action was in contravention of obligations under the Agreement; a recommendation that a Contracting Party should conform to these obligations; and an award of pecuniary compensation for any loss or damage to the requesting Party's investor. Tribunal awards will be made publicly available and will be final and binding but subject to partial or total nullification<sup>13</sup>. If the tribunal nullifies the award, the dispute would be submitted to a new tribunal. There is no explicit mention in the MAI text how many times these processes can be repeated. If a Party fails to comply with the award, the Parties' group<sup>14</sup> may decide to what extent the requesting Party will be allowed to take responsive measures (such as suspension of the benefits to the non-complying Party or its investors). Each party is obligated to pay the cost of its representation, the cost of the tribunal being split between parties. All these rules and procedures apply unless the disputing Parties agree to apply others.

*Investor-state arbitration* - This represents a mechanism under which the foreign investor (but not the host countries' government) may file claims concerning an alleged breach of the MAI, or of a specific obligation acquired by the Contracting Party under an authorization or written agreement. The foreign investor would have the option of having the dispute settled in one of the following venues: to the courts of the Contracting Party, in accordance with any agreed upon procedure or by arbitration<sup>15</sup>. The arbitration tribunal will consist of three members and the arbitration award will be final and binding. The award may declare that the Contracting

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<sup>13</sup> Either party can request the partial or total annulment of an award on the grounds that: the tribunal was not properly constituted, has manifestly exceeded its powers or was faced with corruption; there has been a serious departure from a fundamental rule of procedure; or the award has failed to state the reasons on which it was based.

<sup>14</sup> The Parties group comprise the Contracting Parties assisted by an elected Chair and by a Secretariat. Intergroup decisions should be made by consensus or majority.

Party contravened the Agreement and may request prompt pecuniary compensation or restitution in kind (when possible) of any loss or damage suffered by the investor.

The concerns related to the dispute settlement provisions refer mostly to the investor-state provision. The Ethyl Corporation vs. Canadian Government case presented above is a direct application of the investor-state arbitration mechanism under the dispute settlement procedure as drafted in NAFTA and the MAI. This mechanism allows a foreign investor to take the government of the host country directly to court for an alleged breach of the MAI obligations. As the amount of pecuniary compensation for all perceived direct or indirect expropriation can be extremely high, a national government might be expected to constrain itself from any measure or legislation that might affect foreign investors' expected revenue flows, as in the Etyl corporation vs. Government of Canada case. In this sense, devising policies as well as covering compensations arising out of other direct or indirect interfering measures, could therefore become a costly policy option, particularly for developing countries. As Appleton put it: "if a government persists in its goal of implementing MAI-inconsistent actions, *that government may be forced to rent back jurisdiction*. Governments are able to function freely, but they may have to pay compensation to do what they were elected to do" (Appleton, 1998, pp. 185-186).

## 6. Conclusions

The MAI negotiating draft, as of 24 April 1998, consolidated an important 3 years' dynamic of the most powerful countries in the world towards a benchmark multilateral agreement on foreign investment. As the negotiations collapsed, this draft might never be applied

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<sup>15</sup> The arbitration can be conducted under the Convention on the Settlement of Investment Disputes between States and Nationals of other States (ICSID), the ICSID Additional Facility, the United Nations Commission on International Trade Law (UNCITRAL) or the International Chamber of Commerce (ICC).

in practice or it may differ from any text that is eventually settled upon. Nevertheless, the analysis of the Agreement undertaken in this chapter underlines the overview logic and the main themes of concern, should the MAI or similar agreements materialize in the future.

On one side, the MAI's proponents argue that MAI will enhance the efficient utilization of economic resources, the creation of employment opportunities and the improvement of living standards. In this sense, the MAI represented both a set of general playing rules for foreign investment transactions - designed to reduce the uncertainty of foreign investors regarding national governments' treatment of their investments - and an efficient mechanism of enforcing these rules - via lock-in, roll-back and effective dispute settlement procedures. In their opinion, the MAI would particularly help reforming developing countries that lack credible political commitments and secure systems of property rights and hence, FDI inflows.

On the other side, the MAI's critics argue that the adoption of such an Agreement could have negative implications for governments' policies in the field of social services, health, culture, environmental policy, monetary and fiscal policy or, more generally, for any national development strategy. In this sense, the MAI would constrain governments – particularly developing countries' governments - from imposing obligations on TNCs to serve local economic, environmental or social needs related to their investments. Both proponents and critics of the MAI implicitly recognize that the Agreement would represent the benchmark for any further international agreements on foreign direct investment. The intention was to introduce the MAI under the auspices of the OECD and to proceed from there by peer group pressure for the attraction of the non-negotiating countries, particularly the developing ones to become signatory partners. From the beginning, the intention of the negotiators was to establish a broad-based agreement that would have as signatory members all the developing countries now members of

WTO. The OECD venue for the initial negotiations was considered a better intermediate venue for the conducting of negotiations than the WTO because of fears that the developing countries members of WTO would impede the speed and content of negotiations for such a far reaching agreement (Hart, 1996)<sup>16</sup>. Hence, there are concerns about the imbedded institutional constraint mechanism that resides behind the so-called free accession option of the developing countries.

A closer look at the various opinions on the possible implications of the MAI reveals the polarization of the debate around two main clusters. First, there are general concerns about the possible loss of state sovereignty in favor of the modern (transnational) corporation (the state/firm debate). Second, there are specific concerns about developing countries' possible loss of sovereignty and political flexibility in drawing their own domestic developmental strategies (the 'state/state' debate). An analysis of the arguments of both sides of the debate points out the fact that the differences between the sides reside not so much in the different opinions on possible implications of the Agreement that they envision as in the questions that they address. The MAI critics are more concerned with the questions "will the MAI decrease the sovereignty of states in favor of the modern corporation?" and "is the MAI a lever for constraining developing countries in their integration into the global economy?" In contrast, MAI proponents are more concerned with the question "is the MAI an efficient solution to the development process of both developed and developing countries?" To better understand the sources of the disagreements between the critics and proponents of the MAI we need a closer look at the different main theories (NEO and NIE) that seek to explain the increasing importance of TNCs and FDI in today's world economy, as they have different implications for policy analysis and policy making in the fields of development and reform.

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<sup>16</sup> See also the discussion in chapter one, pp. 19-22

## **Chapter three: The Williamson-North NIE Framework: content and analysis.**

### **1. Introduction**

The objective of the New Institutional Economics (NIE) is to create a theory of institutions and to incorporate it into neo-classical economics to permit the latter to “deal with an entire range of issues heretofore beyond its ken”(North, 1995, p.17). Central questions in NIE are: what are ‘institutions’? why have they come into existence? and what are their consequences for economic performance?

Within NIE Oliver Williamson focuses on institutions like firms and contracts. Douglass North focuses on institutions like politics and property rights. When analyzing the dynamics of institutional development, however, they refer to both types of institutions. Sections 2 to 5 below look at the answers to the main NIE theoretical questions as resulting from the works of Williamson and North. Section 6 concludes by emphasizing the departure of NIE from neoclassical economics (NEO) and the practical implications of this for economic development and reform.

### **2. What are ‘institutions’?**

The variable to be explained in NIE is the institution. Definitions of ‘institution’ refer to a framework of behavior: institutions direct, channel, or guide behavior (Groenewegen, et al. 1995). For North (1990a, 1995), institutions are the ‘rules of the game’ of a society or the ‘institutional environment’ for individual behavior. They are the humanly devised constraints that structure repeated human interaction, by structuring incentives in human exchange, whether political, social or economic (North,

1989,1990a). “They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior and self-imposed codes of conduct), and the enforcement characteristics of both” (North, 1995, p.23).

North is concerned not just with the background rules of a society but also with the main governance structure that creates and enforces these rules. The governance structure behind the institutional environments is the state. In his later works, North (1981, 1989, 1990a, 1990b) and North and Weingast (1989) apply a NIE transaction cost theory of the state. The state is the ‘third party enforcer’ of contracts between agents developed to sustain complex transactions that appear as a result of increased specialization and division of labor. From an organizational point of view, the state is a set of institutions that facilitate political and economic transactions. Compared to other organizations in an economy, the state has a comparative advantage in violence and it trades protection and justice for revenue (North, 1989). Ideology plays an increasingly important role in North’s (1981 on) explanations for the emergence and development of the state (see discussion of non-wealth maximizing motivations in section 3.1. below). When operationalized however, the state is more like a ‘political firm’: it is born for economic purposes – reducing uncertainty and transaction costs – and it runs on economic reasoning – trading protection and justice for revenue. This conceptualization of the state adopts Williamson’s organizational perspective on institutions and downplays the political purposes that underpin the emergence of the state.

For Williamson, institutions are the “institutional arrangements” defined as “the contractual relation or governance structure between economic entities that defines the way in which they cooperate and/or compete”, or as the “institutional matrix, in which



the integrity of a transaction is decided” (Williamson, 1996, p. 378). Four discrete institutional arrangements are recognized: classical market, hybrid, hierarchy and public bureaus (Williamson, 1996). Williamson is directly concerned with the first three. Classical markets (hereafter, markets) refer to the neoclassical concept of perfect markets. Markets are characterized by “large numbers of buyers and sellers on each side of the transaction and [by the fact that the] identity [of the transactors] is not important, because each can go its own way at negligible cost to the other” (Williamson, 1996, p. 378). Hybrids are “long-term contractual relations that preserve autonomy but provide added transaction-specific *safeguards*, compared with the *market*” (ibid.). Hierarchy is defined as “transactions that are placed under unified ownership (buyer and supplier are in the same enterprise) and subject to administrative controls (an authority relation, to include fiat)” (ibid.).

