Chapter 2

Re-Conceptualizing the Theory of Foreign Direct Investment (FDI)

Foreign Direct Investment has played a critical role in the development of national economies for the past decades. However, the beneficial aspects of FDI do not come automatically as they require effective policies in harnessing those foreign investment activities. This chapter will lay out the literatures concerning FDI activities. The study starts with the definition of FDI followed by its categories and theoretical evolution. The role of FDI in economic development aspect will also be analyzed in order to understand the benefits of FDI and how the host country should implement their policies to strengthen their position in attracting FDI for national development. Finally, the study will emphasize the importance role of legal institution or regulatory measure regarding the controlling mechanism for FDI in the national economic development.

2.1 Foreign Direct Investment (FDI) and Its Definition

The definition of Foreign Direct Investment (FDI) is repeatedly addressed by many organizations in the world-trading arena. The characteristic meaning of FDI as defined by the International Monetary Fund (IMF) is "investment that is made to acquire a lasting interest in an enterprise operation in an economy other than that of an investor, the investor's purpose being to have an effective voice in the management of the enterprise."[15] The Organization for Economic Cooperation and Development (OECD) describes FDI as "an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a

[15] International Monetary Fund, Balance of Payments Manual, 136 (4th ed., 1977, reprinted 1987 with minor corrections)

group of related incorporated and/ or unincorporated enterprises which has a direct investment enterprise – that is, a subsidiary, associate or branch – operating in a country other than the country or countries of residence of the direct investment or investors."[16] To be noted, a direct investment enterprise, as mentioned above, is defined by the OECD as "an incorporated or unincorporated enterprise in which a single foreign investor owns 10 per cent of more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise."[17] Though, firms that engage in FDI and operate in more than one country are usually called multi-national enterprises (MNEs).

From the explanations above of foreign direct investment, it can be concluded to be, in essence, an investment of foreign assets by a foreign entity, often a MNEs, to acquire a long-term interest in a certain enterprise in a host economy by aiming to acquire management control of the invested enterprise. Moreover, the feature of a direct investment can be presumed when the equity ownership of a foreign investor meets a minimum of ten percent of a share in the enterprise.[18] FDI can be engaged by either establishing an entirely new enterprise in the foreign countries, also known as "greenfield" investment," or "brownfield" investment, acquiring all or part of the ownership of a share in an existing domestic enterprise through merger and acquisitions. The definition of FDI also includes both the primary transaction between the host country and MNEs and all subsequent capital transactions between them and among affiliated enterprises. For example, it incorporates the reinvestment of earnings into the enterprise and the provision of long-term and short-term intra-company loans between parent and affiliated enterprises.[19] Ultimately,

[16] OECD, Detailed Benchmark Definition of Foreign Direct Investment, 7, (1992).
[17] *Id.*
[18] Anthony Bende-Nabende, FDI, regionalism, government policy, and endogenous growth: a comparative study of the ASEAN-5 economies, with development policy implications for the least developed countries. Aldershot, Hants, England; Brookfield, Vt., (Ashgate, 1999); and Kenneth A. Reinert and Ian A.Goldin, Global Capital Flows and Development: A Survey, Journal of Internal Trade and Economic Development 14(4), (2005).
[19] UNCTAD, Scope and Definition, New York, United Nations, (2005).

FDI embodies two main assets, one being capital, and the second being intangible benefits such as technology. In other words, instead of being viewed as a source of finance, FDI is seen as a "source of investment in capital and intangible assets, the variables capable of improving productivity and wages in a recipient economy."[20]

FDI is closely linked to multinational enterprises (MNEs). It is the MNEs that generate FDI flows. MNEs is defined as a firm that controls or owns production assets located in more than one country. Generally, MNEs can be described as consisting of a parent and one or more affiliates owned and controlled by the parent. MNEs has established production activities (affiliates) in one or more host countries through FDI. Whether a particular firm should be classified as an MNE is not always obvious but depends ultimately on the concepts of ownership and control. For statistical purposes ownership is used as a criterion for FDI since ownership is possible to quantify.

FDI is different from portfolio investments since FDI is performed in order to incorporate the asset in the investing MNEs existing business activities as a part of firm strategy to maximize profits. An investment becomes a direct investment, as opposed to a portfolio investment, if it gives the parent firm some amount of control over the management of the enterprise, usually over 10 percent of the firm.[21] Hence, FDI implies that the investing MNEs achieves a significant degree of control over the asset. The asset itself in the form of a production, research or distribution facility is incorporated into the MNEs intrafirm network of geographically separated affiliates. Companies use FDI, unlike portfolio investments, over long time horizons and generally not for

[20] Keith E. Maskus, *The Role of Intellectual Property Rights in Encouraging Foreign Direct Investment and Technology Transfer*, Duke Comp. and Int.l.J., Vol. 9, No. 1, 30, (1998).
[21] UNCTAD, *World Investment Report 2007: Transnational Corporations, Extractive Industries and Development*, p.245 (2007); International Finance Corporation (IFC), *Foreign Direct Investment: Lessons from Experience*, International Finance Corporation and Foreign Investment Advisory Service, Washington D.C., (1997).

speculative purposes, but rather to serve domestic markets, exploit natural resources, or provide platforms to serve world markets through exports.

Moreover, to study the FDI definition from an organizational perspective, The logical result of the way the IMF defines FDI and the threshold it applies, is that this IGO understands by a foreign direct investment entity "an enterprise (institutional unit) in the financial or non-financial corporate sectors of the economy in which a non-resident investor owns 10 percent or more of the voting power of an incorporated enterprise or has the equivalent ownership in an enterprise operating under another legal structure."[22] A foreign direct investor is defined by the OECD as "an individual, an incorporated or unincorporated public or private enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which has a direct investment enterprise -that is a subsidiary, associate or branch- operating in a country other than the country or countries of residence of the direct investor or investors."[23]

In both the IMF and OECD guidelines a distinction is made between direct investment entities, which are incorporated in the host country, and those who are not. An incorporated direct investment enterprise may either have the form of a subsidiary (wholly owned or partly owned) or of an associate company. Branches are unincorporated investment entities, which can also be wholly owned by the foreign direct investor or jointly with a local partner. A joint venture

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[22] International Monetary Fund Committee on Balance of Payments Statistics, *Definition of Direct Investment Terms*, BOPCOM-05/58, April 2005 (http://www.imf.org/external/pubs/ft/bop/2005/05-58.pdf)._The definition of the *OECD* is similar: *"an incorporated or unincorporated enterprise in which a single foreign investor owns 10 percent or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise"* Organization for Economic Cooperation and Development, *Detailed Benchmark Definition of Foreign Direct Investment*, Third edition, Paris, 7, (1996).

[23] Organization for Economic Cooperation and Development (OECD), *Detailed Benchmark Definition of Foreign Direct Investment*, Third edition, Paris, 7, (1996).

enterprise does not necessarily take an incorporated structure and can also constitute a branch.[24] The foreign direct investor is not necessarily a business entity; it can also be an individual. The U.S. Code of Federal Regulations, as well as several other national systems, also distinguishes between incorporated and unincorporated foreign direct investment entities.[25]

The IMF also defines subsidiaries as entities in which a direct foreign investor owns at least 50 percent of the ordinary shares or voting power. A subsidiary can be wholly owned or partly owned by a foreign direct investor, and in the latter case its ownership can be between 50 and 100 percent. Although probably leading to the same qualification in most cases, UNCTAD's definition of a subsidiary states: "an incorporated enterprise in the host country in which another entity directly owns more than half of the shareholder's voting power, or a shareholder in the enterprise, and has the right to appoint or remove a majority of the members of the administrative, management or supervisory body."[26]

An associate company is the concept used when the foreign direct investor owns less than 50 percent but, at least according to the IMF and the OECD, more than 10 percent because otherwise the investment is to be qualified as a foreign portfolio investment (FPI). The absence of definitional heterogeneity among the different frameworks or organizations is demonstrated again by the fact that UNCTAD defines an associate company as "an incorporated enterprise in the host

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[24] A joint venture is defined by UNCTAD as follows: *"a joint venture involves share-holding in a business entity having the following characteristics; i) the entity was established by a contractual arrangement (usually in writing), whereby two or more parties have contributed resources towards the business undertaking; ii) the parties have joint control over one or more activities carried out according to the terms of the arrangements and none of the individual investors is in a position to control the venture unilaterally".* The IGO further makes a distinction between three kinds of joint ventures: jointly controlled entities, jointly controlled assets, jointly controlled operations, United Nations Conference on Trade and Development (UNCTAD), Glossary of UNCTAD
; http://www.unctad.org/Templates/Page.asp?intItemID=3176&lang=1.

[25] United Nations Conference on Trade and Development (UNCTAD), Glossary of UNCTAD, http://www.unctad.org/Templates/Page.asp?intItemID=3164&bang=1.

[26] United Nations Conference on Trade and Development (UNCTAD), Glossary of UNCTAD, http://www.unctad.org/Templates/Page.asp?intItemID=3173&lang=1.

country in which an investor, together with its subsidiaries and associates, owns a total of at least 10 percent, but not more than half, of the shareholders' voting power. The figure may be less than 10 percent if there is evidence of an effective voice in management."[27] As a result of this definition, which indeed stresses that there can be an associate company and thus FDI even when the 10 percent threshold is not attained, that UNCTAD considers the presence of an effective voice in management as the essential determinant of FDI, which is consequently not in line with the recommendations of the OECD and the IMF.

2.2 Typology of FDI

FDI can take various forms. FDI can be regarded as (1) Vertical, (2) Horizontal, (3) Greenfield and (4) Mergers and Acquisitions.

2.2.1 Vertical FDI

FDI is commonly classified as vertical or horizontal. Vertical FDI involves a geographical decentralization of the firm's production chain, where foreign affiliates in low-wage countries typically produce labor-intensive intermediates that are shipped back to high- wage countries, often to the parent company itself. Vertical FDI is sometimes referred to as "efficiency seeking" FDI, since the main motive for the investment is to improve the cost effectiveness of the firm's production. In the textile and clothing industry, for example, global supply chains are common. The capital-intensive stages (textiles) are located in relatively capital rich countries, human capital-intensive stages (design and up- market apparel) are located in human capital rich countries, and labor-intensive stages (apparel) are located in labor abundant countries. Another industry where

[27] United Nations Conference on Trade and Development (UNCTAD), op. cit.

the production process can easily be separated into stages that differ in factor intensity is the electronics industry, which has played a major role in the industrialization of Malaysia.

