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Abstract

This paper is part survey, part essay. The survey consists of a partial review of the literature on the subject of foreign direct investment in developing countries, with particular emphasis on conflict and its resolution through negotiation. After a brief discussion of the objective functions guiding the strategies of both main actors, the paper turns to a review of the substantive and institutional context surrounding the negotiation process between multinational firms and host countries. Next follow some general principles common to most negotiations, drawn from the experience obtained in other fields, and a discussion of the relevant literature on international business negotiations. The essay emerges as the paper integrates the various threads of analysis into a series of normative conclusions which, while not pretending to be impartial, are offered as challenges for further study.

The relationship between foreign private investors and developing host countries has undergone significant change, both qualitatively and quantitatively, during the past decade. Above all, there has been a dramatic increase in the number of corporate players entering the game. Not only have European and Japanese firms rapidly made up for lost time vis-a-vis the traditional dominance of US investors, but many small and medium size firms of all nationalities have been extending their range of activities to include international operations. New investors from the relatively more advanced among the developing countries have also joined the trend towards greater internationalization of production by establishing manufacturing affiliates in neighboring countries as have large numbers of state-owned enterprises previously restricted to the domestic scene. Concurrently, real private investment flows to developing countries, which grew at about 4% per annum during the 1960s, accelerated to over 10% a year in the 1970s. 1/

Developing countries have benefited from both the larger investment flow and the broader choice of potential investors. Many of them have come to enjoy the luxury of selectivity and used it to improve the terms on which foreign corporations are allowed to operate within their borders. This is not to say that all countries have benefited equally from these trends, nor that they have all succeeded in imposing desirable (in their view) conditions on foreign investors. For many host countries, balance of payments pressures, technological or human capital deficiencies and the need for market access are still powerful constraints on development which only multinational investors can offer to solve.

One concequence of these various trends has been a dramatic proliferation of "new investment" forms and conditions in recent years. 2/ The traditional bundle of production factors contained in a wholly-owned subsidiary of a foreign multinational -- mainly capital, technology, management skills and market access -- can now be obtained more readily from separate suppliers. In evaluating the relative merit of alternative investment proposals, host country officials often find themselves choosing between bundled and unbundled packages with different implications of control and performance for each alternative.

Whatever the definitional and measurement problems, and there are many, it appears evident that there has been a relative shift in bargaining power in the last five to ten years in favor of the host countries. Whether this was caused by a decrease in the monopoly power of large multinational firms, by an increase in the host countries' attractiveness as investment locations, or by any other factor related to the investment process, is immaterial for our purposes. Our concern is with the entry decision and not with the subsequent erosion of bargaining strength that may result from a maturing technology or from changes in the value to the host country of the foreign investor's contributions (except to the extent that these effects can be predicted and, therefore, discounted at entry). Clearly, historical experience and the dynamics of the foreign investment process itself (the concept of an obsolescing bargain) are critical determinants of the context within which entry negotiations will take place and of the future fate of the investment. Precisely as a result of this evolution, entry terms are now typically subjected to lengthy and complex negotiations by host countries; and where alternative choices abound, costs and benefits are carefully if approximately weighed.

This paper intends to serve both as a review and as a essay on the process by which foreign direct investors gain access to developing country markets or resources. The first section below briefly summarizes the principal characteristics of the objective functions which shape the negotiating strategy of both companies and countries. Section II explores the problems involved in carrying out any reasonable cost/benefit analysis on foreign direct investment (FDI) given the objective framework governing each partner's actions. The issues of conflict and congruence, so dependent on the measure and distribution of potential gains, need to be analyzed from both perspectives. Next follows a brief description of the institutional context in which FDI negotiations usually take place and its evolution over the last decade. Section IV tackles directly the issue of negotiation by looking at some general principles of negotiation and tactics, the experience obtained in other fields and the scant literature on host country-foreign investor negotiations. In the end, a more personal view emerges which integrates the previous analysis into a series of normative conclusions. While not making any claims of impartiality for these propositions, they are advanced as a useful agenda for future research in this field.