In NIE each type of institution aligns with a specific legal or contractual structure that offers specific costs as well as specific incentives for the contracting parts.<sup>1</sup> Markets are supported by classical contract law. Hybrid and hierarchy are supported by non-standard forms of contract, sometimes referred to as relational contracts (Furubotn & Richter, 1992). Classical contract law is comprehensive, it applies to the ideal transaction in neoclassical economics in which the identity of the parties is irrelevant, and supports the autonomous market form of organization (Williamson, 1996). Litigations resulting from this type of contract are resolved in court with strict reference to the law.

Nonstandard forms of contract that underlie hybrids and hierarchy emerge as the

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<sup>1</sup> As it will be shown in Section 5 of this chapter, the analysis of the different legal and contractual structure that underlies each type of institution is fundamental for the NIE logic. By looking at the relative costs with the design, enforcement, and adaptation of an institution as well as at the effect the institutions have on

characteristics of transactions diversify and the identity of the transactors matters. In contrast to classical contracts, relational contracts allow for gaps and flexibility in the drafting and revision of the agreement, accepting that “negotiations on matters of concern will be undertaken more or less continuously” (Furubotn & Richter, 1992, p. 20). The forum to which disputes are referred is that of arbitration (in case of hybrids) or hierarchies (in case of hierarchical arrangements) rather than the courts. In the case of hierarchy “the parties must resolve their differences internally. Accordingly, hierarchy is its own court of ultimate appeal” (Williamson, 1996, p. 98).

With reference to the state, constitutions, legislative enactments, regulations and executive decrees, are the legal devices that underlie political transactions. These “political institutions constitute *ex ante* agreements about co-operation among politicians” (North, 1990b, p. 359), are long term oriented, comprehensive and hence last on a flexibility scale of contractual forms. The system of property rights and the “credible commitments”<sup>2</sup> are the most important type of contracts applied by the institutions of the state (ibid. p. 357). The court for settling disputes arising out of these agreements can be Parliament, Congress, the common law courts or society itself – in case of revolutions (North, 1989).

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economic performance via the incentive set that they provide for human behavior, NIE ranks one type of institution in respect to another.

<sup>2</sup> Credible commitment refers to “a contract in which a promisee is reliably compensated should the promisor prematurely terminate or otherwise alter the agreement” (Williamson, 1996, p.377). In case of political credible commitments, “one has assurances that political bodies will not violate contracts of parties or engage in conditions that will alter radically the wealth and income of parties” (North, 1990a, p. 59).

### 3. Why do institutions come into existence?

That the main purpose and effect of institutions is economizing on transaction costs and reducing uncertainties is a theme running through the works of Williamson (1983, 1987, 1996) and North (1989, 1990a, 1990b, 1996). By modifying NEO's basic set of initial assumptions on the behavioral characteristics of the individuals involved in transacting and on the characteristics of the markets in which they transact, NIE allows for the existence of uncertainty and hence, transaction costs. Uncertainty and transaction costs further explain the emergence of institutions.

Neoclassical economic theory is built on the assumptions of scarcity and instrumental rationality. Scarcity implies competition. Instrumental rationality implies that rational behavior means acting in a way that is maximally efficient in achieving one's goals or system of goals (Audi, 1995). The efficiency argument in NEO assumes that the actors possess sufficient information to evaluate correctly the existing alternatives. It also assumes that they possess the sufficient computational power to process this information in order to make choices that will achieve the desired ends. Institutions are not present in the standard neoclassical equilibrium model. This model conceptualizes the 'market' as:

an abstract realm of impersonal economic exchange of homogeneous goods by means of voluntary transactions on an equal basis between large numbers of autonomous, fully-informed entities with profit-maximizing behavioral motivations and able to enter and leave freely (Harriss-White, 1995, p. 87).

Even if the rationality postulate allows for the existence of institutions, they play a purely passive role in the sense that they do not influence the choices the actors make.

In the 'frictionless' neoclassical world described above, new institutional economists argue, "institutions are unnecessary; ideas and ideologies don't matter; and

efficient markets – both economic and political – characterise economies” (North, 1995, p.17). As a result, prices are a sufficient allocative device to achieve the highest value uses, problems of contract enforcement would largely disappear, and there would be no economic advantages to private property and markets over, say, collective planning (Furubotn & Richter, 1997).

NIE retains the scarcity and hence competition assumption, but partially modifies the instrumental rationality postulate and some of the restrictive assumptions in the notion of ‘the market’ central to neoclassical economics. For Williamson the ‘contracting person’ is distinguished from the orthodox conception of maximizing rational person in two respects. First, behavior is “intendedly rational but only limitedly so” (Williamson 1996, p. 377). This condition of “bounded rationality” refers to “limited cognitive competence to receive, store, retrieve, and process information”. The second behavioral assumption is that of “opportunism” defined as “self-interest seeking with guile” (ibid. p. 6). Opportunism describes economic agents’ intention to “disclose information in a selective and distorted manner. Calculated efforts to mislead, disguise, obfuscate and confuse are thus admitted” (ibid. p. 56).

Similarly, North explores two aspects of human behavior: (1) “motivation” and (2) “deciphering the environment” (1990a, p. 20). Motivation refers to opportunistic behavior of economic or political entrepreneurs – to conceal information, “cheat, steal, or lie when the payoff to such activity exceeds the value of alternative opportunities” (ibid. p. 30) and “if the institutional matrix rewards piracy (or more general redistributive activities)...[to the opportunistic behavior] of learning to be better pirates” (North, 1995, p. 24). Deciphering the environment refers to “computational limitations of the individual

...determined by the capacity of mind to process, organize, and utilize information...in conjunction with the uncertainties involved in deciphering the environment" (North, 1990a, p. 25). This is in fact the process of learning or acquiring knowledge from the use of information, a process that North claims depends fundamentally on the "subjective mental models" (ibid. p. 21) of individuals about the world around them. North recognizes that "self-imposed codes of conduct", "altruism" and "ideological convictions" are non-wealth maximizing motivations that play an important role in individuals' decision-making processes and that significantly determine the subjective mental models (ibid. p. 22). Nonetheless, as Rutherford (1995) observes, he adopts the neoclassical practice of assuming behavior is intentionally rational and hence retains its maximizing orientation. Ramstad (1996) makes a similar observation in the case of Williamson.

NIE's modifications in NEO's behavioral assumptions have important theoretical implications. Together with changes in NEO's assumptions about the characteristics of the market they allow for the introduction of transaction costs variables in the NEO model and hence, constitute the building blocks of the NIE theory of institutional development.

With respect to the changes in the second set of assumptions (on the concept of 'market') both authors employ stylized descriptions of the market. North criticizes NEO's assumption of the homogeneity of goods and services by pointing to the different attributes of the products exchanged, and to the different attributes of the performance of the agents involved in transactions. He gives examples like the purchase of an automobile or the purchase of a doctor's services. A particular color, style or gasoline mileage of the

car, in the first case, or the particular skills of the doctor and office waiting time, in the second case, are all different valued attributes by the buyer. "The value of an exchange to the parties, then, is the value of the different attributes lumped into the good or service" (North, 1990a, p. 29) which differs significantly from one case to another.

Williamson criticizes NEO's description of the market by looking at the different attributes of the transactions as they appear in real markets: asset specificity, frequency and uncertainty. Asset specificity refers to "a specialized investment that cannot be redeployed to alternative uses or by alternative users except at a loss of productive value. Asset specificity can take several forms, of which human, physical, site, and dedicated assets are the most common" (Williamson, 1996, p. 377). The different frequency with which transactions recur is important for different reasons. Low frequency, like asset specificity, can lead to bilateral dependency<sup>3</sup> between exchanging parts, higher costs in finding the right terms of exchange and in higher uncertainty. For Williamson, transactions are also subject to different degrees and types of uncertainty, real markets being characterized by greater uncertainty in transactions than ideal classical markets. In NIE, real markets replace ideal homogeneous, frequent, between large numbers of agents, impersonal and secure transactions with asset specific, sporadic, personal, uncertain, and between small numbers of agents, bilaterally dependent and highly uncertain transactions.

Once we adopt the contractual rational person versus the neoclassical rational person, the non-homogeneity of goods and services and the discrete characteristics of the transactions, it logically results that there is a cost of running the economic, social and political system. Finding out the information needed to transact, transforming it into

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<sup>3</sup> Bilateral dependency refers to "an ongoing dependency relation...between a buyer and a supplier when one or both have made durable specialized investments in support of the other" (Williamson, 1996, p. 377).



knowledge, acting upon it and enforcing agreed upon individual or collective actions become costly in terms of money, capital, labor and time. NIE refers to these costs as transaction costs.

For North, transaction costs are the “costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements” (North, 1990a, p. 27). They “consist of the resource inputs of land, labor, and capital involved [...] in transacting – defining, protecting and enforcing the property rights to goods (the right to use, the right to derive income from the use of, the right to exclude, and the right to exchange)” (ibid., p. 28) where information costs are that part of transaction costs which includes “the costs of measuring the valued attributes of goods and services and the varying characteristics of the performance of the agents” (ibid., pp. 30-31). North distinguishes between transaction costs that “go through the market” and therefore are measurable, and “hard-to-measure costs”. The first category includes “the cost associated with banking, insurance, finance, wholesale, and retail trade; or, in terms of occupations, with lawyers, accountants, etc”(ibid., p. 28). The second category includes "unmeasured costs of societal cooperation" (North, 1989, p. 1320) like “queuing, waiting, rationing, bribery” (ibid., p. 1324) present particularly in developing countries.