A particular category of efficiency seeking FDI is sometimes referred to as “technology seeking” FDI. The attraction of the location in this case is not necessarily the low cost of labor, but its unique competence. FDI from industrialized countries to the Bangalore district in India, often labeled the Silicon Valley of Asia, is presumably motivated both by cost efficiency and access to an advanced IT milieu. Indeed, India has the second largest stock of IT specialists in the world, only surpassed by the US.

2.2.2 Horizontal FDI

Horizontal multinational companies produce the same product in multiple plants, and service local markets through affiliate production rather than through exports from the home country of the MNEs.[28] Most of the global FDI is horizontal. For instance, Brainard reports that as little as 13 percent of the overseas production of U.S.- owned foreign affiliates is shipped back to the United States, and that only 2 percent of the output produced by foreign affiliates located in the US is shipped to their parents.[29]

Horizontal FDI is sometimes referred to as “market seeking” FDI. The advantage of being close to the customers may be due to factors such as reduced transportation costs, smaller cultural barriers or avoidance of tariffs. Some countries have used trade policy deliberately in order to attract foreign investment: By erecting high tariff barriers they have made it more profitable for foreign firms to set up local subsidiaries than to serve the market by export from other countries.

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[28] When a substantial share of the foreign affiliate’s sales is to third countries, the horizontal investment is often referred to as export platform FDI.
[29] S.L., Brainard, "An empirical assessment of the proximity-concentration tradeoff between multinational sales and trade," American Economic Review vol. 87 No. 4, 520-544, (1997).

For certain kinds of non-tradable services, such as real estate, hotels, retail trade, and part of the telecommunication, banking and financial sectors, there is no trade-off between trade and local production at all; market entry simply requires FDI or other contractual arrangements for local production. The importance of FDI in services has increased over time, accounting for more than 50 percent of total world FDI stocks in 1999, and an even higher share of FDI flows.[30]

Multinationals involved in extraction or use of natural resources are yet another case of FDI where there is no alternative to the local presence of the firm. Endowments of oil, gas, }minerals, forests and waterfalls may be the most important attraction for international investment in a number of poor countries.

2.2.3 Greenfield Investments

In addition to the horizontal and vertical dimensions of FDI, investments may also be classified as either "greenfield" investments or mergers and acquisitions. A greenfield investment involves the establishment of a new production unit. Greenfield investments refer to investments in new assets; *i.e.,* the creation of an entirely new business entity. The construction of a factory in the host country would for example be qualified as a greenfield investment.[31]

2.2.4 Mergers and Acquisitions

Greenfield investments can be opposed to an investment in an already existing business entity, which only results in a change of the ownership of that entity; i.e., a merger or another kind

[30] UNCTAD, World Investment Report 2001: Promoting Linkages, Geneva: United Nations, (2001).
[31] Erik Canton & Irune Solera, Greenfield Foreign Direct Investment and Structural Reforms in Europe: What Factors Determine Investments?, Discussion Paper 033, June 2016.

of acquisition. Merger and acquisition FDI (M&A) can thus be defined as an investment by which a foreign investor acquires existing assets in the host economy.[32] The concept of outbound M&A is used when the operation involves a national buyer and a non-local target, whereas inbound M&A refers to the reverse situation. Most of the growth in FDI taking place in recent years has been in the form of acquisitions. Indeed, in 1999, acquisitions accounted for more than 80 percent of global FDI. Between 60 and 80 percent of FDI flows to developing countries, however, have been in the form of greenfield investments during the period 1995–99.[33]

While in developed countries FDI predominantly takes the form of M&A, in developing countries greenfield investments constitutes the major part of FDI operations. Nevertheless, although both greenfield FDI and M&A FDI have been increasing in volume over the years, the latter type of investment transactions has increased more significantly in comparison with the latter, including in developing countries despite a shape drop of over 50 percent the first three months of 2020 compared to the statistic in 2019 due to the COVID-19 Crisis.[34] The skeptics towards the proposition that FDI is on balance positive for the host economy, perceive that particularly M&A are least likely to lead to economic growth, increase of labor opportunities or transfer of technology, because the transaction does not necessarily results in more than a mere shift from local to foreign ownership.[35]

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[32] Cesar Calderon, *Greenfield Foreign Direct Investment and Mergers and Acquisitions: Feedback and Macroeconomic Effects,* Policy Research Working Paper, World Bank, no. WPS 3192, 2, http://www- wds.worldbank.org.

[33] UNCTAD, Word Investment Report 2000, *Cross-border mergers and acquisitions and development, Geneva: United Nations* (2000).

[34] UNCTAD, Word Investment Report 2020, *supra* note 8; Asian Infrastructure Investment Bank (AIIB), *Recent FDI Trends in Infrastructure and Outlook*, October 27, 2020.

[35] This skepticism regards mainly *FDI* in developing countries. For a thorough study of the potential effects of FDI on host economies, *see*: MORAN, Theodore H., GRAHAM Edward M., and BLOMSTRÖM Magnus, *Does Foreign Direct Investment Promote Development?*, Institute for International Economics, Center for Global Development, Washington D.C., April 2005. *Also*: United Nations Conference on Trade and Development (UNCTAD), *Foreign Direct Investment and Development*., United Nations Publications, Geneva, 1999; United Nations Conference on

2.3 The Theoretical Evolution of FDI

There exists no general theory that can explain the existence of MNEs and FDI. When considering the large number of motives an individual firm can have to perform FDI, the fact that there is no general theory of FDI is not surprising. In the same way that there is no general theory explaining all trade flows, neither is there a general theory able to explain all flows of FDI. As a result of this, the FDI-literature is diverse and spans over several different disciplines including international economics, economic geography, international business as well as management. Though, there exist several studies providing overviews of FDI theories. This section illustrates the theoretical evolution of FDI. Although it primarily focuses on developing countries, most of the theories described in this section can be applied to all types of economies.

2.3.1 Early Theories of FDI

Theories of FDI is said to have emerged during the post-war period. The process of globalization took a new start after the Second World War. The increasing importance of MNEs and FDI during the 1950s and 1960s created an incentive for researchers to find theories able to

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Trade and Development (UNCTAD), *Should countries promote foreign direct investment?*, United Nations Publications, Geneva, 2001. In the 1992 *Guidelines on the Treatment of Foreign Direct Investment* the *World Bank* doesn't seem to stress differences of impact on host economies in function of the type of *FDI*, as results from its paragraph first: *"The Development Committee Recognizing that a greater flow of foreign direct investment brings substantial benefits to bear on the world economy and on the economies of developing countries in particular, in terms of improving the long term efficiency of the host country through greater competition, transfer of capital, technology and managerial skills and enhancement of market access and in terms of the expansion of international trade". See also*: SINGH, Ajit, *Foreign Direct Investment and International Agreements: A South Perspective*, Centre Trade Series Occasional Paper Nr. 6, 2001, 7. The fact that the efforts of developing countries to liberalize *FDI* primarily results from their intent to advance the cause of their investors *-and the objective of foreign direct investors is to increase their profits-*, is highlighted by Sornarajah: *"that foreign investment is motivated by altruistic motives of developing the economy of the host state is ... an absurdity. Transnational corporations which make overseas investments are not charitable institutions doling out largesse but are companies in search of profits"* (Sornarajah, M., *The International Law on Foreign Investment*, Cambridge University Press, Cambridge, 1999, 342). For more on how international organizations such as the *WB*, the *IMF* and the *WTO* could play a role in imposing social and environmental responsibilities on the multinational companies *(in the context of the North-South investment flows)*, see: NIEUWENHUYS, E.C., and BRUS, M.M., *Multilateral Regulation of Investment*, Kluwer Law International, The Hague, 2001.

explain the behavior of MNEs and the existence of international production. The early theories could only explain a limited share of the total FDI flows. The theories were also inadequate in that they failed to realize that FDI is not only a capital flow but constitutes a package including other components such as management and technology transfer.

Consequently, some of the attempts to develop a theory of FDI failed to incorporate the fundamental difference between portfolio and direct investment. An example is the so-called capital markets approach by Aliber. The idea was to use already existing theories for flows of portfolio investment to explain flows of FDI. FDI was treated as portfolio investment and consequently FDI should flow to locations where the financial return on investment was highest.[36]

However, the theory of FDI is really a theory of the MNEs. During the 1960s, researchers started to focus more explicitly on MNEs and their activities. Vernon applied the idea of the product life cycle to international trade in order to explain the existence of international production as well as trade. According to Vernon, as a product moves through the product-life cycle, the characteristics of the product change.[37] These changes imply that the optimal location for production of the product also changes over time. The basic idea is that the high level of income and demand in the U.S. results in an environment conducive for innovation. The product-life cycle begins when innovations are transformed into actual products. Increasing competition eventually forces production to move from the U.S. to lower income economies in order to reduce production costs. As the standardization of the product and its production process intensifies and the product moves into the mature stage of its life cycle, production in high and average income economies

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[36] R.Z. Aliber, A theory of direct foreign investment, in C. Kindleberger (ed.): The International Corporation, 17-34, The MIT Press, Cambridge, (1970).
[37] R. Vernon, International investment and international trade in the product cycle, Quarterly Journal of Economics, 80, 190-207, (1966).

comes to an end as a result of ever-fiercer competition. The demand for the product is instead satisfied through exports from low income, developing economies to the rest of the world.

Vernon was a contribution since it could explain some of the outflows of FDI from the U.S. during the 1950s and 1960s.[38] It was also the first theory treating trade and direct investment as two dynamic alternatives to serve demand in a foreign market. Unfortunately, the theory fails to explain most of the flows of direct investment observed today. The large flows of FDI between developed economies described in the New Trade Theory discussed later in this section cannot be explained by Vernon's theory. The focus on innovations also makes the theory difficult to apply to outflows of FDI from industries, which are not innovative.

2.3.2 Firm-specific Advantages and the OLI Paradigm

The theory of firm-specific advantages developed by Stephen Hymer emerged approximately at the same time as Vernon's theory. Hymer's dissertation from 1960 contributed the foundation necessary for the so-called eclectic paradigm that has had a large impact on FDI theories.[39] The theory of firm-specific advantages was the first theory treating international production explicitly, and the first focusing on the MNEs itself.