I

FOREIGN DIRECT INVESTMENT AND NATIONAL OBJECTIVES

In order to study the process of negotiation between two classes of adversaries, one must first understand their respective strategic objectives in relation to any possible outcome. This is not the place to review either the empirical evidence on FDI nor the major theoretical explanations for FDI and its global distribution. It is essential, however, that we deal with the questions of motivation, risk propensity and organizational commitment which shape the objective function of the potential foreign investor as it enters the negotiation process. It is equally important that we understand the underlying development priorities which both encourage and limit the role foreign investment can play in the development process.

Corporate Strategy and Foreign Investment

The literature on FDI and multinational companies has reached staggering proportions.[3/] A large share of this outpouring has been devoted to the task of finding a coherent explanation for international investment which is more or less consistent with neoclassical economic theory or with other branches of economics such as industrial organization. In reality, foreign direct investment decisions are influenced by a multitude of interrelated factors; the "ecletic" theory of FDI recently advanced by Dunning (1980). These range from the internal dynamics of the firm -- its profit or growth maximization, risk reduction or diversification objectives, to organizational or human (personal interest) causes; from purely environmental circumstances such as public policy requirements, to the competitive effects of cost differentials, market failure or oligopolistic reaction.[4/] Sectoral and firm characteristics play a major role in terms of the prevalent factors influencing investment decisions. Clearly, firms in extractive industries will have different motivations than those in service or manufacturing sectors. Equally, among the latter, import-substitution investments will respond to different criteria than investments oriented towards export markets (see Table 1).

Regardless of the model employed, any foreign investment decision is likely to depend on the total contribution the proposal can be shown to make to the corporation's well being, and would include both direct returns on the investment and synergistic contributions to other members of the global system. In either case, the decision will be influenced by competitive conditions and potential oligopolistic reaction, which vary from sector to sector, and by an assessment of political risks that, as Kobrin (1979) has suggested, may serve to discard certain countries from consideration. There are also choices to be made about organizational structure, degrees of ownership and control, financial policies and transfer prices, conditions on the sale and transfer of technology, etc., which are at the heart of the issues that concern both parties. These policies have been found to vary widely from one sector to the next, and between companies in the same sector, according to certain predictable patterns. Furthermore, as conditions change which give rise to changes in the company's global strategy, they are likely to be accompanied by modifications of policies along these same patterns.[5/]

Two issues are of particular importance here. The first deals with the concept of "market attractiveness," a compendium of all the reasons why a particular investment location should be important to a given firm, and the firm's desire for control. The main hypothesis here, indirectly supported by many of the studies cited above, is that the more attractive the market, the more willing the company is to undertake a high level of risk and commit the necessary resources for success. It follows that the higher the importance of a particular investment proposal to the company's global strategy, the greater its need for management integration and, therefore, control.[6/]

The second relationship deals with the impact of the "investment climate," defined as the sum of those factors which affect risk other than in a normal commercial sense, on the investment decision. Goodnow and Hansz (1972) tested the relationship between degree of control and a proxy measure of both market attrativeness and investment climate. Countries were labeled "hot" or "cold" on the basis of their volume of FDI inflow. High levels of control (i.e., ownership) were found to be associated with "hot" countries and vice versa. While very aggregated, the results appear to indicate a preference on the part of firms to make a greater commitment (financial, marketing and human resources) to the countries which have the greatest interest for them; and to hedge their bets (through minority positions or non-equity arrangements) elsewhere.

The upper left-hand corner in Figure 1 represents those desirable situations where the firm is interested in maximizing its financial and market commitments, and is encouraged to do so by a favorable investment climate. Under these circumstances, it will choose, whenever possible, to do so on a wholly-owned basis. As the investment climate deteriorates, the prospective investor will wish to reduce financial commitments while attempting still to maximize its market performance. In contrast, an excellent investment climate is no substitute for market potential, and thus a limited-commitment vehicle may be preferred for market entry. Where poor market prospects co-exist with a bad investment climate, the firm will tend to refuse any commitments and deal at arms length, if at all. How these trade-offs are made and what measures are used to arrive at them, are critical factors to understanding the investment process.