For Williamson transaction costs are “the costs of running the economic system” (1996, p. 379). Because in his analysis every transaction aligns – as a function of its characteristics - with discrete contractual forms, and simultaneously, with different governance structures, he refers interchangeably to the concepts of ‘transaction cost’, ‘cost of contracting’, and ‘cost of governance’. Williamson distinguishes between “the ex

ante costs of drafting, negotiating, and *safeguarding* an agreement” and “the ex post costs of maladaptation and adjustment” (Williamson, 1987, pp. 81-82). Ex-ante costs refer to measurement and searching expenses to assure a closer correspondence between the value and price of the product exchanged or labor force employed. They also refer to expenses incurred in designing the most appropriate contract for safeguarding the values in exchange (ex ante incentive alignment). Ex-post costs “arise when contract execution is misaligned as a result of gaps, errors, omissions, and unanticipated disturbances” (Williamson, 1996, p. 379). Hence, they underlie the effort to facilitate efficient adaptations of the ex ante agreements. The ex post costs “include the setup and running costs of the governance structure to which monitoring is assigned and to which disputes are referred and settled” (Williamson, 1987, p. 388). Critical examples of ex post adaptation costs are “sunk costs” and “bureaucratic costs” (Williamson, 1987, 1996). Sunk costs emerge as a result of asset specificity. Where transactions are sufficiently unique and/or infrequent that reputational constraints do not obtain and one party of the transaction can affect the value (costs and quality) of the product supplied, sunk costs must be incurred by one or both parties to the exchange to support the continuation of the contract. Bureaucratic costs refer to costs implied by bureaucracy - the support staff and administrative control required for providing direction to the operating parts of a hierarchical enterprise (Williamson, 1996).

In conclusion, in NIE transactions costs can be thought of as embracing all those costs that are connected with: (i) the creation, enforcement and restructuring of an institutional environment or arrangement; and (ii) the use of an institutional environment

or arrangement (Furubotn & Richter, 1992)<sup>4</sup>. The observation that imperfect information and uncertainty make any transaction costly and that reality resembles a world characterized by positive transaction costs fundamentally changes NEO's idea of the real world. People are not perfect, their actions can have unexpected individual or unintended collective outcomes. Markets are not perfect; they might break down and not clear via price movements. Additional mechanisms for coordination, such as institutions, are needed to make transactions possible. In designing efficient economic reforms policy makers need to identify efficiency criteria to choose between different alternative institutions (institutional environments and arrangements). Determining such criteria calls for theoretical explanations of the interaction between institutions and economic performance.

#### **4. The consequence of different institutions for economic performance.**

Neoclassical economics defines economic performance as efficient –under conditions of zero transaction costs - if based on a profit-maximization rationale. At the micro level an efficient firm is maximizing profits and minimizing production costs. At the macro level an efficient economy, or nation state, is maximizing its gains from trade. Institutions are not influencing economic performance as Pareto optimal efficiency (maximizing the welfare of the society in the sense that no one will be able to be better

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<sup>4</sup> Although Furubotn and Richter don't use directly the institutional environment - arrangement terminology in their classification of transaction costs, but rather talk about the creation, change, and use of "an institution or organization" (1992, p. 8), it is precisely the former distinction that they have in mind. The "creation, enforcement and ... restructuring [of the] "rules of the game" ... represent activities that are associated with the first kind of transaction cost [the creation or change of an institution or organization]...[The] "second type of transaction cost [the use of the institution or organization] ...are costs associated with the use of markets ...[and]...the right to give orders within a firm" (ibid. pp. 8-9).

off without making someone worse off) arises from the atomistic interaction of self – seeking individuals.

NIE points out that although NEO implies the existence of institutions, it is not able to explain them. By introducing transaction costs, maximization becomes costly both in the production and in the management sense, and individual and groups' decision making suddenly takes place within a constantly uncertain and dynamic environment. Institutions become necessary to allow for rational maximization at minimum total costs (production and transaction costs). Institutions affect the performance of the economy by reducing the transaction costs and hence by increasing the maximum social output. But, as NIE explains, allocative efficiency (the best allocation of scarce resources at minimum cost) is only part of the story. Maximization takes place at both a certain moment in time and over different time periods. The initial concept of the allocative efficiency of resources applied by neoclassical economics is then enlarged in NIE to deal with situations of adaptation over time. "Adaptive efficiency" is concerned with the kinds of institutions that shape the way an economy evolves over time (North, 1990a, p. 80).

The NIE's theoretical explanation of the interaction between institutions and economic performance rests on the idea that each institution offers different incentives that have different allocative and adaptive efficiencies. Through the incentive structure that it provides, the general institutional environment constrains the choice set of individual choices. Alternative institutional arrangements emerge to take advantage of opportunities embedded in the institutional environment. The historical development of the institutional arrangements is drastically constrained by the initial institutional framework. Efficient adaptations at the institutional environment level are slow and

incremental. The causality however runs both ways, with political and economic entrepreneurs devoting resources to alter a certain institutional environment when the expected benefits (in terms of minimizing transaction costs) exceed the cost of transformation (North, 1990a). Development arises from the interaction between these two institutional levels with technology and the entrepreneurial spirit being the major forces that determine change (North, 1990a; Williamson, 1996).

## **5. Efficiency criteria for comparative institutional analysis**

The components of the institutional environment can either increase or decrease the society's total costs of exchange and production. The institutions of state, for example, can imply different levels of organizational costs. The U.S. Congress represents in North's opinion the closest proxy to the ideal model of polity being characterized by low cost transacting "as compared to a totalitarian polity"<sup>3</sup> (North, 1990b, p. 360). But the most important component of the institutional environment in effecting development is an "efficient system" of property rights, that is, one that "maximizes social output" (North, 1981, p. 24) or reduces transactions costs and "encourages economic growth" (ibid, p. 25). In North's opinion, the institutional environment most favorable to affect efficient property rights is a modern democratic society with universal suffrage and flexible vote trading. Lack of economic growth in developing countries is attributed to "inefficient property rights" that arise out of the attempts of those who control the

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<sup>3</sup> As both North and Williamson point out, as a comparative institutional matter, secure totalitarian regimes can, according to the transaction costs logic, be expected to design more efficient public agencies. However, if one takes in consideration the "unmeasured costs of societal cooperation" (North, 1989, p. 1320) like "queuing, waiting, rationing, bribery" (ibid, p. 1324) or "if democratic values are held to be paramount...[...].the apparent inefficiencies of agencies under a democracy are simply a cost of this form of governance" (Williamson, 1996, p. 229).

apparatus of the state to generate rents together with problems of measurement and transaction costs (Rutherford, 1994, p.161).“Third World countries are poor because the institutional constraints define a set of payoffs to political/economic activity that do not encourage productive activity” (North, 1990a, p. 110).

North’s explanation for the contrast between the success story of the developed countries (principally the U.S.) with the failure of the developing countries is the prevalence of incentives for cost reducing institutional innovations in the one and their absence in the other. One may ask, however, why rational political and economic actors in developing countries do not replicate the efficient type of institutions of the developed ones? How can we explain a history of persistent underdevelopment of the developing countries? North (1990a) finds the explanation in the opportunistic behavior of the actors and their subjective perceptions about the true model of the world and about the fairness of the institutional environment. The subjective perceptions are reflected in self-enforced codes of conduct and in the ideologies embraced by economic and political actors. Together with the “cultural constraints embodied in customs, traditions and codes of conduct, they represent the key to explaining the path of historical change”(1990a, p. 6). “Path dependency” arises from the type of knowledge encouraged and rewarded by the institutional environment and hence, the type of knowledge acquired by the entrepreneurial firms (ibid, 112). Productive knowledge that encourages entrepreneurial spirit and innovation will lead to efficient economic outcomes. Knowledge of learning to be better pirates under an institutional environment that encourages redistributive versus productive activities will lead to inefficient path dependent outcomes. North considers the



formation of path dependency directly related to the initial institutional framework. In the case of developing countries,

the initial set of institutions that provide disincentives to productive activity will create organizations and interest groups with a stake in the existing constraints. They will shape the polity in their interests. Such institutions provide incentives that may encourage military domination of the polity and economy, religious fanaticism, or plain, simple redistributive organizations, but they provide few rewards from increases in the stock and dissemination of economically useful knowledge. The subjective mental constructs of the participants will evolve an ideology that not only rationalizes the society's structure but accounts for its poor performance. As a result the economy will evolve policies that reinforce the existing incentives and organizations (North, 1990a, p. 99).

The resultant "path dependence" of these economies comes from the "increasing returns mechanisms" described above that reinforce the direction once a given path is established (North, 1990a, p. 112). In conclusion, for North, developing countries failure to reach the economic level of the developed ones is not to be explained by external factors but by history and endogenous institutional factors (Collard, 1995).

From a practical point of view it is essential to determine what kinds of policies or phenomena can cause a positive turn around situation in relatively less efficient economies of the developed countries or in the inefficient dependency paths of developing countries. In North's opinion, technological change and innovation play a fundamental role in development by drastically reducing the level of transaction costs (North, 1990a). Policies that stimulate innovation - like education and research - and, more important, policies that facilitate the import and assimilation of new advanced technology from developed countries - like liberalization of trade and investment - are fundamental. Hence, changes in the institutional environment coming from an efficiently reformed polity are in most cases necessary but as North remarks, "we know very little about how to create such polities" (North, 1995, p. 366) as "we do not know how to create adaptive efficiency in the short run" (ibid. p. 367). What we do know however is

that “one gets *efficient* institutions by a polity that has built-in incentives to create and enforce efficient property rights” (North, 1990a, p. 140).