To Hymer, firms operating in a foreign country are at a disadvantage compared to the domestic firms. The disadvantage is a result of operating in a foreign environment. The domestic firms are assumed to have lower costs of operation since they are more familiar with local conditions such as legislation, business culture, language and so on. A foreign firm must therefore have an offsetting, firm-specific advantage allowing it to compete with domestic firms. Firm-

[38] *Id.*
[39] Stephen H. Hymer, The International Operations of National Firms: A Study of Direct Foreign Investment, The MIT Press, Cambridge, (1960).

specific advantages include superior technology, brand name, managerial skills and scale economies. Firm-specific advantages have to be excludable for a substantial time period in order to provide the possessing firm with a long-term advantage.

A weakness of the concept of firm-specific advantages is that it had little to say regarding the actual decision about FDI. This void was filled by John Dunning, who developed the idea of firm-specific advantages further, resulting in the so-called OLI paradigm of FDI, also known as the eclectic theory of FDI. The paradigm was presented in Dunning.[40] The contribution of the OLI paradigm is that it provides a framework for a discussion of the motives for FDI. It also allows for a discussion of the choice of an MNEs between licensing, exports and FDI in order to serve a foreign market. This choice is determined by Ownership advantages, Location advantages and Internalization advantages, thus the acronym OLI.

Ownership advantages are based on the concept of firm-specific advantages. To cancel out the disadvantage of operating in a foreign country, a firm must possess an ownership advantage. The ownership advantage comes in the form of an asset reducing the firm's production cost and allows it to compete with domestic firms in the foreign economy despite the information disadvantage. Ownership advantages come in the form of assets such as patents, management or technology. In order to provide an ownership advantage, the possessing firm has to be able to exclude competing firms from using the asset. To create conditions for FDI, ownership advantages

[40] John H. Dunning, Trade, location of economic activity and the MNE: a search for an eclectic approach in B. Ohlin and P.O. Hesselborn (eds.): The International Allocation of Economic Activity, 395-418, Macmillan, London, (1977).

also have to be transferable to a foreign country and possible to use simultaneously in more than one location, to create conditions for FDI.[41]

Location advantages determine how attractive a location is for production. A strong location advantage reduces a firm's production costs in that location. Location advantages can never be transferred to another location but can be used by more than one firm simultaneously. For example, a supply of cheap labor can provide a location advantage for several labor-intensive firms. If the home country provides the strongest location advantage to the firm, FDI does not take place. Instead, production is located in the home country, and the output is exported in order to meet demand in the foreign economy.[42]

The existence or non-existence of an internalization advantage determines how the MNEs chooses to use its ownership advantage. Existence of an internalization advantage implies that the firm's most efficient alternative of using an ownership advantage is through exports or FDI.[43] If an internalization advantage is missing, it is more profitable for the firm to exploit its ownership advantage through selling the right of its use to another firm through licensing. Existence or non-existence of an internalization advantage determines an MNE's choice between own production and licensing of the production to an external firm.

[41] John H. Dunning, Trade, location of economic activity and the MNE: a search for an eclectic approach in B. Ohlin and P.O. Hesselborn (eds.): The International Allocation of Economic Activity, 395-418, Macmillan, London, (1977).
[42] *Id.*
[43] *Id.*

While possession of an ownership advantage is a prerequisite for a firm to be able to serve demand in a foreign market, it is the existence of location and internalization advantages that determines how the foreign market is served.

FDI only occurs when the MNEs possesses both an ownership and an internalization advantage and the foreign country has a location advantage. For the case where the MNEs lacks an internalization advantage, production is licensed to local firms in the foreign market. If the MNE's home country has the strongest location advantage, the MNEs uses exports to serve the foreign market. The OLI paradigm can, therefore, also be used as a framework for a discussion about the relationship between FDI and trade.

Dunning uses the framework of the OLI paradigm as a base for the investment development path (IDP) theory.[44] The idea of the IDP-theory is that there is a U-shaped relationship between the level of an economy's development and the net outward flows of FDI. In the first low-income stage, FDI inflows are small and outflows are zero or close to zero. Domestic firms have not yet acquired ownership advantages and therefore have no prospects for investing abroad whereas location advantages are too weak to attract inward FDI inflows. Economies where significant improvement of the location advantages takes place (for example, an improvement of the educational level), enter the second stage. Inflows of FDI increase substantially while outward FDI remains very small, resulting in an increasingly negative net outward FDI position. During the third stage, net outward flows are still negative but increasing. There are two possible causes for this. The first possibility is that outward investment is constant and inward investment is falling. Alternatively, the outflows of FDI are rising faster than the inflows due to eroded ownership

[44] John H. Dunning, Explaining the International Direct Investment Position of Countries: Towards a Dynamic or Development Approach, 30-64, (1981).

advantages of the foreign investors or as a result of domestic firms developing ownership advantages, generating outflows of FDI. During the fourth stage, the outward flows of FDI surpasses the inflows of FDI, implying domestic firms have developed strong ownership advantages.

Empirical applications of the IDP-theory include Barry et al., who analyze inward and outward FDI flows for Ireland. They find that the growing inflows and subsequent outflows of FDI are consistent with the IDP-theory. Most developing economies are still in the first low-income stage, explaining the extremely small inward stocks of FDI per capita for Africa and Asia.[45]

2.4 Understanding MNEs Engagement in FDI

This section analyzes the reasons for MNEs engagement in FDI. For a long time, MNEs have been the subject of intense study and controversy. Rather than a well-known entity to policy makers, MNEs have become an economic phenomenon that is difficult to define.[46] Some definitions emphasize on multi-nationality, geographic dispersion, and management orientation, while others on ownership and control. Some definitions stress several different criteria such as (1) organizational structure and ownership;[47] (2) the number of countries in which operations are carried on;[48] (3) size of total operations;[49] (4) attitude of management (ethnocentric, polycentric or geocentric).[50]

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[45] F. Barry, Görg, F., and McDowell, A., Outward FDI and the investment development path of a late-industrializing economy: evidence from Ireland, Regional Studies, 37(4), 341-349, (2003).
[46] United Nations Department of Economic and Social Affairs, Multinational Corporations in World Development, 5, (1974).
[47] Yair Aharoni, *On the Definition of a Multinational Corporation*, in *The Multinational Enterprise in Transition*, A. Kapoor & P. Grubs eds., 4-5, (1972).
[48] J.H. Dunning, *The Multinational Enterprise: The Background*, in *The Mutlinational Enterprise*, J. Dunning ed., 15-16, (1971).
[49] R. Vernon, *Sovereignty at Bay: The Multinational Spread of U.S. Enterprise*, (1971).
[50] *Id*.

With its characteristic attributes and distinctive behavior, some have described MNEs as comprising an international system that own or command globally vast amounts of technological, financial, managerial, human, or marketing resources.[51] Functionally, the MNEs represents a network of operations, services, or a global-plant system connected through a common resource pool and a common strategy with all its component parts. The structure is controlled by either a monocentric or polycentric management command system. As such, MNEs enjoy tremendous flexibility in its operational decision process. Its decisions are neither bound nor seriously limited by considerations of distance, time, space or by regional, national or cultural allegiances. Although MNEs differ in size, technical capabilities, and degree of product and geographical diversification, this flexibility still is inherent in the MNEs control system and permits the MNEs to manipulate its global operations in response to various economic stimuli, costs, government attitude, and geopolitical considerations.[52] Thus, according to Kojo Yelpaala, the same MNEs, "through the establishment of foreign subsidiaries, or global affiliates" may "extract raw material in one country, to be manufactured as semi-finished products in a second country, to be used in the manufacturing of a finished product in a third country, to be marketed in yet a fourth country."[53] Through this system, MNEs are afforded the opportunity to use each affiliate as a channel for shuttling resources from one country to another and / or to shift profits from high-tax environments to low-tax environments accordingly to the dictates of the management command system.[54]

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[51] Kojo Yelpaala, *The Effect of Tax Incentives: Within the Framework of the Neoclassical Theory of Foreign Direct Investment: A Legislative Policy Analysis*, Tex. International L.J., 365, 379, (1984).
[52] Horst, *The Theory of Multinational Firm: Optimal Behavior under Different Tariff and Tax Rates*, Pol. Econ., 79, (1971).
[53] R. Newfarmer and W. Mueller, *Multinational Corporations in Brazil and Mexico: Structural Sources of Economic and Noneconomic Power*, Report to the Subcommittee on Multinational Corporations of the Senate Committee on Foreign Relations, 94th Congress, 1st Session, 14, (1975).
[54] See *Id.* R. New Farmer and W. Mueller, at 7.

There are a variety of reasons, both internally and externally, as to why an MNE engages in FDI.[55] As will be analyzed below, an MNEs may undertake FDI in a host country to (1) enhance product competitiveness in a host country's market through "tariff-jumping" FDI,[56] (2) utilize cheap labor for production facilities,[57] (3) secure a supply of natural resources,[58] (4) to take advantage of a host country's investment incentives among other reasons.[59]

Above all, the most common motivation for MNEs engagement in FDI is to invest abroad with the intention of expanding their market. Each of these motivations for undertaking FDI is ultimately based on the search for increased profits.[60] According to Caves, beneath this phenomenon there must be at least some governance or transaction-cost advantage to placing their plants in the host countries for MNEs. The transaction-cost theory asserts that MNEs will exist only if the plants they control and operate attain lower costs or higher revenue productivity than the same plants in the home country. Moreover, a foreign investor must be knowledgeable of the policies and rules in order to build up, run and secure his business in the host state.[61] The legal dimension in this perspective concerns the protection against possible risks, the facilitation of an individual investment and the means of dispute avoidance and dispute regulation. The factors with regard to the engagement of MNEs in FDI activities can briefly demonstrate as follows.

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[55] Jeswald Salacuse, *Toward a New Treaty Framework for Foreign Direct Investment*m J. Air L. & Com., 50, (1985).
[56] Oliver Morrissey and Yogesh Rai, *The GATT Agreement on Trade-related Investment Measures: Implications for Developing Countries and Their Relationship with Transnational Corporations*, J. Dev. Stud., 31, (1995).
[57] Robert Pritchard, *Introduction: The Contemporary Challenges of Economic Development,* in *Investment and the Law: Issues of Private Sector Foreign Investment, Foreign Investment and the Rule of Law in a New Era,* Robert Pritchard ed., 5, (1996).
[58] See *Id.*
[59] World Trade and Organization (WTO), Annual Report, (1996).
[60] For a review of the theory of MNE investment in developing countries, see generally Robert Gilpin, *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment* (1975) and Theodore H. Moran, *Multinational Corporations: The Political Economy of Foreign Direct Investment* (1985).
[61] See *Id.* at 3.