Development Priorities and Foreign Investment

Economic development is above all a political process; one characterized by an almost infinite range of approaches, subject to a myriad of pitfalls and reverses, and laced with high ideological content. In the making of economic policy, developing country governments are constantly faced with basic choices of strategy that must be kept in harmony with political ideas:[7/] should development be an open, internationally oriented process, or one instead closed to external factors and based on the exploitation of internal resources and the satisfaction of internal needs?; should it be rural and agriculturally-based, or urban and industrially-based?; should economic growth be kept in pace with the development of social and political institutions or not, at the risk of periodic convulsions in the fabric of society?; should the benefits be equally distributed to all, or should certain disparities in income distribution be allowed in exchange for factor growth?; what is the acceptable time span in which development can take place?; to what extent must indigenous culture and traditions be preserved? The economic literature of the last two decades has added volumes to the analysis of the relative merits of different development policies. Yet, the fundamental choice of development strategy governing these policy decisions remains squarely a political process subject to the usual interest group pressures, accommodations and compromises, but deeply rooted in historical experience and social reality. From it will emerge the basic decision as to whether cooperation with foreign firms is at all acceptable to the Nation. If the answer is positive, the limits of that cooperation can then be subject to delineation and control, and hence the negotiation process.

The contribution of FDI to national objectives must be judged within the context of the overall development strategy of the host nation -- the non-negotiable constraints imposed on FDI by the political system -- and not in isolation. Consider the debate that raged among development economists and politicians over the relative merits of an inward, import-substituting development strategy versus an externally-oriented stragtegy.[8/] One cannot, as some dependency analysts have implied, attribute the blame for many of the ills of inward development policies to the firms that carried them out.[9/] In most instances, domestic firms were performing the same tasks, with similar subsidies and with equally devastating effects on economic efficiency and income distribution. The fact that foreign-owned firms were involved only made matters worse, but the basic fault lies in the policies themselves and the behaviour they encouraged.

Governments are not monolithic entities, and national policies represent hard fought compromises among competing interest groups. Whether the system of government is more or less democratic, there will be many interpretations of the political will of the country that will yield different conclusions as to the acceptable means for their attainment. And these views can be motivated by nothing more than self-interest.[10/] Thus, one finds that Government is often required to spend more time in sorting out internal conflict and in establishing a common negotiating position than in facing its adversary. The case of Mexico, for example, demonstrates how different governmental agencies held conflicting views over time on development strategies, and how this resulted in variable policies toward FDI, while ideology (and, at least, the public expressions of the political will) remained outwardly constant. The imperative of a growth strategy clashed with the relative priorities of different agencies and different regimes in power with probably debilitating effects on Mexico's bargaining strength, in spite of its high power of attraction.[11/]

An obvious but critical conclusion is that the outcome of any negotiations will depend not only on the relative strength of both parties and on how important each is to the other's strategy, but also on how internal conflicts are resolved in arriving at such a strategy. This is a problem of considerably greater complexity for nations, with their multitude of conflicting interests, than for relatively single-purpose multinational firms. Yet, long-term vs. short-term goals, social and economic objectives, tangible vs. intangible criteria, etc., will have to be weighed in arriving at some approximate trade-offs. Without such an effort, evaluating alternative investment proposals becomes an impossible task.

II

EVALUATING FDI AND THE CHOICE OF CONTROLS

Foreign investment is not a zero-sum game. As long as an investment by a foreign firm yields higher retunrs than the first best alternative to employ similar resources, real benefits will occur. Since both parties may be using different yardsticks to measure their respective returns from the investment, and since alternative yields may be lower in any case, positive gains are often possible. How they will be distributed is, of course, the main issue for negotiation.

In evaluating the possible gains and losses from the investment, Dunning (1974) suggested three criteria: efficiency, equity and sovereignty. Efficiency has to do with the investment's real contribution to GNP, less the income earned on foreign-owned domestic assets. Here the argument for world-wide allocative efficiency is rejected to the extent that any benefits accrue to third parties and are, therefore, beyond the country's or the company's grasp. Equality, on the other hand, relates to the distribution of the gains, both between countries and within the country.[12/] Lastly, sovereignty is a measure of the country's ability to run its own affairs and set its own priorities without outside interference. Economic nationalism and independence are goals in themselves which give rise to national utility, perhaps not as readily measured but equally important to more quantifiable economic objectives.