An analysis of the incentive structure embedded in the polity goes back to the organizational perspective on institutions as governance structures having a life of their own (Williamson, 1996). Williamson’s analysis at the level of institutional arrangements claims to bring relevant answers to these issues of development and reform (Williamson, 1996). The relative efficiency of different institutional arrangements is assessed based on three efficiency criteria: “adaptability”, “bureaucracy” and “incentive intensity”(ibid., p. 151). The capacity of an institution to adapt to change can take two forms. The first is the “autonomous adaptation” which describes spontaneous change via spontaneous institutional arrangements (markets or the price system). The second is the “cooperative adaptation” which describes coordinated, strategic change via intentional institutional arrangements (hybrids and hierarchies) (ibid., p. 103). The market is superior to hierarchy in respect to autonomous adaptation but inferior in respect to cooperative adaptation as asset specificity, and hence bilateral dependency, becomes more consequential. When bilaterally dependent parties are unable to autonomously adapt in a time efficient and hazard mitigating efficient way, because of disagreements and self-interested bargaining, the need for coordinated adaptation via firms or hybrids arises (Williamson, 1996). The transfer of such transactions, from the realm of the markets to the realm of firms, creates added bureaucratic costs. But if the cost of transactions that go through the market can be thought of as the “cost of using the price mechanism” (Coase, 1937, p. 390), the bureaucratic cost can be thought of as the “cost of utilizing the right to give orders” (Furubotn & Richter, 1992, p. 10). Bureaucracy represents the equivalent mechanism for

hybrid and hierarchy that the market finds in the 'invisible hand' of Adam Smith or in the marvel of the price mechanism. The market however is characterized by higher incentive intensity than hierarchy as a result of subsequent agency problems under the latter mode of organization. Incentive intensity is:

a measure of the degree to which a party reliably appropriates the net receipts (which could be negative) associated with its efforts and decisions. High powered incentives will obtain if a party has a clear entitlement to and can establish the magnitude of its net receipts easily. Low-powered obtain if the net receipts are pooled and/or if the magnitude is difficult to ascertain (Williamson, 1996, p. 378).

Markets and hierarchies are the polar opposite modes of organization with the hybrid mode located between the two in all efficiency criteria respects. Hybrid "is characterized by semi-strong incentives, an intermediate degree of administrative apparatus, displays semi-strong adaptation of both kinds, and works out of a semi-legalistic contract law regime" (Williamson, 1996, p. 105). As compared with the market it "sacrifices incentives in favor of superior coordination among the parts. As compared with the hierarchy, the hybrid sacrifices cooperativeness in favor of greater incentive intensity" (ibid., p. 107). As Ramstad (1996) points out, Williamson concentrates on the governance structure implications for transactions costs and on the contracting problems that will be encountered in achieving transaction cost economizing. His theory is

centered first, on governance of various types of bargaining transaction via the market (price mediated transactions) and relational contracting (transactions mediated by means of a negotiated procedure) and, second, on the conversion of bargaining transactions into managerial transactions (intra-firm, command-mediated transactions) (Ramstad, 1996, p. 2).

Hence, Williamson's analysis emphasizes his efforts to create a theory of the firm not as a production unit (neoclassical sense), but as a governance structure. "Throughout, the objective is to show how specific types of arrangements manifest the general rule that the governance procedures are efficient solutions to the problem of transacting cost

minimization” (Ramstad, 1996, p. 2). As a general rule, as societies develop and economies become more complex, asset specificity builds up and hybrids and hierarchy are more efficient solutions than markets. “Problems with markets arise as bilateral dependencies, and the need for cooperative adaptations, builds up” (Williamson, 1996, p. 237). Within hybrids and hierarchies, private or private-public institutional arrangements are superior to public institutional arrangements in all efficiency criteria respects. In terms of incentive intensity, private property is advantageous largely because when contract enforcement is costly, ownership aligns with individual incentives (Furubotn & Richter, 1997). In terms of bureaucracy and adaptability, public institutions are closely related to political markets and hence to the initial institutional framework. In Williamson’ words: “Were it not that systems drifted away from their initial conditions, efforts to replicate markets within hierarchies (or the reverse) and selectively intervene would be much easier-in which event differences between organization forms would diminish” (Williamson, 1996, p. 240).

## **6. Conclusions and implications for economic development and reform**

For Williamson, NIE is an “exercise in comparative institutional analysis, in which the efficacy of alternative modes of organization – markets, hybrids, hierarchies, public bureaus – are examined in relation to and aligned with the attributes of transactions” (Williamson, 1996, p. 327). Paraphrasing Williamson, for North, NIE is an exercise in comparative institutional analysis, in which the efficacy of different social contracts – in developed and developing countries – are examined in relation to and aligned with the attributes of transactions. In conclusion, both authors apply the same

theoretical logic in which transaction is the basic unit of analysis, contract is the main instance of an institution (viewed as either an institutional environment or an institutional arrangement) and minimizing transaction costs is the main cause for the emergence and efficient development of institutions. This is the core NIE logic and it departs from NEO in three main respects.

First, by conceptualizing institutions as contracts NIE blurs away a clear distinction between economics and politics. NIE recognizes that public sector bureaucracies are different in kind from the private ones. This is partly because the transactions that are assigned to the public sector are different, in general being characterized by higher transaction costs than commercial transactions (North, 1990b). Additionally, public sector bureaucracies are shaped by politics (Williamson, 1996). But although politics is different it is not as though there is no private sector counterpart (*ibid.*). Hence, “there is no reason why we cannot or should not extend the analysis of pricing and contractual arrangements to problems of a larger scale, in particular by treating the constitution of a country as a contract and the state as a giant firm” (Cheung, 1998, p. 520). This modification of the NEO paradigm to cover political issues has profound implications for policy making in the field of economic development and reform. For example, one can argue for private contractual arrangements based on financial incentives and profit maximizing rationale for virtually any aspect traditionally covered by the public sector like health, education, environment, culture or legislative processes. The corporatization of the public realm is justified in NIE on the grounds of relative institutional efficiency. In NIE, the modern capitalist corporation has grown to

have a life of its own borrowing some traditional state-like functions and hence, carving its own space in the state sovereignty.

Second, if NEO views TNCs more like firms acting in a monopolistic anti-competitive way, NIE views the modern corporation more like a market (Williamson, 1996). The TNC internalizes transactions from the realm of the market for efficiency purposes. Hence, it should be viewed not as a monopolistic economic agent but as an alternative market for delivering, goods, services, funds, jobs and know-how. This reconceptualization of competition – a TNC competes with a market rather than with other firms within a market - has profound policy implications. It can advocate, for example, mergers and acquisitions and down play the possible crowding-out effect on smaller-size firms in the host countries for TNCs.

Third, NIE explains the persistent development gap between developing and developed countries as a result of endogenous factors (North, 1990a). Inefficient domestic institutions, ideologies and mental models lead to underdevelopment and path dependency. The direct policy implication is that development does not arise automatically as assumed by NEO. Developing countries need to mirror not only the economic but also the institutional system of the developed countries, should they want to succeed in closing the development gap. Overall, there is a tendency to rank private property rights and private firms and arrangements (hybrids and hierarchy) as the institutions most enhancing of economic development and hence, the most efficient. Reforming developing countries' legal and judicial systems based on developed countries models is a necessary condition for the creation of the enabling institutional environment for economic growth. This process has to be combined with the reform of developing



countries' production systems, most of them functioning on public institutional arrangements.

In terms of the relevance of the NIE policy implications for the MAI's possible implications for developed and developing countries, as it will be shown in the next chapter, Williamson's work seems more relevant for informing the state/firm debate (will MAI decrease the sovereignty of states in the favor of corporations?). North's work seems more relevant for informing the developed/developing countries debate (is MAI a lever for constraining developing countries in their integration into the global economy?). The marvel of the NIE is that it informs these debates from a different, realistic if you want, perspective. The point of the discussion for new institutionalists is not which side in these debates is wrong or right. For NIE the feared results by the MAI critics are already happening, and hence, the critics are right. The new point of discussion becomes: are these transformations good or not for economic efficiency and development? Are they malign or benign (efficient) adaptations of the economic system to the characteristics of modern capitalism?

The novelty as well as the mainstream academic and political acceptance of the NIE is based on NIE's extension of the NEO to answer these particular questions itself. As it will be shown in the next chapter, NIE's ideas are used not only to explain the emergence of TNCs and the role of FDI but also to integrate these explanations into a comprehensive institutional theory of global development and reform. Such a theory reinforces the need for a global institutional framework of the world economy in which all countries, particularly the developing ones, stand to gain from global rules on trade and investment that secure and facilitate the foreign transactions of TNCs.

## **Chapter four: NIE, a possible theoretical foundation for the MAI**

### **1. Introduction**

As presented in chapter three, the debates on the Multilateral Agreement on Investment (MAI)'s policy implications can be organized on two main issues. The first issue, the state/firm debate, has focused on the transfer of sovereignty between nation states and the modern corporation. The second issue, the state/state debate, focused on the decreasing sovereignty and political flexibility of the developing countries in formulating their own development strategy. New Institutional Economics (NIE) does not debate these transformations but rather views them as efficient adaptations of the economic system to the characteristics of modern capitalism. The reconceptualization of the modern firm as an efficient alternative mechanism for governance - in respect to the nation state - and for production and trade - in respect to the market, explains why a transfer of sovereignty from the nation state to TNC is economically efficient. The adaptation of NIE's logic to construct a global theory of development and reform explains why developing countries might benefit from less flexibility by locking-in reforms through agreements with developed countries. Sections 2.1. and 2.2 below look in more detail at the commonalities between NIE's and MAI's possible practical implications. Assuming that the main MAI debates would resurface in any analysis of future global rules on FDI, this analysis is relevant for both MAI and future rules on FDI. Section 3 traces the influence of the NIE on the official discourse on development, reform and FDI in support for arguing that NIE is a possible theoretical foundation for the MAI. Finally, section 4 draws some conclusions and implications for the study of MAI and future

global treaties on foreign investment. The limitations of this study are discussed and areas for future related research are proposed.

## **2. The commonalities between NIE's and MAI's possible practical implications**

### **2.1. The state/firm debate**

The preamble section of the MAI text reflects the belief of the Contracting Parties that international investment assumes a greater importance in the world economy and that multilateral rules on investment are needed to complement the world trading system. NIE is relevant here in that it stresses that coordinating institutions are intrinsic to any development process<sup>1</sup>. The MAI is an international institution fundamental for the development of the global economy, because, as NIE explains, the current face of the global economy does not reflect an NEO image of perfect markets but a nexus of firms and their investments with foreign direct investment (FDI) gaining an increasing developmental role.