2.4.1 Economic Factors

Inarguably, a predominate reason MNEs seek entry to foreign markets is to take advantage of prevalent economic benefits. The type and number of economic advantages that are present vary from country to country, and investment to investment. There are three major economic benefits present in the host country. First, FDI may be undertaken to obtain access to the specific resources that are present in the host country. Second, FDI may be partially motivated by the existing labor situation in the host state. Third, FDI may also be motivated by the reduced costs of capital outlay. Overhead costs connected to FDI, such as land, buildings and materials relative to the same items in developed nations, which tend to be higher.[62]

Economic motives for partaking in FDI are not isolated to the country where the investment will occur. There also exist certain economic considerations in the home country of the investor that affects their decision to go abroad. The four main economic considerations are as follows. One, limitation of the domestic market serves as a prime reason for an investor to seek opportunities abroad. Two, stringent antitrust policies in the investor's home country may also effect an investor's decision to engage in FDI. Three, high levels of taxation in the investor's home country increase the cost of MNE's home production, deterring them from investing domestically and thus, propelling them to undertake FDI. Lastly, the presence of a powerful nation and / or comparatively high wages in the home country of the investor can also lead to FDI.[63] Hence, there are various economic factors that must be considered by the potential investor, both in the home and host countries, when contemplating FDI engagement. The importance placed on each of these economic factors will however vary according to the type of investment.

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[62] Isaia Litvak and Christopher Maul, *Foreign Investment: The Experience of Host Countries*, 11, (1970).
[63] *Id.*

2.4.2 Political Factors

Political factors are also of great importance to an investor when dealing with an unpredictable investment climate. Regardless of the potential economic benefits that FDI in a country presents, an investor may decide that the potential risks outweigh the probable benefits, especially if such an investment is at a great risk of being nationalized or expropriated.

A reasonable investor will place a great deal of consideration on the political ideology and political stability that is found in the host country.[64] Significantly, the potential investor will assess the prior experience of other foreign investors in the particular host country of interest, the host country's practice with regard to payments for expropriation, and the general attitude towards FDI. While an investor, in many cases, has the ability to obtain political risk insurance, the investor entering an FDI is usually seeking a sound, secure, and long-term investment and would prefer not to resort to compensation provided by political risk insurance. The policies of the investor's home country can also potentially affect their investment options.

2.4.3 Legal Factors

The legal environment present in a host state is another contributing factor in whether an MNE engages in FDI. The crucial issues involve the availability of legal actions and / or restrictions on the repatriation of capital, profits, and dividends. Many countries place capital percentage requirements and domestic labor percentage requirements for employees on the investment project. Also, the investor must look to the laws of the host country to determine if such foreign investment is permitted, and what limits, if existent, are placed on the ability of a

[64] *Id.* at 34.

foreign investor to own or control such FDI.[65] These factors are normally determined early on in the decision-making process due to the fact that many of these issues may be negotiable with the host country's government prior. Within these negotiations, there are other factors that will play an important role such as the type of investment, and the extent of power the investor has in the negotiating process.[66]

2.4.4 Socio-cultural Factors

Another area of concern for MNEs is the effect that the foreign investment may have on the culture of the host country. Many countries deem areas such as radio, television, and publishing culturally sensitive and thus seek tight control upon these sectors. The existence of a strong religious base in the host country also affects the investment decision of MNEs in which case the investor must ensure that the investment does not infringe on or create any conflicts with the local religious beliefs.[67] Moreover, the MNEs should consider the diversity of major cultural groups in the host country with a unified culture. The potential investor, by locating operations in one area of the country, predominantly inhabited by one cultural group, may inadvertently offend other groups. When determining the appropriate location for their investment, the MNEs must, in

[65] Many nations place limits on how much ownership and / or control a foreigner can obtain. For example, Mexican law limits certain types of foreign ownership and control to 49% of the total FDI. *See* Ralph H. Folsom, et. al., *International Business Transactions*, 752, (1991).
[66] For example, in pre-NAFTA Mexico, even though the law stated that foreign ownership and control of an investment could not exceed 49%, the Presidential regulations placed no such limit on FDI, and in Mexico, the regulations supercede the law. Further, prior to the regulation being implemented, in the case of IBM, IBM sought to invest in Mexico. IMB was able to negotiate an agreement with the government, which allowed them to retain 100% ownership. This deal was a direct result of the benefits that the IBM investment brought to Mexico, including jobs, hard-currency and technology. Therefore, it is not only important to determine the legal environment, of the host country, but also to recognize that sometimes the laws are not set in stone. *See* Ralph H. Folsom, et. al., *International Business Transactions*, 752, (1991).
[67] Isaia Litvak and Christopher Maul, *Foreign Investment: The Experience of Host Countries*, 11, (1970).

certain instances, consider these sociocultural factors and the effect that these may have on the investment.

Together, the economic, political, legal, and socio-cultural factors are significant in an MNE's decision-making process to whether or not it engages in FDI. MNEs must assess each factor at both the individual level and collectively to determine whether or not they will undertake FDI in a host country.

2.5 The Role of FDI in Development

After considering the engagement of MNEs in FDI activities, now the study turns to the issue of the possible positive impact of FDI to the development process of host country. Developing countries, emerging economies and countries in transition have come increasingly to see FDI as a source of economic development and modernization, income growth and employment. Countries have liberalized their FDI regimes and pursued other policies to attract investment. Accordingly, countries have addressed the issue of how best to pursue domestic policies to maximize the benefits of foreign presence in the domestic economy.

The overall benefits of FDI for developing country economies are well documented. Given the appropriate host country policies and a basic level of development, a preponderance of studies shows that FDI triggers technology spillovers, assists human capital formation, contributes to international trade integration, helps create a more competitive business environment and enhances enterprise development.[68] All of these contribute to higher economic growth, which is the most

[68] Baiashvili & Gattini, *Impact of FDI on economic growth: The role of country income levels and institutional strength* (2020), *supra* note 2; R. Farrell, Japanese investment in the world economy: A study of strategic themes in the internationalisation of Japanese industry. Cheltenham, UK: Edward Elgar (2008); OECD, *Foreign Direct Investment for Development; Maximizing Benefits, Minimizing Costs* (2002).

potent tool for alleviating poverty in developing countries. Moreover, beyond the strictly economic benefits, FDI may help improve environmental and social conditions in the host country by, for example, transferring "cleaner" technologies and leading to more socially responsible corporate policies.

2.5.1 Technology Spillovers

Economic literature identifies technology transfers as perhaps the most important channel through which foreign corporate presence may produce positive externalities in the host developing economy. MNEs are the developed world's most important source of corporate research and development (R&D) activity, and they generally possess a higher level of technology than is available in developing countries, so they have the potential to generate considerable technological spillovers.[69] However, whether and to what extent MNEs facilitate such spillovers varies according to context and sectors.

2.5.2 Human Capital Enhancement

The major impact of FDI on human capital in developing countries appears to be indirect, occurring not principally through the efforts of MNEs, but rather from government policies seeking to attract FDI via enhanced human capital. Once individuals are employed by MNEs subsidiaries, their human capital may be enhanced further through training and on-the-job learning. Those subsidiaries may also have a positive influence on human capital enhancement in other enterprises with which they develop links, including suppliers. Such enhancement can have further

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[69] M. Blomström, *"What explains growth of developing countries?"* in W.J. Baumol, R.R. Nelson and E.N. Wolff (eds) *Convergence of productivity: Cross national and historical evidence*, Oxford University Press, New York, (1994).

effects as that labor moves to other firms and as some employees become entrepreneurs. Thus, the issue of human capital development is intimately related with other, broader development issues.

2.5.3 International Trade Integration

While the empirical evidence of the effects of FDI on host country foreign trade differs significantly across countries and economic sectors, a consensus is nevertheless emerging that the FDI-trade linkage must be seen in a broader context than the direct impact of investment on imports and exports. The main trade-related benefit of FDI for developing countries lies in its long-term contribution to integrating the host economy more closely into the world economy in a process likely to include higher imports as well as exports.[70] In other words, trade and investment are increasingly recognized as mutually reinforcing channels for cross-border activities. However, host country authorities need to consider the short and medium-term impacts of FDI on foreign trade as well, particularly when faced with current-account pressures, and they sometimes have to face the question of whether some of the foreign-owned enterprises' transactions with their mother companies could diminish foreign reserves.

2.5.4 Competition

FDI and the presence of MNEs may exert a significant influence on competition in host country markets. However, since there is no commonly accepted way of measuring the degree of competition in a given market, few firm conclusions may be drawn from empirical evidence. The presence of foreign enterprises may greatly assist economic development by spurring domestic competition and thereby leading eventually to higher productivity, lower prices and more efficient

[70] S. Lall,"Technological capabilities and industrialization," World Development Vol. 20 No. 2, 165-186, (1992).

resource allocation.[71] Conversely, the entry of MNEs also tends to raise the levels of concentration in host country markets, which can hurt competition. This risk is exacerbated by any of several factors: if the host country constitutes a separate geographic market, the barriers to entry are high, the host country is small, the entrant has an important international market position, or the host country competition law framework is weak or weakly enforced.

2.5.5 Enterprise Development

FDI has the potential significantly to spur enterprise development in host countries. The direct impact on the targeted enterprise includes the achievement of synergies within the acquiring MNE, efforts to raise efficiency and reduce costs in the targeted enterprise, and the development of new activities. In addition, efficiency gains may occur in unrelated enterprises through demonstration effects and other spillovers akin to those that lead to technology and human capital spillovers.[72] Available evidence points to a significant improvement in economic efficiency in enterprises acquired by MNEs, albeit to degrees that vary by country and sector. The strongest evidence of improvement is found in industries with economies of scale. Here, the submersion of an individual enterprise into a larger corporate entity generally gives rise to important efficiency gains.