Measuring the Costs and Benefits of FDI

This is not the place to enter into a discussion of the relative contributions or failings of FDI; the literature on the subject is vast and relatively inconclusive, even contradictory.[13/] Most of the relevant impacts, however, can be encouraged or discouraged by direct governmental policy. The question than becomes one of assessing the relevant costs and benefits of the particular investment within a given policy framework. Various methods have been developed for carrying out social cost-benefit (C-B) analysis, mainly in relation to public development projects.[14/] These methodologies can be adapted to evaluate foreign investment along a number of social dimensions, although a number of caveats are important:

1. No foreign investment proposal should be evaluated in isolation. Its contributions must be measured against a range of feasible alternatives involving different levels of resource commitment. These might include: continue to import the product; do without it; replace the FDI by an equivalent domestic investment; a licensing or management services agreement; or enter into a joint venture with the FDI supplier.
2. There are serious conceptual problems with a universal acceptance of the very definition of welfare which underlies the C-B methods. For example, the fact that relative world market prices (the correct "social" value of a product in the C-B analysis) do not necessarily reflect relative needs in developing countries is a major handicap.
3. There are also many practical problems in the application of C-B tools. The use of an appropriate discount rate to equate long-term costs and benefits to more recent contributions, the lack of appropriate data to correctly calculate many border prices, and the scarcity of technical personnel to carry out the analysis are only three examples.
4. The C-B method ignores many externalities to the FDI that, particularly in the case of non-marginal investments, could be critically important to the development process. Contributions such as linkages and learning effects, dynamic competitive effects, spill-over of trained personnel, etc., are ignored in the analysis, as are hidden costs such as reduction

of domestic enterpreneurial activity or detrimental changes to the industry's structure.

In spite of these shortcomings, cost-benefit analysis constitutes an important starting point to the process of FDI evaluation and negotiation. Wells (1975) and Penrose (1978) have suggested that the firms themselves should be encouraged to carry out a social cost-benefit analysis in order to understand better where national priorities lie and how their prospective investments fit these priorities. By exposing those elements that represent the highest potential social cost, government negotiators (and the investor) can act to minimize the project's most harmful characteristics without having to forego the investment altogether.

National Controls on FDI: The Issues

In this sense, it would be preferable to carry out the cost-benefit analysis under different assumptions of governmental control. But first it is essential to distinquish between three related but separate issues: the severity of any conditions, regulations or performance requirements that apply to foreign investors either on entry or during their tensure in the country (and henceforth called the "level of restrictions" for simplicity); the degree of discretion with which such restrictions are imposed in specific cases, that is, the flexibility inherent in the control system; and the stability or continuity which characterizes whatever system is adopted and put into effect. In the extreme, one can envisage a totally flexible system where the conditions applying to each investment are exactly tailored to the circumstances and charateristics particular to the proposal. If, for example, the investment's technological contribution was found to be of significant value and long expected life, royalty fees could be set to reflect this.

Alternatively, if the investment were to make intensive use of scarce domestic resources which have high opportunity costs when compared with their financial cost (e.g., local scientists and engineers), the firm could be required to undertake personnel training programs of a magnitude that would compensate for the hidden social subsidy to its operations.

Instead, however, the scope for discretion can be progressively limited and certain entry requirements imposed universally. Sectors involving national security or high national priority can be closed to foreign investors. Tax legislation can be harmonized and limits imposed on the discretionary range of fiscal incentives. Capital and dividend repatriation limitations can be fixed. Ceilings can be established for interest, parent-company over-heads, technology and management fees and other similar payments to parent companies. Ownership limitations can be legislated for an extended list of sectors, or for the economy as a whole. Fade-out requirements can be imposed and export quotas made mandatory. And so forth. Regardless of the severity of the measures, the country can end with a strict set of entry and performance guidelines which apply to all but the most unusual FDI cases. There are certain advantages to such a system: the scope for corruption is minimized since no arbitrary decisions are possible; the required governmental machinery for monitoring existing investments and evaluating new proposals can be kept to a minimum; and the investment climate, to the extent that it is represented by the "rules of the game" as described above, is a model of certainty and stability (barring radical government changes). But, there are costs as well to such a rigid system.