The preamble also reflects the belief that MAI is an efficient institution for economic development by locking-in effective global standards for the liberalization of investment regimes and protection, and effective dispute settlement procedures (OECD, 1998a). Many critics disagree. They interpret the preamble to the MAI text as positioning private property rights above environmental, social, labor or constitutional rights. The MAI provisions would prevail, even in cases when they would appear, for some analysts, as inconsistent with legitimate environmental, labor, or other development policies. NIE's policy recommendations for development and reform are relevant here in that they emphasize secure property rights as the most important component of an institutional

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<sup>1</sup> As opposed to NEO which assumes that growth and development arise from the unharnessed game of market forces.

environment for successful development. For North, “the history of the world...is really a series of illustrations of the alleged explanatory power of institutions and especially of property rights” (Leys, 1996, p. 99).

The scope section of the Agreement establishes how broadly or narrowly the Agreement is to be interpreted. The application of a broad definition of investment raised concerns about equating investment rules across fields like health, education, culture, and financial markets. Similarly, the application of a broad definition of investor raised concerns about equating legal rights across economic agents like public bureaus, private and not-for profit organizations. NIE's equal treatment of alternative institutions as contracts supported by incentives explains the logic of common treatment across various institutional environments or arrangements. As explained in chapter three, the NIE blurs away a clear distinction between economics and politics and for that matter between the private and public realms. The corporatization of the public realm via privatization or contracting out of services in the fields of health, education, protection of environment or culture, traditionally provided by the state, is justified in NIE on the grounds of relative institutional efficiency. Private contractual arrangements based on financial incentives and a profit-maximizing rationale should compete with public contractual arrangements based on subsidized incentives and a redistributive rationale.

From a functionalist point of view, an efficiency argument based on NIE logic can be made for introducing competition between different economic agents involved in providing services across diverse economic sectors. The issues at stake in the MAI debates however, stands for more than that. The transfer of the production and distribution of certain transactions from the public to the private realm also involves a

transfer of sovereignty and power from the nation state to the modern corporation. The issues at stake are in the negotiations of rules for opening up competition between the nation state and the modern transnational corporation not just in the production and distribution of goods and services, but also in the production and distribution of rights in a society. The MAI provides corporations with rights while simultaneously imposing obligations on nation states to refrain from constraining these rights.

The obligations and dispute settlement sections of the Agreement reflect the specific obligations that governments have regarding the treatment of foreign investors, and the mechanisms for enforcing these obligations. The main logic of these sections of the Agreement is to provide a complex legal instrument of constraint. The intention is to constrain the legislative power from controlling foreign investors' decisions in economically inefficient ways. The instrument works by (i) changing the incentive set that underlies governments' policy decisions, (ii) providing an effective mechanism for assuring protection and reducing uncertainty, and (iii) providing an effective lock-in mechanism for liberalization and protection of investment regimes.

As presented in chapter two, the obligations of the Contracting states in the agreement to:

- (1) treat the foreign investors in a non-discriminatory way in respect to privatization, to the creation, maintenance, or elimination of monopolies, in the granting of concessions and investment incentives (relative standards of treatment);
- (2) hold themselves from imposing any performance requirements - as a condition for the establishment, acquisition or disposition of an investment or from expropriating current or future benefits from investments (absolute standards of treatment);

(3) restrict their control on the capital account (financial services provisions);

(4) list all the non-conforming measures and exceptions to the agreement (national reservations provisions), refrain from newer or more restrictions (standstill principle) and eliminate them over a determined period of time (roll-back principle);

(5) accept an investor-state arbitration mechanism for the settling of disputes arising out of this agreement; and finally, to

(6) be bound to the MAI provisions for 20 years after accession (withdrawal provision),

raised serious questions about the possible loss of state sovereignty in favor of corporations. All national governments currently use some form of these policy tools in coordinating development. The idea of the MAI however, is not to open a trial race against all government measures but to make sure governments' incentives to engage in "unfair expropriations" of any kind from foreign investors are systematically reduced. Under the MAI any measure that might affect an asset of the foreign investors can be legally challenged and can result in awards of full and immediate compensation. As the *Ethyl vs. the Government of Canada* case has shown (see chapter two), the value of claims arising from dispute settlements can be a powerful tool in reducing governments' incentives to engage in any harmful practices against foreign investors.

Critics pointed out that governments may be forced to rent back jurisdiction by paying compensation to do what they were elected to do (Appleton, 1998). The NIE discourse is relevant here in that it emphasizes that this transfer of power is economically efficient. The incentives underlying governments' actions are not necessarily economically efficient. The government is using its power to maximize its revenue by trading protection and justice with different interest groups (North, 1990b). Built-in



mechanisms of self-restraint are therefore necessary for ensuring that the state would submit to economic efficiency and promotes an efficient institutional framework for development. The institutional framework further determines the incentive structure to which the economic actors respond and the way they function in the economy. Protective or subventionist measures like the differential treatment of foreign and domestic investors leads to the emergence of inefficient economic organizations and hence, underdevelopment (North, 1990a).

The MAI provides a mechanism of secure protection by delegating the right of governments to decide which development policies are appropriate for other economic agents. The IMF, not the national governments, would decide which monetary policies are considered appropriate development policies. Similarly foreign investors and TNCs would decide which government measures interfering with their activities can constitute legitimate development policies and which might constitute indirect expropriation. It has been argued, for example, that by defining expropriation to include indirect expropriations the MAI opens a new door for foreign investors to extend the battle over expropriations outside normal political and legal processes, where at least both sides have the right to be heard, into the one-sided MAI system (Durbin, 1997).

NIE's reconceptualization of the firm reveals particular insights for this type of debate. In NIE the modern corporation has grown to have a life of its own, borrowing some traditional state-like functions and hence, carving out its own space in the state's sovereignty. "To Williamson, although he does not say so explicitly, the modern corporation has become state-like in its functions. It is no longer just a firm, but something more - much more" (Dugger 1990, p. 428.). Hence, NIE is advocating the

transfer of the management and governance of certain transactions from the realm of the state to the realm of the corporation for efficiency purposes.

Providing firms with the right of directly taking a government to court obviously involves a transfer of sovereignty and power from the realm of the state to the realm of the corporation. A better idea of the magnitude of this phenomena is obtained however, by analyzing the characteristics of the modern corporations that conduct today's FDI transactions. The empirical data presented in the first chapter showed a highly concentrated universe of TNCs in which the largest 100 TNCs control about one third of the worlds' FDI and are associated with about two thirds of all international transactions. In this sense, one can argue that a better description of the transfer of sovereignty is a transfer between national states and a few big TNCs. Further, around 60 per cent of the TNCs activities are M&A as opposed to greenfield investments. This describes a further trend towards greater centralization of governance and corporate power. In this sense one can argue that, with his theory, "Williamson is trying to shrink state sovereignty to protect the transactions of the powerful" (Dugger, 1996, p. 427). However, in NIE logic this transfer of sovereignty is as economically efficient as the emergence of the TNC itself. For Williamson "the modern corporation is first and foremost an efficiency instrument...[efficiency purposes being] served by granting corporations considerable latitude to craft cost effective internal structures" (Williamson, 1993, p. 53).

Williamson advocates the legalization of non-market arrangements of conglomerate corporations. Territory and customer restrictions, reciprocal trades, tie-ins, vertical and horizontal integration, and other "nonstandard modes of organization" have frequently been viewed by the United States' courts as some form of monopolization.

Williamson objects and argues that such practices should not be viewed exclusively through the inhospitable lens of antitrust as they could represent new forms of transaction cost economizing (Dugger, 1996). In his opinion, the state should change its biased antitrust policy and recognize the modern corporation not as a monopolistic economic agent but as an alternative mode of organization acting in an efficient, and hence competitive, way (Williamson, 1996). The implications of the MAI or similar future agreements on foreign investment on the relative balance of power between nation states and TNCs will also depend on the evolution of international rules on antitrust policy and on the influence of NIE on such developments<sup>2</sup>.

Finally, the MAI provides an effective lock-in mechanism for the liberalization and protection of investment regimes through the standstill, roll-back and withdrawal provisions. By listing all their national reservations, governments would have to expose all explicit and implicit existing policies that, if not eliminated in the future, could be challenged at a latter date under the MAI. The withdrawal provision assures compliance with the provisions of the agreement for a minimum of 20 years after adoption. Hence, no electoral or other political changes could affect the continuous liberalization and protection of the investments. Some critics argue that this lock-in mechanism would constrain countries towards one model of development, the most liberal one. NIE's discourse is relevant here in that it emphasizes the importance of path-dependency in

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<sup>2</sup> The effect of NIE's ideas on the U.S. antitrust policy were summarized by Williamson as follows: "there is growing agreement that antitrust would not have been reformed but for the development of the new theory. The differences between the 1968 and the 1982 merger guidelines of the United States Department of Justice evidence some of the changes that resulted from the paradigm shift away from the market power (monopolizing) in favor of efficiency (economizing)" (Williamson, 1996, p. 281).

economic history. Changes in incentives and in the institutional structure are path dependent. An institutional arrangement or mechanism (like the MAI) “that can affect a change in laws or property rights” (Davis & North, 1971, pp. 6-7) requires an extended post-contractual period of secured enforcement for breaking inefficient dependency-paths.

In conclusion, NIE discourse justifies the transfer of sovereignty and power from the nation state to the modern corporation as a result of MAI implementation on economic efficiency arguments. However, as the state/state debates have shown in chapter two, strong developed states (such as the OECD states) gain an increasing role in development as guarantors of credible commitments for developing countries.

## **2.2. The state/state debate**

As presented in chapter one of this thesis there was a general recognition between the MAI negotiators that the MAI or future similar agreements would constitute sensitive issues to bring to the negotiating table with the developing countries. All the possible implications analyzed in the previous debate are magnified for developing countries. The increased sensitivity in negotiations, results from the general perception that developing states need more flexibility in development policy-making to be able to react to the current dynamics of the forces of globalization. A decrease in the sovereignty and political flexibility of the developing countries in drawing their own development strategy would seem for some to affect the governments needing it the most.