2.6 FDI and Development Perspective in Reality: The Matter of Legal Institution

As the study suggested, in the last section, the beneficial aspects of the FDI to the development of the host FDI country, the history of theoretical approaches to the FDI and the statistic impact of it on the country development have pointed to the crucial role of the regulatory

[71] D. Salvatore, *International Economics*, Prentice Hall, New Jersey, (1998).
[72] A. Kokko,"Technology, market characteristics, and spillovers," Journal of Development Economics, vol. 43 pp. 279-293, (1994).

framework or the legal institution of the host state governing the FDI activities. Recent studies emphasize the significant role of legal institutions of the country to fully receive beneficial aspects of FDI activities.[73] The history of theoretical perspective regarding the FDI and national development has shown that there are some flaws in the classical theory. The classical theory suggests that FDI will benefit host FDI countries, mostly developing economy, in strengthening their economic growth, human capital development, employment and technological enhancement.[74] This theory has been dominated the international trade and investment arena as it was largely supported by the developed economy which is the net export of FDI.

On the contrary, those beneficial elements of FDI have shown a different result from the experience of developing world. Originating from Latin American economies, the dependency theory views that FDI is a tool created by the developed economies as well as their multinational enterprises in distracting the benefits from developing country. The FDI activities would serve the benefits and interests of MNEs headquarter and their shareholders in the developed economy. As a result, the host FDI country becomes *subservient* or *peripheral* economies serving the interests of the home states as discussed in the work of Sonarajah.[75] In addition, the impact of foreign investment could widen the gap between rich and poor people by increasing the wealth and business opportunity of local elites and support the oligarchic regime that leads to the entrenchment economy.[76] By this condition, the developing country will never achieve the higher standard of development in term of the meaningful distribution of wealth to their citizen.[77]

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[73] Baiashvili & Gattini, *Impact of FDI on economic growth: The role of country income levels and institutional strength* (2020), *supra* note 2.
[74] M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT, 2nd EDITION, 51-56 (2004).
[75] *Id.* at 57.
[76] JENNY R. KEHL, FOREIGN INVESTMENT AND DOMESTIC DEVELOPMENT: MULTINATIONALS AND THE STATE 13 (2009).
[77] *Id.* at 59.

However, the battle between those above mentioned theories in early 1980s has diminished due to the strong wind of globalization and trade liberalization in the world trade regime during recent decades. The global economic trend along with the studies of the United Nations Commission on Transnational Corporations (UNCTC) has significantly impacted the positive attitudes toward the FDI activities of MNEs. The study suggested that developing economies can achieve beneficial impact of FDI by implementing the effective regulatory measures which lessen the negative effects of FDI such as human right violation and environmental issues as well as the defective business practices that cause the negative impact to domestic market of the host states.[78] Thus, the role of the domestic regulatory measure has emerged as a crucial factor in strengthening the positive impacts of FDI to the economic development of the host country.

The role of domestic regulation regarding the FDI activities has been an important tool of developing country in harnessing FDI, particularly since the economic crisis in the 1990s.[79] Many model FDI legal frameworks have been implemented to secure the benefits of the foreign investments, ranging tax-incentives investment promotions to the liberalization of FDI admission in the county. Nevertheless, the changing perspective toward the FDI legal framework has proved to be insufficient in recreating the higher level of economic development in some country. This partly demonstrates through the problem so-called *"Middle-Income Trap Dilemma"* which is apparent in current world economic context, particularly in the case of Thailand.[80] FDI has been seen as a tool to economic development. Yet, the result appears otherwise. Thus, this raises another

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[78] Theodore H. Moran, *The United Nations and Transnational Corporations: A Review and A Perspective, Transnational Corporations*, Vol. 18, No. 2, August 2009.
[79] KEHL, *supra* note 76, at 1-3.
[80] Haruhiko Kuroda, ADB President, Keynote Speech at the ADB-PRC Knowledge Sharing Forum to commemorate 25 years of ADB-PRC Partnership: Opportunities and Challenges Middle Income Transition (March 22, 2011).

set of questions on what factors hinder the effective implementation of FDI regulatory regime to stimulate the economic development.

In addressing the problem regarding the role of regulatory measure and the development of national economy, the theoretical approach of a New Institutional Economic (NIE) Discipline should be discussed since this theory argues that the institution, or for more precise meaning, the legal institution framework of the country is the key factor in determining the result of the government effort to create a well-established market-oriented economy that stimulate economic development. As stated above, the importance of legal institutions in the development of the national economy can be best exemplified through the perspective of the New Institutional Economics (NIE) discipline. The divergence in the levels of economic performance among countries, as evident in the case of the East Asia region, has prompted several economists to seek an explanation for these differences. The NIE theory has, thus, emerged to explain these divergences where the neoclassical assumption has failed to address. This section seeks to emphasize the crucial role of existing institutions in the economic development of countries, particularly the role of institutions in facilitating Thailand's economy. This section highlights the historical and empirical evidence that showcase the significance of institutions in modern market economies and in the economic development of nations.

The New Institutional Economics is an integration between the theory of institutions and the economic discipline.[81] Its roots lie in neoclassical theory but it extends, alters, and elaborates the neoclassical ideology to enable a more complete comprehension of the range of issues that arebeyond the scope of its predecessor. The New Institutional Economics relies upon the fundamental

[81] Bruce E. Kaufman, *The Institutional Economics of John R. Commons: Complement and Substitute for Neoclassical Economic Theory*, 5 SOC. ECON. REV 3 (2007).

assumption of scarcity and, its byproduct, competition, which underlies the choice theoretic approach concept central to microeconomics. Most notably, however, is the omission of the instrumental rationality concept which is one of the neoclassical ideology's assumptions that renders it incapable of incorporating institutions into its theory. The implications of this neoclassical assumption are argued by Herbert Simon:

> If we accept values as given and constant, if we postulate an objective description of the world as it really is, and if we assume that the decisionmaker's computational powers are unlimited then two important consequences follow. First we do not need to distinguish between the real world and the decisionmaker's perception of it: he or she perceives the world as it really is. Second we can predict the choices that will be made by a rational decisionmaker entirely from our knowledge of the real world and without a knowledge of the decisionmaker's perceptions or modes of calculation (we do, of course, have to know his or her utility function). [82]

The neoclassical assumption of instrumental rationality[83] deems institutions as unnecessary; ideas and ideologies of individuals are, thus, disregarded in its entirety. Economies, according to their conception, are characterized by the efficiency of markets – economically and politically. It is in fact the case that individuals have limited mental capacity and are incapable of amassing information in its totality. In the human interaction process, individuals, therefore, impose a set of constraints in order to structure exchange in the market. Thus, the role of institutions emerged to direct the behaviors of individuals, firms, and other players in a particular economy in order to maximize the productivity implication inherent in neoclassical theory.

When firms or investors enter the foreign market as in the case of FDI, they will operate under unfamiliar economic environment. The investors will have to adapt their operations and activities in order to survive in the new market conditions. The various conditions and development of domestic market around the world, as Douglass C. North, recipient of the 1993 Nobel Prize in

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[82] Herbert A. Simon, *Rationality in Psychology and Economics*, 59 J. BUS. 210 (1986).
[83] Joseph Raz, *The Myth of Instrumental Rationality*, 1 J. ETHICS & SOC. PHIL. (2005).

Economic Science suggested, are the result of the effectiveness of the domestic legal institution that shape and dictate the ideologies of players or "investor" inside the market whether to be productive or unproductive in conducting their businesses. . In *Institutions, Institutional Change and Economic Performance,* North begins his work by stating that history matters. In accentuating the connection between past, present, and future, North argues that "Today's and tomorrow's choices are shaped by the past. And the past can only be made intelligible as a story of institutional evolution. Integrating institutions into economic theory and economic history is an essential step in improving that theory and history."[84] The history matters not just because we can learn from the past, but because the present and the future are connected to the past by the continuity of a society's institutions.[85] North also contends that institutions and the way they evolve determine economic growth, and it is the evolution of such institutions that dictate the transaction and production costs, or more simply, the way investors and firms doing businesses in a market economy.[86] North's perception of economic growth greatly explains the hindrances that the Thai economy faces with regard to the FDI regime in Thailand.

In North's study, he describes the definition and purpose of legal institution as follows:

> Institutions are the 'rule of the game' in a society or more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social, or economic.[87][…] Institutions consist of formal rules, informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and the enforcement characteristics of both. In short, they consist of the structure that humans impose on their dealings with each other.[88]

[84] DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE vii (1992).
[85] *Id*.
[86] *Id.*
[87] *Id.* at 3.
[88] DOUGLASS C. NORTH, TRANSACTION COSTS, INSTITUTIONS AND ECONOMIC PERFORMANCE 9 (1992); *Id.* at 18.

North explains his concept through the model of competitive team sports. In the example of sport competition, the fundamental rule of the game is functioned through both formal written rules and informal code of conduct, unwritten rules e.g. sportsmanship and team sport manners. Both of which strengthen and facilitate the fair play of all players in the sport competition scenario. For example, it is unacceptable to intentionally injure other player in the game. And when the rule of the game is violated, it is the punishment that will be enforced to make sure that the formal and informal rules will still uphold the fundamental principle of the game. Thus, it is the "the costliness of ascertaining violation and the severity of punishment" that will dictate the behavior of the player in the game. If the game violations are costly, the player will abide by the rule of the game. On the contrary, if the enforcement of the rule is weak and the punishment is not proportionate to those violated activities, the player will override the rule in order to maximize their advantage in the game. North's scenario is applicable to the reality of the market economy. In sum, those three elements of legal institution, as North proposed, is crucial in determining the effectiveness of the institution in the economy.

However, such institution has also been influenced and changed through the inherited elements or "socio-cultural factors" of each nation. These factors are the *"transaction cost"*, as North suggests, that is the main hindrance to the effective implementation of the legal institution or in other word, the regulatory measures to guide and shape the activities of investors or players in the market to be productive for the prosperity outcome of the market development.[89]

In the light of the subsequence sections, it is helpful to point out to some example of specific sets of legal institution that influence the development of the foreign investment regime

[89] NORTH, *supra* note 84, at 27-35.

in Thailand. The FDI controlling measure such as the Foreign Business Act of 1999 is considered to be a crucial tool in facilitating the well-organized foreign investment policy that propels the development of a nation. The FDI controlling regulation is the screening mechanism at the first point of contact when foreign investors enter the gate of domestic economy. Such law should be able to restrict and classify the type of foreign investments that need to be regulated and also will ultimately facilitate the development of domestic enterprises and national economy. By controlling the foreign investment participation in the market, the law should be able to primarily identify the national of the entering investor or enterprise. Thus, the rule applicable to the nationality of the investment enterprise, such as the corporate ownership and control structure, has emerged to be a critical issue in the Thai foreign investment sphere as demonstrated in the light of the *"nominee problem"* which results in the ineffective implementation of the FBA.