The extent to which the severity of entry requirements and performance controls on FDI affects the investors' economic and social performance is the most critical and misunderstood aspect of the analysis. Most writers agree that as certain restrictions are imposed on the foreign firm's freedom of action, the "net benefit" to the country increases in some complex, non-linear fashion. Clearly, for example, regulations controlling transfer payment manipulations will avoid that some of the economic gains the country derives from the investment be offset by lower tax revenues and increased returns to foreign-owned assets. Equally, performance requirements on net balance of payments effects may increase the net positive contribution to the host country. Yet, it appears that restrictions on FDI can also go "too far"; that by reducing the returns to the firm below some minimum desirable level, excessive controls may diminish corporate performance along socially desirable dimensions. One area where direct evidence exists of this pheomenon concerns local ownership requirements. It appears that zealous insistence on majority domestic capital, ceterus paribus, can result in reduced corporate commitment to capital expansion, to further investments in technology and to export markets. 15/

Therefore, one can hypothesize ex-ante a relationship such as that shown in Figure 2. For a particular developing country, at a specific point in time, the socio-economic analysis of a given foreign investment proposal may yield various levels of net benefit to the host nation. At some a priori level of restriction (for example, the "expected" level based on recent policies) the net benefit might be found at point A. 16/ If the level of restrictions were to be relaxed, say to point X, the result may be to encourage certain corporate practices that might reduce the size of the net contributions, perhaps below some "minimum acceptable level" (zero at the appropriate discount rate in the cost-benefit analysis). On the other hand, a tightening of the screws beyond the "expected level" of restrictions to point Y may have the effect of closing a number of loopholes and raising the net benefits to C. A further jump to level Z may in fact be so traumatic to the firm that it may choose to limit its commitment and/or exposure in the country along the lines described earlier. The parent company, for example, faced with this increasingly hostile environment, may act to reduce technology transfer, limit the affiliate's access to other corporate markets, accelerate capital repatriation etc., so that the net benefit to the host nation drops to D. Any further tightening of the level of restrictions may in fact drive the firm out of the country (or make it decide not to undertake the investment).17/

Assume, however, a competing firm (same industry, same general characteristics) to which the country in question represents a rather unique opportunity to advance its global competitive strategy. It may be a firm in an ologopolistic industry anxious to match a competitor's move elsewhere, or to preempt the other's entry to this potentially lucrative market. Whatever the cause, the "market attractiveness" measure (see figure 1) will be higher for the "eager" firm than for its competitors, signifying a willingness to make a large early commitment of resources (and, therefore, a relatively high net benefit) at low levels of restriction (B') which continues only slightly diminished as the level of restriction rises (A', C', D').

The point of the comparison is that a single, inflexible policy that imposes uniform restrictions on all comers has, in this case, failed to capture the maximum potential benefits from either one of the prospective investors. Only by actually examining net benefit results at various points in the restriction spectrum could an optimal economic policy be enacted for this industry. While this is clearly an oversimplified case and the complexities of the calculations are significant, such an analytical approach would allow the host country to maximize its share of the joint sum to the extent possible in each case. The analysis would indicate the sensitive areas of positive or negative contribution, and flexible arrangements could then be put in place to encourage socially beneficial behaviour or vice versa. The practical problems are indeed staggering, but if the nation understands its own development priorities and has a good grasp of the determinants of corporate strategy for each firm, it should be able to construct the relevant parameters for the net benefit analysis without undue difficulty. The rest is a matter of adequate training and experience in the analytical process and in bargaining. [18/]