The NIE discourse is relevant here in that it explains that “fewer degrees of freedom (rules) can have advantages over more (discretion) because added credible commitments can obtain in this way. Effective economic reform thus requires that

political reneging options be foreclosed if investor confidence is to be realized” (Williamson, 1996, p. 268). In the case of developing countries, NIE argues, public bureaucracies are particularly bad in terms of incentives that underlie their policy decisions and hence, their economic outcomes. By signing long-term agreements, they are able to signal credible commitments and gain investors’ confidence. MAI’s strong focus on investors’ rights and states’ obligations, as opposed to a more balanced treatment, mirrors the underlying logic of the Agreement as a protection tool against government bureaucracy’s opportunism. A similar logic underlies NIE’s support for governments’ focus on creating efficient (i.e., private) property rights as opposed to direct involvement in the production area.

The critics’ concerns with possible cultural threats for developing countries finds an interesting response in NIE’s logic. Throughout his work North insists on the importance of cultural constraints for the formation and evolution of economic inefficient path dependency. The right type of knowledge, which is, mostly technological knowledge and ‘know-how’, not only receives a higher attached value in terms of its effects on economic development, but sometimes it is posited against other types of local knowledge that can inherently influence wrong mental models and ideologies. Further, the 20 years lock- in condition can be interpreted as not just signaling long-term credible commitments but also signaling a mechanism for penalizing wrong macro-ideologies for efficiency purposes. As North (1990a) points out, for assuring a shorter life of inefficient dependency paths, institutional mechanisms should be devised to penalize historically proven wrong macro-ideologies. As NIE explains, the persistent development gap between developed and developing countries is a direct result of endogenous factors

(North, 1990a). Inefficient domestic institutions, ideologies and subjective mental models lead to underdevelopment and inefficient path dependency. Development does not arise automatically as assumed by NEO models. Developing countries need to mirror not only the economic system but also the institutional system of the developed countries if they want to succeed in closing the development gap.

### **3. Tracing the influence of the NIE on the official discourse on development and reform**

Chapter one of this thesis looked at NIE's influence on current theories of FDI and trade. It pointed out how NIE's modifications of NEO led to revisions in the way international trade and investment theorists explore the role of flows of international capital in today's world economy. The industrial organization school based on NIE ideas criticizes the 'old' international school based on NEO which fails to acknowledge the distinction between flows of factors of production in the form of FDI, and flows of goods and services in the form of trade. The argument at stake is that TNCs are choosing more FDI over trade mechanisms in serving foreign markets, for transaction costs efficiency purposes. Hence, global rules governing FDI are necessary to complement the current WTO program of building global rules for trade. As the empirical trends presented in Chapter one shows however, the growth of FDI and of the TNCs are challenging national states control in both the production and governance arena and nation states' sovereignty.

The reality of today's world economy shows a persistent economic disparity between developed and developing countries. One can question, then, the exact relation between global rules on FDI and the development process. NIE shows that arguments for



global rules of FDI can be made also from a larger perspective in which FDI are venues for development and reform between countries at different levels of development. Current attempts of incorporating these theoretical perspectives into a new development paradigm are in this sense relevant for analyzing NIE as a possible theoretical foundation for the MAI.

In their role as the World Bank's annual intellectual flagship publication, the World Development Reports (WDRs) have, for more than 20 years, reflected the official mainstream discourse on development and reform. Traditionally addressing developing countries, WDRs' analysis and policy recommendations for economic reforms have also become relevant for developed countries, particularly to the ones implementing economic reforms of the public sector. As Leys (1996) points out in his account of the "rise and fall of development theory",

since the late 1960s, the debate about 'development theory' has in fact been more and more clearly about the theory of global development that each one presupposed, although the participants have all too often not recognized, or not acknowledged, that this was the issue at stake (Leys, 1996, p. 43).

If, until the first part of 1980 NEO was the ruling philosophy of the World Bank, the 1987 WDR marked the shift towards a NIE approach. The report, which focused on foreign trade and industrialization, relied explicitly on North and cited his comparison of the contrasting development paths of the U.K. and Spain as support for its emphasis on the need for governments to concentrate on establishing clear private property rights rather than involve themselves in productive activities and for opening up to trade and foreign investment in order to introduce the right economic incentives for economic growth.

The 1994 WDR "Infrastructure for Development" relied heavily on Williamson's analysis of the relative efficiency of different institutional arrangements for its emphasis on the need for governments to contract out or privatize the distribution and management of infrastructure services like transportation, electric power, telecommunications, water and sanitation, and waste disposal, traditionally provided and managed by public bureaus. The report's insistence on the need to "manage infrastructure more like a business than a bureaucracy" (World Bank, 1994, p. 2) and to introduce competition in the provision of these services from domestic and foreign private firms led some to the conclusion that "the report's treatment of the issues at stake as if they were purely 'technical', by excluding crucial political and social considerations is patently ideological" (Leys, 1996, p. 91).

The preference for a NIE functional conceptualization of the institutions of the state continued in the 1997 WDR "The State in a Changing World" which addressed more comprehensively the role of the state in development. As Kapur (1997, p. 8) pointed out "a more curious aspect of the [1997] WDR's conception of the state is the virtual absence of politics in an analysis of an entity whose very essence is political." The basic message of the report is that a state's role must match its capability. The state must focus on social and economic fundamentals of which a foundation of law and property rights is the most important one. Only states with strong capacity should consider industrial policy objectives. States with weak capability - defined as a characteristic of most of the developing states - should focus on fundamentals as well as on increasing their institutional capabilities. The latter can be realized by enhancing liberalization and decentralization, which is, by contracting out productive activities to the private sector.

Signaling credible commitments, like signing international agreements for monitoring liberalization can also temporarily increase the capabilities of the weak states. Shortly, the state has to open itself up to competition in both the production and the governance arena.

The 1998/99 WDR "Knowledge for Development" worked out of the same theoretical framework. The Report explored the role of knowledge in explaining the development gap between developed and developing countries. While recognizing that there are many different types of knowledge the report focused on two types: technical knowledge or know-how (about production, accounting) and knowledge about attributes (the quality of goods and services, the diligence of a worker). It proposed a two pronged strategy. One strategy is to narrow knowledge gaps between developed and developing countries. This focuses on acquiring efficient economic knowledge, which is technical knowledge, from richer countries. Governments should facilitate this process through an open trading system, foreign investment and partnerships with the TNCs:

Improving policy and business environment...is one of the most important ways for countries to obtain knowledge from abroad. Openness to foreign direct investment goes hand in hand with an open trade regime, and it provides benefits for the acquisition of knowledge in its right. Because multinational investors are global leaders in innovations, their activities in developing countries can be important in transmitting knowledge. (World Bank, 1998, p. 8)

The second strategy is to address problems of imperfect and incomplete information, which hamper development. The Report explains how information problems impede the efficient functioning of markets and also challenge the ability of the governments to deal with these problems taking into consideration that governments also suffer from problems of information failures or corruption. Again the underlining message is that governments should focus on establishing a secure institutional environment for markets

to be able to function while contracting much of the production functions to a more incentive efficient institutional arrangement like the private sector<sup>3</sup>.

Finally, the most recent 1999 WDR "Entering the 21<sup>st</sup> Century" draws on both Williamson and North to argue for new institutional reforms by national governments needed in a globalizing and localizing world. Globalization – the progressive integration of the world's economies- requires national governments to seek agreements with other national governments, international organizations, nongovernmental organizations and transnational corporations through supranational institutions. Localization – the growing desire of people for a greater say in their governments- requires governments to reach agreements with regions and cities through subnational institutions. The most important forces behind globalization and localization are trade, capital flows, urbanization and migration. The need for agreements that facilitate trade and FDI is a recurrent policy recommendation for governments in harnessing these forces.

As the Report points out, with the increasing role of the TNCs and of the international production networks that sustain their operations, trade and investment - particularly trade in services - are becoming fundamentally intertwined. The continuation of global trade transactions would require complementary FDI rules to secure the operations of the TNCs. "The new production networks thrive on - indeed they expect - stable, predictable trade and investment policies" (World Bank, 1999, p. 66). To continue or increase the pace of modernization, industrialization and urbanization developing countries will need huge injections of capital. With the recent East Asian financial crises caused by volatile short-term capital flows, FDI becomes a more stable attractive source for finance.

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<sup>3</sup> See for example, p.149

Along with goods, services and investment between 2 million and 3 million people emigrate each year, the majority going to just four host countries: United States, Germany, Canada and Australia. By accelerating growth, and expanding better-paid employment opportunities within TNCs, FDI can reduce incentives to emigrate. TNCs can also effect repatriation of highly skilled emigrants.

A country that adopts measures to enhance foreign direct investment and integrates with global production networks by maintaining low and predictable trade barriers will find that doing so generates additional benefits. If the quality and technological sophistication of a developing country's exports increase, highly skilled emigrants may decide to return. (World Bank, 1999, p. 39)

In case emigrants decide not to return to their home countries, diasporas can serve as another source of global interconnection between these countries and the rest of the world. Countries “with large and growing emigrant communities scattered throughout the world will have the opportunity to tap into the development potential of their diasporas” (World Bank, 1999, p. 40). However, “as long as economies remain inwardly oriented, predisposed to regulating business activities, and prone to arbitrary actions, diasporas may not be able to evolve into business networks that strengthen markets and prod development” (ibid.). Openness towards foreign markets and investors and stable protecting FDI legislation is again a requirement.