2.7 The Regulatory Framework of FDI

This section studies the national regulatory framework for the admission of FDI and its impact to the favorable FDI climates and the development of host-FDI economy. As Douglass C. North suggested, institutions are the rules of the game in a market and effective institutions will reduce production and transaction costs in the business operation.[90] Consequently, effective institutions boost profitability, returns on investment and eventually economic activities, while ineffective and weak institutions create uncertainty and higher costs of production.[91] The host FDI regulatory framework at the admission is the important element for the successful policy regarding the FDI admission. The admission regime is the fundamental component for host state's FDI promotion activities. As mentioned in the last section, the national FDI controlling measures

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[90] *Id.*

[91] Baiashvili & Gattini, *Impact of FDI on economic growth: The role of country income levels and institutional strength* (2020), *supra* note 2, at 19.

at the admission stage is the depiction of national market's environment. It similar to the security screening point at the entrance of the stadium before investor can enter into the domestic market. Thus, it's the crucial point of first contact between investor and host FDI state that will dictate the subsequent activities of the investor. The FDI admission, if it is effectively implemented, can serve for the benefit of both investors and host FDI country. Most importantly, the model of admission must not present the high cost for entering the domestic market such as cumbersome screening processes, bureaucratic hindrances and uncertain regulatory measures.[92]

With regard to the type of admission regime, this section will generally address the category of FDI admission models from the controlling one to the open-admission model. Moreover, the determinants of a host country's FDI favorable climates will also be discussed as it is divided in three main categories: the rules applicable to the entry of FDI, the rules governing the treatment of foreign direct investors and their investments, and the rules on the exit of FDI. All of these aim to provide a clearer understanding of the regulatory framework of FDI. The study proceeds with a successive analysis of the national legal determinants of FDI systems. From a certain perspective, each of the elements examined, taken individually, can constitute some indication of a country's FDI hospitality. Indeed, each of them constitutes a definitional component of a country's legal and regulatory system. However, it is important to note that regardless of several beneficial aspects of FDI, the potential negative effects of FDI are also needed to be addressed and mitigated. Thus, it is crucial for developing country to implement the effective FDI controlling measure and other related policies that aims to attract the right kind of FDI to maximize the development of nation. The analytical decomposition of FDI systems in different determinants can thus render a first comparison between national systems less complex as well as

[92] THOMAS POLLAN, LEGAL FRAMEWORK FOR THE ADMISSION OF FDI 3 (2006).

provide a more transparent understanding to how a country can adapt their policies to be more hospitable towards FDI.

As mentioned, the most pertinent elements to define a specific host economy's legal investment climate and to determine its extent of attractiveness can broadly be regrouped into three main categories of provisions: the rules that apply to the entry of FDI, those applying to the treatment and protection of foreign investors and their investments, and those applicable to the exit of FDI.

On the basis of these three categories of rules, the following issues will be discussed: the types of entry procedures that can be encountered (notification formalities or screening and approval procedures); the exclusion of certain sectors of the host economy from FDI and the underlying rationales for such carve-outs (national security concerns, superior national interests, national interests in general, or mere economic protectionism); foreign ownership restrictions; entry conditions and performance requirements such as technology transfer, employment of locals, minimum capital, local content and export quotas; the treatment of foreign investors in comparison with their national counterparts; legal protection and guarantees including the issue of expropriation; financial and other incentives to attract foreign direct investors; the applicable tax regime including the issue of double taxation treaties; foreign exchange regulations; the regime applicable to the settlement of disputes between foreign direct investors and the host country and reciprocity requirements.

It is less complex to extract those rules-determinants from FDI systems that are organized in a series of investment laws and regulations and even more so if the rules are integrated in a single comprehensive investment code- than when a country's FDI regime is dispersed over a broad set

of sources. In any event, an increasing number of countries opt for more transparency of their regulatory FDI framework; consequently, the number of national systems with a well-organized and easily accessible FDI regime has been increasing over the years.

For the purposes of this research, the analysis of FDI determinants is limited to the rules governing inbound foreign investment; i.e., to the perspective of a country acting in its quality of host economy as opposed to source or home country of foreign investors. It can, however, briefly be highlighted that a source country's policy and laws in general and those governing outbound FDI in particular, strongly influence the decisions of its nationals whether to invest abroad as well as the volume and the pattern of the investment outflows. FDI towards a specific host economy can, for example, be facilitated (or deterred) by the existence (or absence) of a BIT between both countries. Other examples of outbound FDI determinants are the tax treatment applicable to the income generated abroad, the nature of its foreign exchange control system, the availability of subsidies or other promotional measures for outbound FDI, and, occasionally, a source country's legal system even regulates FDI to some extent extraterritorially.

2.7.1 The FDI Admission Models

The model of FDI admission is varied amount countries from the total exclusion of FDI to the open admission regime. The FDI admission regimes can be mainly categorized into 5 key models as follows; 1) The Investment Control Model, 2) The Positive List Model, 3) The-Regional MNE Model, 4) The Negative List Model, and 5) The Open Admission Model. These models are the result of national policies which have been influenced by several inherited factors among

countries such as history, economic, culture and politics. Those factors are all play apart in creating the country's perceptions toward the regulatory framework for admission of FDI.[93]

1) The Investment Control Model

The Investment Control Model is the strictest form of national FDI controlling measure. This mode of control allows the host country to assert full authority over the admission of FDI. It lies upon the discretion of the host FDI government in opening up the domestic market to the foreign investors. The benefit of this type of model can be demonstrated as follows. First, host FDI countries can exercise its full economic sovereignty over the FDI activities.[94] Second, the model serves as the safeguard of domestic infant industries.[95] Third, the cultural impact from FDI can be lessened by adopting the strict admission model.[96] Lastly, the investment control measure helps the host country to avoid the impact of FDI in sensitive industrial sectors such as natural resources sector and defense industry. Nonetheless, the investment controlling model has some disadvantages that are recognized by scholars. Most importantly, the model sends the negative signal to the foreign investment climate of the country. Moreover, the strict controlling measures may nurture the rent-seeking behaviors and encourage the corruption practices as the investors have to find the way to circumvent the regulations to enter into the host country market.[97]

2) The Positive List Model

The model limits the right of investor in the admission process by permitting the foreign investment in some specific business sectors. Despite those businesses that specifically listed on

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[93] *Id.*
[94] *Id.* at 139.
[95] T. Walde, International Law of Foreign Investment: Towards Regulation by Multilateral Treaties 30 (2000).
[96] Pollan, *supra* note 92 at 140.
[97] *Id.* at 141

the list, other businesses are prohibited for foreign investment. The positive list model has been implemented by the country that needs to gradually liberalize their domestic market. Developing country use this type of model to strengthen their cautious approach in trade negotiation round. The advantages of the positive list model are the preservation of economic sovereignty as the model allows the host country to exercise controlling power over the FDI activities. As the model gives the foreign investment the right to entry in some specific sector, the country, therefore, can liberalize its market sector by sector. This can mitigate the impact of FDI in some sensitive business sectors. The model also enhance the position of the host country in the negotiation round since the country can re-negotiate the degree of restrictions with the FDI home country and the host state can also grant more rights for an easier access to the foreign investors.[98]

However, the shortcoming of the positive list model are quite resemblance to the problems described in the last section. The positive list model gives the discretion power to policy makers and bureaucrats who can influence liberalization process of the country. This leads to a protectionism regime for an inefficient domestic enterprise which can result in the corruption and rent-seeking behaviors. The model also sends a negative signal to the foreign investment climate of the country. And it will influence the flows of FDI to particular business sectors which regulatory barrier is low. This will affect the pattern of foreign investment diversification since the flow of FDI cannot expand to other protected business sectors. FDI will then contract and concentrate in certain particular sector prohibiting the spill-over effects of FDI to a whole economy. The positive list model has been utilized at the multilateral and the regional trade negotiation round for trade in services as in the cast of GATS. Service sector is the most sensitive and well-protected sectors in any countries since it involves many dominant domestic businesses.

[98] *Id.* at 157.

Thus, the positive list model has been applied to guard those businesses. This has given the opportunity for the domestic enterprises to grow and accumulate their wealth through the history. Such example can be seen from the experience of many countries in Southeast-Asia region.[99]

3) The Regional MNEs Model

The model is mainly created based upon the idea of regional integration perspective by facilitating the regional industrialization cooperation. It aims to utilize the concept of comparative advantages among countries in the region. The model allows the establishment of regional MNEs to encourage the interregional business resulting in development of capital, skilled workers and technology. The main beneficial aspects of this model are: corporations can acquire a wide range of production factors that exist inside the region. Moreover, this model facilitates the expansion of the market and also reduces the cost of research and development (R&D) since the cost can be shared among the corporations in the region. Nonetheless, the Regional MNEs Model has some weaknesses as it can limit the FDI flows only inside the region creating the barrier for external FDI flows. The production factors, such as technology and talent, will ultimately concentrate among countries in the region. Lastly, it also prone to political influence since it involves the political will from many governments in the region.[100]

4) The Negative List Model

The model allows foreign investor to access all domestic business sectors except the one indicated in the controlled business lists. The list provides host FDI country to exercise its sovereign rights in some special circumstances in order to protect particular domestic business sectors while allowing the country to attract FDI into their market. The model is considered to be

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[99] *Id.* at 158.
[100] *Id.* at 163-164.

one of the most liberal FDI admission regimes except the standard provided by the open admission model. The main beneficial aspects of the model are: First, the model sends a positive signal to the investment climate of the country as it allows foreign investors to invest in all business sectors except the one regulated by the special business lists. Second, it gives investor a legal security since they are well informed by the host government about rules and regulations concerning their investment project. Third, the model facilitates the entrance of FDI without interrupting their decision-making process by implementing unreasonable FDI controlling measures.[101] Lastly, the negative list model provides certain degree of control for the host government to regulate and nurture the infant industries. This can lead to the development of domestic enterprise.[102]

However, the model presents some disadvantages as it can disguise the protectionism concept through the extensive regulated business list. Generally, the negative list model applies the concept of the open admission regime of FDI to its fundamental principle while allowing some degree of controlling power to the host FDI country. Nonetheless, in some particular cases, the host country intentionally applies this model by directing too many controlled businesses into the lists. This defeats the fundamental purpose of the model as the lists are served as the main barrier to strictly control all FDI activities rather than the necessary means to guard a national interest in some particular circumstances. As Thomas Pollan suggests:

"A negative list that allows for too much discretion will limit the liberalization effort of the negative-list-mode"

A too far reaching negative list will hamper the free flow of FDI which is the disadvantage demonstrated in the positive list regime.