III

THE INSTITUTIONAL CONTEXT

A number of detailed studies have emerged in the last five years evaluating different national systems designed to control the entry and performance of foreign investment. The most extensive, covering fifteen countries and the Andean Common Market (ANCOM) was performed by R. Robinson (1976). He concluded that, "Above all else...national sovereignty is not at bay." Major similiarities and differences were observed in the approach of the thirteen developing countries in the sample to the problems noted above. A few trends predominated:

- a "universal pressure to force the spin-off of foreign ownership into domestic hands;"
- "movement in the direction of forcing the divestiture by foreign firms of certain functions" as an alternative to, or concurrent with, forced nationalization;
- the appearance of "the notion of a public trust institution" that would act as a way station until domestic capital sources could absorb the equity of foreign firms; and

- a willingness "to create a climate that both protects national interests and reduces risks...to foreign investors and suppliers" by stabilizing the rules of the game.

There were also wide differences in approach, and in terms of the administrative charateristics and effectiveness of the various entry control systems. These differences could be attributed in part to the relative priorities accorded national political and economic objectives, to differences in the level of economic development of the respective countries, to the availability of data and/or trained personnel, and to ideology.

Robinson noted that most systems seemed to be oriented more towards channeling investment to desired areas than to either maximizing or minimizing the flow of FDI in general. 19/ This raises an interesting question as to the dual purpose of most evaluation systems. First, they are meant to screen out undesirable investments, that is, proposals that do not appear to make a significant contribution to the nation's expressed objectives. In terms of Figure 2 above, these would include all proposals that fail to show a net benefit impact above the cut-off point, over a relevant range of restrictions. However, most of the analyses concerned only one set of assumptions: those derived from existing guidelines for FDI and available cost-benefit methods. The Colombian system described in detail by Lombard (1978) is essentially one geared to perform just such a one point estimate. The evaluation may be more or less complex, involve multiple criteria, and be based on relatively objective analysis; but the decision is binary: Accept or Reject.

The second and probably most important purpose of any control system is to manipulate the policy variables available to the government in order to maximize the real returns to the nation of any given investment. It is in this sense that the conflict between fixed and flexible rules becomes critical. Robinson stated (p. 328) that "the national controllers in at least thirteen countries were quite certain that they could induce alien business firms to respond adequately to national interests. Not one voiced serious doubts." Although there is little evidence in his study as to how this persuasion was realized, all countries tended to view the system flexibly and to vary the terms of the entry contract, "the contents of which were subject to negotiations within certain legislated guidelines... Negotiations was the rule, not the application of a set of implacable rules."

We argued above that the degree of commitment that a firm was willing to make to a country was a function of both the country's market attractiveness and some vague notion of the perceived political risk associated with it. It has been suggested by many corporate spokesmen and most researchers that almost anything is acceptable to the firm as long as it is known and constant. Multinational firms are lining up to invest in Eastern Europe and China where conditions are severe but where stability has been more or less assured. Robinson (p. 330) also raises this issue and compares the apparent willingness of firms to enter the market in Burma, under very restrictive conditions, while avoiding any commitments to Peru, a richer and less restrictive market where the investment climate was considered more uncertain.

An Optimal Level of Restrictions

In their landmark study, Lall and Streeten (1977 , p. 209-210) tackled the question of the supply of FDI as a function of the expected rate of return, arguing that it should not be viewed as a continuous, downward-sloping marginal productivity of investment curve. Instead, a step function, bracketed by the "advantages" owned by the firm and the "cost" to the host country of seeking alternative arrangements (or of doing without the investment), would be a better representation of the real range for negotiation. This line of reasoning could be modified to look at the aggregate supply of FDI under different levels of restrictions. Assuming a constant political risk assessment (i.e., political stability and the other elements discussed earlier) and a certain market attraction represented by the market's size, its level of development and growth rate, etc., a similar step function relationship can be hypothesized (see Figure 3).