Although the WDRs analyzed above tend to be subject specific, there are some common underlying themes. In terms of policy recommendations the options differ depending on the institutional capacity of the national government. Weak governments – most of developing countries - should compete with other institutional arrangements in both the production and governance areas. In production, public bureaus should be privatized or behave more like businesses than bureaucracies, and compete on equal playing fields with private organizations. In the governance area, weak governments



should restrain from conducting industrial policy. Opening markets to competition, trade and FDI is fundamental for changing the inefficient incentive sets imbedded in the weak institutional framework. Enforcing the rules is as important as creating good rules. Weak states lack efficient institutions of restraint. As the process of changing incentives and of learning new knowledge takes time, signing international agreements with strong states can serve as external institutional arrangements for signaling credible commitments and for reducing uncertainty by locking in economic and political reforms. In the case of strong states, it is indirectly implied that they should represent examples of “best practices” of successful economic and political systems and that they should help weak states in closing the knowledge and development gap through international institutions and agreements in which they are the major stakeholders.

No national government however, weak or strong, can in today’s globalizing and localizing world pursue independent, uncoordinated development policies. A global economy, like a national one, needs an institutional framework and institutional arrangements or organizations to support its international functioning. The conceptual analysis of past attempts for such a global treaty, like the MAI, and of the main theoretical framework that underlies its logic are important for understanding the building process of the future fully integrated global economy.

A closer look at the underlying conceptual theoretical framework of the WDRs points to the NIE as the latest development paradigm used to explain and coordinate this process. Sections (3.1.) to (3.4.) below present a more detailed analysis of the influence of the NIE ideas in the past WDRs.



### 3.1. The paradigm shift

As mentioned in the previous chapter, the main objective of the NIE is to inject a theory of institutions into mainstream neoclassical economics. The main theoretical questions NIE is addressing deal with the concept, purpose and role of institutions in development. Overall, the purpose is to compare different institutional environments and different institutional arrangements and to argue that there are good reasons to favor one type of institution over another based on their relative efficiency in inducing development. The 1997 WDR explains the shift in the official discourse of the past WDRs to this new paradigm:

Despite five decades of effort, enormous disparities remain in the quality of life of people around the world. Indeed by some measures the gap between rich and poor has widened. Explanations for these huge international differences in living standards have changed over the years. For centuries, access to natural resources-land and minerals-was considered the prerequisite to development...[then]...physical capital-machines and equipment-was held to be the key to development...[then]...technology-knowledge and ideas...[then]... human capital [...] Since the 1980s the focus shifted to the role of sound policies in explaining why countries accumulate human and physical capital at different rates. This, in turn, has led to yet another shift of focus, to the quality of a country's institutions. New, more complex questions have emerged. What institutional arrangements best allow markets to flourish? What is the role of the state both as a direct agent (mostly in the provision of services) and as a shaper of the institutional context in which markets function? How do policies and institutions interact in development? The answers to these questions are central to our understanding of the deeper sources of differences in development outcomes ...[The purpose is to shift] the focus of our thinking about development toward the quality of a country's institutions and the capability of the state-for bringing institutions into the mainstream of our dialogue about development. (World Bank, 1997, pp. 29-30)

The recent 1999/2000 WDR that starts with an introduction section on “new directions in development thinking” (World Bank, 1999, p. 13) explicitly positions “new institutional economics” (ibid., p. 23) at the front stage of its current development approach. The new “sectoral” and “structural” guidelines for development add to the well known “human and physical aspects of development” dimensions:

Sectoral aspects stress the importance of cross-cutting elements such as coordination, management, and maintenance of an effective enabling environment for private business and community initiatives. Structural aspects focus on the need for good

governance, transparent decisionmaking, efficient legal and judicial processes, and sound regulatory systems. (World Bank, 1999, p. 3)

The underlying message is that:

a solid foundation of effective organizations and enabling institutions is a necessary precondition to development'. ... Specifically, countries need institutions that strengthen organizations and promote good governance, whether through laws and regulations or by coordinating the actions of many players, as international and public-private partnerships do. (World Bank, 1999, p. 3)

### 3.2. What are 'institutions'?

The WDRs use the concept of institutions to refer to both the institutional framework or to the institutional arrangements. The 1998 WDR, for example, states that: "institutions, broadly defined to include governments, private organizations, laws, and social norms, contribute to establishing recognized standards and enforcing contracts, thus making possible transactions that would otherwise not occur" (World Bank, 1998, p. 3). NIE defines the institutional environment as "the set of fundamental political, social and legal ground rules that establishes the basis for production, exchange and distribution" (Davis & North, 1971, pp. 6-7). They are humanly devised constraints composed of formal rules, informal constraints, and the enforcement characteristics of both that structure incentives in human exchange. Similarly, the 1998/99 WDR defines "the broader institutional environment for behavior [as] the incentive structure to which economic agents respond" (World Bank, 1998, p. 32). Elsewhere the same Report states that "...the formal rules-laws and regulations-that are part and parcel of a country's institutional environment [...] along with the informal rules of the broader society, are the institutions that mediate human behavior" (ibid., p. 30).

Concerning the "institutional arrangements", NIE defines them as arrangements "between economic units that governs the ways in which these units can cooperate and/or

compete" (Davis & North, 1971, pp. 6-7). They can provide a "structure within which its members can cooperate" or "a mechanism that can effect a change in laws or property rights" (ibid.). Similarly the 1997 WDR points out that in order to "prosper, economies need institutional arrangements to resolve disputes among firms, citizens, and governments; to clarify ambiguities in laws and regulations; and to enforce compliance. Societies have devised a broad array of formal and informal mechanisms to do this" (World Bank, 1997, p. 100). Public institutional arrangements have emerged for "setting the broader institutional environment for behavior: the incentive structure to which the economic agents respond" (ibid., p. 32). "Private institutional arrangements have evolved to restrain opportunism in business dealings, while bypassing court proceedings" (ibid., p. 46). Examples of institutional arrangements analyzed by the WDRs range from "the guilds of medieval Europe and the premodern Arab world, long-term trading relationship, sharecropping, the interlinking of contracts across markets, permanent labor contracts and collateral" (World Bank, 1998, p. 79) to "leasing contract", "concession contract", "private ownership and operation" (World Bank, 1994, pp. 110-111).

Chapter three of this thesis analyzed North's treatment of the institutions of the state. The state represents a special institution in that it is the creator and main enforcer of the institutional environment. The state represents the third party enforcer of contracts between agents without which no complex economic markets can function. At the same time, the organization of the state is a set of institutional arrangements created to facilitate political transactions, which are, exchanges of votes for promises. As an organization, the state has a comparative advantage in violence, vis-à-vis other

institutional arrangements, and it uses its power to maximize its revenue by trading protection and justice with different interest groups.

The 1997 WDR "The State in a Changing World" which focused on the role of the state in development, adopted North's analysis without qualification. "*State*, in its wider sense, refers to a set of institutions that possess the means of legitimate coercion...[and that] monopolizes rulemaking within its territory through the medium of organized government" (World Bank, 1997, p. 20). The state is the creator and enforcer of the institutional environment in which different institutional arrangements emerge: "[it] sets the formal rules-laws and regulations-that are part and parcel of a country's institutional environment. [...] These formal rules, along with the informal rules of the broader society, are the institutions that mediate human behavior" (ibid., p. 30). At the same time, the state is an institutional arrangement itself. It shares similar organizational and efficiency problems with other institutional arrangements and is influenced by the very same institutional environment that it created: "the state is not merely a referee, making and enforcing the rules from the sidelines; it is also a player indeed often a dominant player, in the economic game. [...] The state, then, is in a unique position: not only must it establish, through a social and political process, the formal rules by which all other organizations must abide; as an organization itself, it too, must abide by those rules" (ibid., pp. 30-31).

### 3.3. Why institutions emerge?

NIE maintains that the basic reasons for the emergence of institutions are reducing uncertainty and economizing on transaction costs. Uncertainty in transactions exist because of information, coordination and enforcement problems. Information problems arise because the goods and services exchanged have complex multiple attributes and people have bounded rationality. Coordination and enforcement problems exist because of peoples' opportunistic behavior. Institutions emerge to deal with these problems and to reduce the transaction costs. The cost of seeking out the right information or the cost of enforcing agreements are examples of transaction costs.

Again, NIE's explanations for the emergence of institutions are clearly mirrored in the latest WDRs. Take for example information problems. One report states that: "information problems occur because people and firms inevitably have limited information and understanding, or because the rules of the game are unclear. [...] The costs of seeking out such information decline as markets thicken and their supporting institutions develop..." (World Bank, 1997, p. 43). Information problems are also underpinned by the non-homogeneity of the goods and services exchanged: "a variety of institutional arrangements emerges over time in response to verification and enforcement problems..." (World Bank, 1998, p. 79). Verifying "the attributes of a good or service - the durability of a product, the productivity of a worker" is costly (ibid., p. 73).

Analysis of coordination and enforcement problems are found in both the 1997 and the 1998/99 WDR. Similar to NIE, opportunistic behavior plays a major role in explaining coordination and enforcement problems: "coordination of economic activity is difficult because self interested people and firms behave strategically - they generally are

willing to share information only when they do not lose by doing so. The presence of moral hazard - the risk that parties might opportunistically renege on agreements - hinder firms for taking advantage of opportunities for mutual gain" (World Bank 1997, p. 43). In what concerns the "enforcement problem" it refers to the "imperfect monitoring and difficulties with ensuring compliance" (World Bank, 1998, p. 75). Spot markets (characterized by simultaneous exchange) or small community-type exchange are less affected by these problems. In modern economies however, "requiring sophisticated transactions over long distances, traditional information mechanisms such as local reputation to establish quality or reliability become inadequate" (ibid., p. 149). For such complex transactions "the costs of providing adequate information and enforcement mechanisms to enable business to proceed can be formidable. Well functioning institutions can reduce these transaction costs" (World Bank, 1997, p. 43).

### **3.4. What are the implications for development?**

For NIE, development is a process of interaction between the institutional environment (rules) and the institutional arrangements (firms and contracts) that emerge as a result of the embedded incentive set. The key connection between the two institutional levels – institutional environment and institutional arrangements - is the incentive set. The key connection between this mechanism and development is transaction costs.