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[101] *Id.* at 176.

[102] UNCTAD, World Investment Report 1999, at xxviii (1999).

5) The Open Admission Model

The model is the most liberal form of FDI admission regime. It gives the foreign investors a national treatment and a right of establishment. The model restricts the government intervention at the minimum level except in the case of public policy and national security reasons. This is an exceptional FDI admission regime in the world arena since most of the host country tends to preserve their economic sovereignty in FDI activities. The most beneficial aspect of the model is the clear positive signal towards the FDI regime. The model also allows the efficient resource allocation resulting in a low level of transaction costs in the market. This enhances the transparency and lowers the corruption rate in business sectors.[103]

2.7.2 Rules Applicable to Entry

1) Entry Procedures

FDI entry procedures can be broadly divided in two categories: notification procedures and approval procedures. The concept of an FDI notification system is used as meaning that the foreign direct investor has the obligation to declare the investment transaction to the administrative authority designated by the national law for those purposes. On the other hand, in an approval and screening system, the foreign investor cannot proceed with his projected FDI transaction before having obtained administrative approval. Apart from the entry procedures, some national laws require foreign direct investors to report periodically to the competent administrative entity on specific data. This can be required for the limited purpose of gathering information and statistical data, or for other purposes.

[103] Pollan, *supra* note 92 at 196.

However, there exist a wide variety of forms and practices for each of those categories, and their results sometimes overlap (e.g., a notification procedure with possibility for the authorities to review, suspend and prohibit retroactively). Moreover, several kinds of entry procedures can exist within the same national system. For example, the obligation to notify the investment can be the general rule applicable in most sectors of the host country's economy, while for specific sectors considered sensitive in the particular country a prior authorization system could be imposed.[104] That country could, moreover, have more than one notification procedure or approval procedure. For example, there are different procedures for the different kinds of FDI transactions or business structures involved, in function of the specific sectors or sub-sectors or in function of the nationality of the foreign direct investors. It can be observed that in countries where mere notification is the general rule and prior approval a rare exception, the latter is generally inspired by national security or public interest concerns.[105]

The extent of rigor and burdensomeness of a prior approval system can vary substantially from one national system to another. While in some systems the governmental approval is given quasi automatically and in a short period, and consequently often a mere formality, in others, the restraint of the approval and screening procedure is effective and sometimes even made unduly cumbersome and complicated. In addition, within the same national system, obtaining governmental approval can be easy in certain sectors or circumstances but particularly burdensome in more sensitive sectors or circumstances. For example, the rigor of the entry procedure will especially vary in function of the amounts invested in Argentina, while it can significantly vary in function of the percentage of foreign ownership in the Philippines.[106] The approval can be

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[104] Sherif Seid, *Global Regulation of Foreign Direct Investment*, Ashgate, Burlington, 36, (2002).
[105] *Id.*
[106] *Id.*

subjected to conditions on objective criteria or on uncertain criteria. Especially in the latter case, approval procedures can be the source of corrupt practices. In certain countries, the relation between the foreign direct investor and the administrative authorities has to be laid down in an investment contract, generally containing conditions tailored to the specific circumstances.

The competent authority for monitoring the notifications or for screening and granting the approvals varies from one country to another. It can for example be a Ministry, the Central Bank, a statistic division of the administration or a specialized entity. While in some countries, there is only one centralized entity; in other systems there exist a network of decentralized authorities spread over the national territory. Additionally, one specific authority can be competent for all investments, or there can be several competent authorities deciding on the specific factors, such as the kind of investment or the amounts involved. Over the last years, more countries have progressively evolved towards a wider application of the notification procedure and consequently a less extensive use of the approval and screening mechanism.[107]

2) Sector-Specific Exclusions of FDI

The present section focuses on that part of national FDI laws that prohibits foreign investment in particular sectors of the host economy or in specific circumstances. The scope of activities open to foreign investment varies substantially across national systems. While in certain countries foreign investors have the freedom to participate in virtually all economic activities, in others there can be an important number of circumstances or sectors (or sub-sectors) in which foreign investment is excluded.

The number and kind of foreign investment prohibitions can thus vary largely across

[107] *Id.*

national systems, and this issue in combination with the underlying rationale for the carve- outs applied in a specific regime, are representative indicators of a country's FDI policy and its extent of openness towards foreign investment. Virtually all legal systems, including those of the countries that are considered as having some of the most liberal and FDI hospitable countries in the world, do exclude foreign ownership in particular sectors or on specific grounds.[108] However, in countries characterized by a high level of hospitability towards FDI, such prohibitions are often limited to a significant extent to sectors or circumstances in which national security concerns, or at least superior national interests, are involved. The latter can include sub-sectors in the energy industry with the objective of ensuring the provision of energy to the local populations at all times.

It is not infrequent that beyond concerns of national security and superior national interests, FDI hospitable countries moreover exclude a few other sectors of their economy, generally because they are considered sensitive. Those sectors are often some of the following: banking and financial services, mail and telecommunications, broadcasting, aviation, maritime shipping, real estate, specific national resources and/or governmental contracting.

Whether excluded for national security reasons, superior national interests or because considered as sensitive sectors, and apart from those already listed above, the sectors most frequently excluded for foreign investment are nuclear energy generation, uranium and toxic industry, military equipment, hydrocarbons, mining, air and sea transport, electric power, agriculture, forestry, health services, insurance, security services, brokerage, customs agencies, publishing, fishing and the uranium industry.[109]

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[108] M. Sornarajah, *The International Law on Foreign Investment,* Cambridge University Press, Cambridge, (2004).
[109] *Id.*

3) Entry Conditions and Performance Requirements

Countries that provide for entry conditions and performance requirements in their laws and regulations mainly pursue this to maximize the benefits that can result from FDI for the host economy. Although performance and commitment requirements relate to the post-entry operation of the investment entity, they are technically spoken entry conditions, and therefore they have been included in the category of rules that conditioning the entry of FDI.

A first group of conditions that can be encountered in an FDI system are the capitalization requirements. Capitalization requirements can be defined as requirements "that a foreign investor making entry should bring in all or a certain percentage of it from overseas."[110] Such requirements find their main rationale in avoiding the raising and using of local capital for investments, which in part serve the interests of foreign investors, while this capital is then unavailable for local projects.

A second group of requirements are those related to the level of employment of locals, i.e., local participation quotas. Provisions requiring that a minimum percentage of nationals be employed can be applied at the level of the whole direct investment entity or at a specific level such as the management or the research department. Such requirements aim not only at increasing local employment but also to ensure the transfer of technology or management skills to nationals of the host economy.[111]

Another kind of condition frequently applied in FDI systems are performance requirements. Performance requirements can be defined as "operating expectations demanded of

[110] *Id.* at 106.

[111] M. Sornarajah, *The International Law on Foreign Investment*, Cambridge University Press, Cambridge, 106, (1999).

foreign owned enterprises."[112] A specific performance requirement of a host country can have a rather general application or be limited to particular sectors. The most frequent forms of performance requirements are export requirements (export quotas requirements), local content requirements and trade balancing requirements.

Export quotas, i.e., the requirement that a percentage of the production of the foreign direct investment entity be destined for export finds its main rationale in the fact that export can provide the exporting host country with important revenues and contribute intensively to its economic growth. Export quotas, as entry and performance requirements are usually not found in the general frameworks of developed countries. Those countries can nevertheless apply export quotas as a condition to benefit from certain incentives, such as a less burdensome tax regime.

2.7.3 Rules Governing FDI and Its Investors

For the purposes of an analytical discussion of the legal treatment of foreign investors and their investments in a host economy, a distinction will be made between the rules defining the treatment of foreign investors in comparison with their local counterparts, the legal protection and guarantees on which they can prevail (which includes the issue of expropriation of foreign direct investment) and finally, the potential incentives of which they can benefit and the applicable tax regime.

1) Treatment of Foreign Investors

National FDI policies and their legal translation can be distinguished based on the treatment the regulatory and legal framework of a country reserves for foreign direct investors in comparison

[112] Sherif Seid, *Global Regulation of Foreign Direct Investment*, Ashgate, Aldershot, 37, (2002).

with their local counterparts. This issue is a substantial determinant when measuring a system's openness and attractiveness to FDI. While some systems generally treat foreign direct investors in the same manner as the local investors (national treatment) others favor the latter over the former (discriminatory treatment). It occurs that in certain occasions or areas a system favors foreign investors over the nationals.

The legal principles of national treatment and most-favored-nation treatment are related though clearly different. In the OECD Draft Multilateral Agreement on Investment of April 24, 1998[113] the principle of national treatment in the context of international investment is defined as the obligation of the host country to accord to foreign investors and to their investments "treatment no less favorable than the treatment it accords in like circumstances to its own investors with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment and sale or other disposition of investments"; the principle of most-favored-nation treatment as the obligation for the host country to accord to foreign investors and to their investments "treatments no less favorable than the treatment it accords in like circumstances to investors of any other [country] and to the investments of investors of any other [country], with respect to the establishment, acquisition, expansion, operation, management, maintenance, use, enjoyment, and sale or other disposition of investments."[114] The definitions of the principles of

[113] This is the last draft used in the context of the last round of negotiations in the light of the adoption of a highly investment-protection and investment-liberalization oriented Multilateral Agreement on Investment, open to both *OECD* and non-*OECD* countries. The negotiations failed so no such Agreement was adopted and no further attempts have been made within the *OECD*-structure (the latest version of the text which was negotiated can be found on: http://www.oecd.org/dataoecd/46/40/1895712.pdf. The attempts to create a multilateral agreement liberalizing and protecting foreign investment is now focused on by several developed countries in the framework of the *WTO*.

[114] Article 3 of the draft of 28 April 1998, of the negotiations text of the *OECD Multilateral Investment Agreement*.

national treatment and most-favored- nation contained in the 2004 United States Model Bilateral Investment Treaty are almost identical in formulation.[115]

A distinction can thus be made between those systems where the favoring of local investors is the rule not the exception, and those countries where national treatment is the general rule applicable to foreign direct investors and their investments. Almost every country, if not all, which reserves national treatment for foreign direct investors, implements nevertheless a certain number of sector-specific FDI restrictions in the sense that local investors result favored over foreign investors.

The derogations to national treatment applicable in legal systems abiding as a general rule to that principle vary substantially from one country to another. There are nevertheless certain exceptions that are relatively common to such systems. Common exceptions to the principle of national treatment are those based on considerations of national security. In developing countries, it is frequent that the general rule of national treatment is derogated to a certain extent based on development objectives.

When a state does not accord national treatment to foreign direct investors and their investments, a question that surges is the treatment to which they are entitled. This varies substantially from one national system to another. However, this is an issue where national frameworks have significantly been impacted by international law in general and particularly by

[115] Article 3 defines the principle of national treatment, article 4 the principle of most-favored-nation treatment. Article 3.3. contains a supplementary formulation in order to highlight explicitly that the same principle that is applicable on the federal state level is to be applied on the regional level: *"The treatment to be accorded by a Party under paragraphs 1 and 2 means, with respect to a regional level of government, treatment no less favorable than the treatment accorded, in like circumstances, by that regional level of government to natural persons resident in and enterprises constituted under the laws of other regional levels of government of the Party of which it forms part, and to their respective investments"*.

international provisions agreed upon by the concerned State. Such provision of fair and equitable treatment is often included in bilateral investment treaties involving a country which system does not apply higher standards. A bilateral investment treaty can of course also accord a higher standard of treatment of foreign investors such as national treatment of the nationals of the contracting country, most-favored-nation treatment, both of the latter, or any other standards.

2) Legal Protection of Foreign Investors and Guarantees

FDI legislation often includes a provision guaranteeing compensation in case of expropriation of the investment property. Such provisions have a 'signaling function' and are especially important in countries with a substantial expropriations history.[116] The World Bank Guidelines on the Treatment of Foreign Direct Investment recommend that States only expropriate in pursuance of a public purpose and without discrimination between nationals and foreign investors.[117] Those guidelines also stress the importance of an adequate, effective and appropriate compensation in case of expropriation, and the guidelines consider the determination of the amount by reference to the fair market value as a reasonable mechanism.

A substantial variety of regimes exist from the perspective of legal protection and guarantees to foreign direct investors and their investments. In each of the OECD countries expropriation is expressly regulated by material laws and only occurs for public purposes without discrimination against foreign investors, and results in an adequate compensation which can be appealed before an impartial judicial system. In other jurisdictions the rules are not very transparent. However, considering the importance of foreign investment, most countries, even

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[116] M. Sornarajah, *The International Law on Foreign Investment*, Cambridge University Press, Cambridge, 95, (1999).
[117] Article 4 of the WB Guidelines on the Treatment of Foreign Direct Investment.

those without a transparent legal system or that didn't conclude a BIT containing a 'fair and adequate compensation' provision, rarely proceed with expropriations without adequate compensation.

2.7.4 Rules Governing the Repatriation of FDI

It is clear that a foreign investor desirous to invest in a particular host economy will be especially concerned with the regime applicable to the transfer of funds. It would generally make little economic sense to invest abroad if the profits could not be repatriated. The issue of the repatriation of the invested capital is inherently similar to the repatriation of profits. More in general, the free transfer of all funds related to foreign investments, including the payment of royalties, interests, license fees, management fees, the repayment of the principal of loans, and other payments related to the investment, is an essential issue.[118]

The restrictions to free transfer of funds can be of various kinds and of different degrees of burdensomeness. The domestic law can provide for the free transferability of funds without prior authorization as a general rule. Other systems apply an authorization system, which can be combined with the requirement of documented evidence to support how the funds were gained. Ceilings can be applied on the transfer of funds in general or on the transfer of certain funds or in certain circumstances.[119] Though, there have been trends towards further liberalization.

2.8 FDI and Digital Economy Era

The Digital Transformation has begun to create new challenges and opportunities for FDI regime around the world. The MNEs has adopted new digital technologies to their business

[118] M. Sornarajah, *The International Law on Foreign Investment*, Cambridge University Press, Cambridge, 95 (1999).
[119] *Id.*

operations, and this creates an implication to international investment policy of host FDI countries. The study by OECD in 2018 has noticed the changes in Global FDI landscape and it raised the criticism of the implication of digital transformation for international investment policy.[120]

First, as MNEs utilizes digital technology in the operation regardless of a kind of business sectors they are operating in, the widespread adoption of artificial intelligence (AI) and the collection of big data could result in the reconceptualization of the issues such national security and public interest consideration of the government authority in the host FDI country. Second, as digitalization becomes a key element underpinning the way MNEs organize their international operations, this gives rise to national security concerns over foreign ownership, and various related issues such as the rules on the collection, storage, and use of digital data under the data protection regulations. This could affect the amendment of existing laws as well as the adoption of new laws regarding the FDI screening measures. Third, the adoption of digital technologies across different business sectors could result in a diffusion of the technologies and productivity for the development of economy. Just as MNEs have long served as an internalized cross-border transmission channels for goods and services financial flows, and intellectual property with their international production networks, they could serve as a vehicles to transmit digital technologies globally that strengthen the standard of digital infrastructure of countries.[121]

Furthermore, the study has shown the statistic during 2008 to 2017 that suggests the upward trend of digital transformation of MNEs across business sectors, surprisingly in traditional sectors such as agribusiness, real estate/property, construction, healthcare, professional series and retail.

[120] Michael V. Gestrin and Julia Staudt, The digital economy, multinational enterprises and international investment policy, OECD, Paris (2018), www.oecd.org/investment/the-digital-economy-mnesand-international-investment-policy.htm
[121] *Id.*, at 7.

A large share of these international investment is going into digital infrastructures. For example, cross boarder investment to acquire digital data storage assets reached USD 13.8 billion in 2016, the highest level of record.[122] Cross-border investment to acquire intangible assets (i.e. knowledge-seeking FDI) have also been and important driver of the growth in cross-border digital investment. For instance, cross-border acquisitions to acquire software developers increased fifteen-fold since 2009 to reach USD 102 billion in 2017.[123] This emerging projection of digital transformation in global FDI regime has recently accelerated by the COVID-19 pandemic and it cause the national governments to reconsidering their international investment policy as well as the exiting law concerning the FDI controlling regulatory measure.[124]

The COVID-19 Crisis has caused a dramatic fall of global FDI by 40% in 2020 comparing to the statistic in 2019 value of USD 1.54 trillion.[125] A recent study by World Economic Forum in 2020 suggested that the adoption of digital transformation by MNEs has substantially increased.[126] Digitalization is creating new economic activities while also expanding the scale, scope and efficiency of exiting economic activities. This will thus underpin the future growth and it is the key to COVID-19 economic recovery.[127] However, the national government need to reshape their FDI policy and regulatory framework to attract more Digital MNEs.[128]

Nonetheless, attracting FDI in the digital economy may require specific policies,

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[122] *Id*., at 10.
[123] *Id*., at 11.
[124] World Investment Report 2020, *International Production Beyond the Pandemic*, xii.
[125] *Id*., at x.
[126] Matthew Stephenson, "Digital FDI: Policies, Regulations and Measures to Attract FDI in the Digital Economy." World Economic Forum White Paper, September 2020.
[127] McKinsey Digital, 14 May 2020, "The COVID-19 recovery will be digital: A plan for the first 90 days", https://www.mckinsey. com/business-functions/mckinsey-digital/our-insights/the-covid-19-recovery-will-be-digital-a-plan-for-the-first-90-days; World Bank Group, 2016, World Development Report 2016: Digital Dividends. World Bank Publications, https://www.worldbank.org/en/publication/wdr2016
[128] In this study, the term "Digital MNEs" is intended to include all firms that invest in the digital and technology sectors.

regulations and measures because digital firms have business models that vary from traditional MNEs. Digital companies rely heavily on data and know-how, often involve platform economies and leverage non-traditional assets.[129] At the same time, some of the fastest growing and most highly valued firms in the world are in the technology sectors, creating hug opportunities for investment that is win-win between firms and recipient economies.[130] However, there is some specific requirements that the host FDI country should consider to create a favorable FDI regulatory framework for the Digital MNEs. To understand the factors that dedicate to a favorable climate for FDI, the study carried out a survey of 310 investment decision-makers in technology and digital firms around the world. The main finding of the study concerning the regulatory elements of host FDI country is that to create a digital-friendly investment climate, the government may require to implement specific policies, regulations, and measures with regard to FDI. One of the key factor in regulatory framework to attract digital FDI is the ease of receiving licenses for digital business and infrastructure. This element particularly relate to the screening process under the FDI controlling measure of the country. Thus, an effective regulatory measure concerning the FDI screening process is needed in creating a positive signal for host FDI country.[131]

In conclusion, the theoretical study in this chapter suggests that FDI has a positive impact to the development of host FDI countries. However, those mentioned results have not come automatically. The host FDI countries need to be successful in implementing the effective legal institution that control and stimulate the positive activities of FDI in the country. The legal institution is a crucial element in the process of maximizing the most benefit of FDI. The recent

[129] Stephenson, "Digital FDI: Policies, Regulations and Measures to Attract FDI in the Digital Economy.", *supra* note 126, at 6.
[130] PwC, "Global Top 100 companies by market capitalisation", May 2020, https://www.pwc.com/gx/en/audit-services/ publications/assets/global-top-100-companies-2020.pdf.
[131] Stephenson, "Digital FDI: Policies, Regulations and Measures to Attract FDI in the Digital Economy.", *supra* note 126, at 15.

study of FDI in digital transformation era has suggested the need to strengthen the FDI controlling regulation to attract Digital MNEs. Yet, the set of institution is still subjected to the historical development of internal market as well as norms and ideologies of the player, or those entrepreneurs in particular economy. History and inherit norms do matter in determining the result of the effective implementation of the legal institution, as North suggests. Thus, next chapter will address the development of Thailand's domestic market as well as its player in the market. The family-owned businesses and their business conducts will be focused as they are the prominent player in Thai market.