Inefficient rules form the wrong incentives that lead to higher transaction costs and lower levels of total output. Efficient rules create correct incentives that lead to lower transaction costs and higher levels of total output. Efficient property rights are the most



important component of the institutional environment created by the institutions of state. They represent “the foundations for market-led growth and poverty reduction” (World Bank, 1997, p. 45). The private sector's ability to function critically depends “on the reliability and effectiveness of institutions such as the rule of law and the protection of property rights” (ibid., p. 32). However, efficient property rights are not sufficient as political and public institutions have an inherent tendency to function inefficiently. “Even if the rules themselves are benign they might be applied by public organizations-and their employees-in harmful fashion” (ibid.) for example by imposing huge transaction costs, in the form of red tape and bribery. As a result, the institutions of state should represent an efficient institutional arrangement by conducting its functioning more on business than bureaucratic principles. Because of path dependency, historical development of the institutional arrangements is drastically constrained by the initial institutional framework. However, under the forces of entrepreneurial spirit and technological change, mutations in the institutional arrangements can emerge that fight back for changes in the institutional frameworks. As mentioned before, states’ policies that focus on facilitating trade and FDI are fundamental in this sense.

Finally, “the largest source of state-inflicted damage is uncertainty” (ibid.). In order to function efficiently, individuals and firms must know that the rules of the game are stable and that they will be enforced. Efficient institutions at both national and international levels are needed for establishing the foundations for an efficient national and international economy.

The changes in the official discourse on development and reform analyzed above, shows NIE’s role in the reinterpretation of the development paradigm with FDI and

global rules of FDI playing an increasing developmental role. These developments have fundamental implications for national governments' policy making in general and for reconsidering the study of MAI or future global treaties on foreign investment in the process of development in particular.

#### **4. Conclusion**

This thesis has argued that NIE is a possible theoretical foundation for the MAI. This has been argued by looking at the commonalities in terms of NIE's and MAI's development and policy implications and by looking at the NIE's contribution to the official discourse on development and reform. First, this thesis has showed that the MAI and NIE did not develop in a vacuum. They developed as social and intellectual reactions for dealing with significant changes in the global economy particularly, the increasing importance of TNCs and of FDI within the context of persistent disparities between countries' levels of economic development. The empirical data on FDI transactions show (i) an increasing internationalization of the control of previously domestically controlled factors of production; (ii) a shift in the transfer of control of productive assets from the developing to the developed world; and (iii) a concentration of the control of factors of production within large TNCs, during the last decades. The emergence of the NIE and of the MAI is connected by a common purpose in theory and practice to explain these fundamental transformations of the global economy.

Second, this thesis has shown that the MAI's logic and policy implications directly relate to NIE's recommendations for development and reform. NIE extends the NEO program (i) by explaining the emergence of, and need for, firms and institutions for

economic development and (ii) by explaining the continuous economic disparities between developed and developing countries by appeal to endogenous institutional factors. NIE's recommendations for the nation state to open itself up to competition both in production and governance arenas directly relates with the MAI's state/firm and state/state debates. NIE's underlying intellectual task to extend the NEO program to deal with issues beyond its ken represents a remarkable theoretical success. The third argument of this thesis referred to the successful development of the NIE towards a global development theory by looking at its influence on the current official discourse on development and reform. This thesis has argued NIE has helped redesign the official discourse on development and reform with FDI and global rules on investment gaining an increasing developmental role.

This thesis contributes to the existing body of literature on the MAI and NIE in a number of ways. It contributes to the MAI literature in four ways. The first contribution is underlying the need for clearer identification of the theoretical logic behind the MAI or future similar agreements. This is important for two reasons. Firstly, critics and opponents of the MAI have been equally unclear on this issue hence, too often, have lacked a common language for conducting an open debate. Secondly, different theories designed to explain the role of TNCs and FDI have different implications for policy analysis in the field of development and reform. An open recognition of the theoretical underpinnings of the MAI or future similar agreements would foster a critical and constructive debate. This thesis invites such a debate by arguing that NIE is a possible theoretical foundation for the MAI. Further research should be conducted on the possible

contribution of other theories to the theoretical foundations of the MAI and on the relation of these theories with the NIE.

The second contribution of this thesis to the MAI literature is in its insistence of the relevance of the MAI for developing countries. The possible implications of the MAI or future similar agreements for developing countries has been less explored by the MAI analysts with the attention being focused on the OECD negotiating countries. By drawing special attention to this aspect of the debate this thesis intends to contribute to filling this void. The analysis in this thesis is however only exploratory. Further comprehensive research should be undertaken to identify the possible complex effects of such agreements on developing countries. The current study undertaken by UNCTAD (1999) on the conceptual issues allowing for a certain flexibility of developing countries participating in international investment agreements, in the interest of promoting growth and development, represents a positive sign in this sense.

Future research on the effects of the further liberalization of financial flows for developing countries as a result of the MAI or future similar agreements' provisions is also imperative, if only, in the light of the recent Asian currency crises. In relation to this, further research should be undertaken on the role and possible implications of the current attempts to change the International Monetary Fund's (IMF) by-laws to expand its control over capital account liberalization. The MAI's financial provisions provide that countries' requests to regulate capital outflows in cases of financial crises would require IMF approval. The IMF's Articles of the Agreement however, currently apply only to a nation's current account transactions. By amending Article VIII and XIV of the Articles of Agreement the IMF could expand its control over capital account transactions.

The third contribution of this thesis to the MAI literature is in its insistence that if MAI-type agreements are to be opposed then they must be opposed not only at the level of arguing that the outcomes will be undesirable but also that the underlying theory – in this case the NIE – is also flawed. By exposing the theoretical roots of the MAI it is now possible to construct alternative theories of the firm and of FDI flows which would permit the development of a quite different constitution for the global economy.

The fourth contribution of this thesis to the MAI literature is underlining the need to analyze the MAI not just as an individual project that could determine the dynamics of foreign investment transactions but also as a fundamental part of an ongoing process of building a global institutional framework that would determine the distribution of rights and power in the global economy. This is important since powerful MAI proponents, like the United States and Japan, continue to argue for non-binding environmental, labor or other social clauses in an international agreement on foreign investment. The current country proposals for negotiating an international agreement on FDI at the WTO reflect the difficulties and on-going negotiation for grasping a consensus on these issues. Recognizing that MAI-type agreements are still negotiated in different foras and that a future agreement on foreign investment will eventually emerge, further research should be done on alternative MAI proposals that balance the rights and obligations of the TNCs, nation states and citizens by taking in consideration all these specific concerns. The recent proposal advanced by Marc Lee (1999) to the British Columbia Special Committee on the MAI represents promising research on this direction. In particular, his arguments that:

a fundamental aim of a global investment treaty should be to effectively regulate investment and to prevent abuses of power that undermine the livelihoods of people. That is, given that production and finance have become global, there is a need for counterweights at a global

level to balance the power of these actors. Measures to deter speculative capital inflows, as well as measures to ensure that responsibilities and obligations are specified for longer-term investment, are required. (Lee, 1999, p. 2)

find resonance in the ideas expressed in this thesis.

This thesis also contributes to the existing body of literature on NIE in two ways. First, it advances the argument for a complementary Williamson-North NIE framework. This approach does not necessarily dismiss the claims of differences between the two theoretical branches of the NIE but it points out that, in some cases, the study of institutions can be better informed by a complementary Williamson-North NIE framework rather than by the individual work of its parts. This observation is important because most of the NIE critics were more concerned with differentiating between the two perspectives and failed to recognize the increasing acceptance of a complementary NIE perspective in the official discourse on development and reform. Secondly, this thesis contributes to the NIE versus NEO debate by analyzing the line of departure between the two paradigms in answering fundamental theoretical questions.

Lastly, but not least, this thesis contributes to the theory and practice of international political economy by reinforcing the opinion that dominant social practices are sustained and constituted by mainstream theoretical discourses. NIE successfully modified the NEO paradigm and subsequently the official discourse on development and reform. Any theoretical success, however, has to be weighed against its possible practical implications. Strictly speaking NIE is a theory of the firm - its birth, objectives, growth, metamorphoses, tools, and power. Its application to other types of organizations, like the state, and to development starts from the same logic and represents more or less relaxed variations on the same theme. The empirical data presented in Chapter one show that from a descriptive point of view, NIE is a better theory in presenting the shifting balance



of power between the main actors in the current world order, in redefining the unit of analysis and in helping us to see through the eyes of corporate logic. To this end, given that current developments will continue to unfold towards a corporate world, this theoretical attempt is a useful exercise for understanding the corporate mind and for imagining future scenarios with diverse corporate-governments institutional hybrids.

To MAI's opponents' question 'an international agreement for whom?' MAI's proponents answer is clear: MAI is an international law for investment and investors (there are other relevant bodies for negotiating labor, environmental and social issues), for reducing their uncertainty, and by reducing the trade and investment barriers that they face (which add unjustifiable production and transaction costs). Nevertheless, as long as theoretical attempts to construct an NIE theory of world development are given ultimate recognition in the mainstream intellectual academia and as long as we are told that the MAI represents the fundamental piece in writing of the constitution of a single global economy, we should analyze both NIE and MAI as global developments that ultimately involve and affect all social agents' behavior, choices and rights – be they firms, individuals, states or NGOs - and not just the rights of the corporate firm. The MAI provisions represent a system of global regulations governing investor and corporate rights. The issue is not so much that its legal body does not integrate clear and binding provisions on labor, environmental or other human rights or that it might reduce states' sovereignty in favor of the corporation – as much of its criticism is focused on. But that it provides a mechanism for contracting out some traditional state functions – and with these the power and right to decide a certain distribution of rights in society - to the realm of corporate governance. All these, in the name of economic, social and political

efficiency. To this end we should recognize the prescriptive relationship between the theory (NIE) and the social practice (MAI) and its far-reaching implications.

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