A general expectation among investors for some minimum level of entry and performance regulations in any country would account for the steady response of FDI to rising restrictions up to a point (P). Beyond P, potential investors begin to assess alternative investment opportunities more favourably (expected returns are lower due to the greater share of total rents appropriated by the host country, or because of the higher uncertainty associated with their realization) and refuse further consideration. Some investors, of course, will be willing to go ahead irrespective of the level of restrictions, as the cases of Eastern Europe and Burma cited earlier corroborate, either because they lack better alternatives, they assign a lower discount factor to future returns, or they structure the investment in such a way as to capture the necessary gains.

Suppose now that one could sum the net discounted socio-economic contributions of all prospective investors (as measured in Figure 2), over the entire range of entry restrictions, taking into account the supply considerations discussed above. If such an exercise were possible, which of course it is not, a hypothetical <u>economic</u> optimum level of control could be found for the nation where the total net benefit from all FDI would be maximized given a specific set of social cost-benefit weights and a definitive development objective function, as long as these two remain unchanged. Such a relationship can be represented by the solid curve in Figure 4, where OA stands for the maximum gains possible. As the level of restrictions exceeds this economic optimum, incremental gains from some investments are more than offset by losses in others and by the general decrease of FDI activity.

Let us extend the argument further and assume that the level of restrictions imposed on foreign investors represents more than just an attempt by the host country to capture a greater share of the gains; that, in fact, there is considerable national support for any policy that assures the country control over its economic destiny by, in part, restraining foreign investment within severe limits. We could than add to Figure 4 a broadly gauged set of political indifference curves (dotted lines) which would represent combinations of net economic benefits and feelings of political independence (as derived from the level of restrictions imposed on FDI) that would result in comparable levels of utility to the nation.[20/] The point of tangency of the two relationships would represent a <u>political</u> optimum set of restrictions where total utility, in economic and political terms, would be maximized. The difference between OA and OB is equivalent to the economic sacrifice that the local citizens are willing to endure in order to retain a significance measure of independence.[21/]

This framework, while highly impractical as an administrative tool, represents the real constraints within which any national system of FDI entry controls must operate. No single point set of restrictions, whether it represents the economic or political optimum, could be expected to maximize net benefits for each investment proposal. By setting policy according to aggregate criteria, significant sub-optimization will occur on individual investments. A certain amount of flexibility, on the other hand, will permit the nation to capture the maximum benefits possible from competing investment projects. Yet, the deciding authority must not stray too far from the limits imposed by the aggregate political reality without incurring grave risks. Thus, the usual practice is to mix legislated conditions, which are kept as close as possible to some politically acceptable level of restriction, with a certain latitude of negotiation where particular incentives or requirements can be adapted to fit the circumstances.

<u>Implementing the System</u>

The range of approaches and trade-offs between legislated and negotiated terms is large. The analysis carried out by Robinson shows a large variation among the thirteen countries he studied. So does the work of Draper (1974) and Allen (1979) on the systems developed by the ASEAN member countries. But none of these studies examines the process by which these trade-offs are made. One can see how many projects were approved and how many rejected. But, what about the modifications made to projects between proposal and implementation? What trade-offs were made, by whom, and supported by what analysis?

As all proponents of entry control systems have observed, the operational problems are significant. Lombard (1978) notes, for example, that in spite of fairly clear objective criteria, the Colombian "screeners" who actually performed the analysis showed large varitions in their subjective interpretation of the weights which were appropriate to different components of the analysis. Also, "standard" procedures were circumvented in more than 25% of the cases. Part of these problems can be attributed to lack of information or data critical to the analysis; part to normal bureaucratic inefficiencies due to the large number of agencies (four) involved in different decisions.

The human factor has been recognized as a critical bottleneck in the process. Lombard's analysis suggests that education alone is not the problem (all screeners has a Masters degree or higher), but that high rotation might be. An argument can be made for a separate agency, staffed by specialists in various fields (engineers, economists, financial analysis) which will remain long enough at their jobs to gain critically valuable experience. Given the noted difficulties in obtaining reliable data, and the variability inherent in the cost-benefit analyses, the experience factor will play a fundamental role in the efficiency of the system.

The reaction to these difficulties has been, according to the Robinson evidence, to overreact in terms of the fixed portion of the restriction package with serious consequences, one might pressume, for the size of the total benefits captured by the host country. For example, the trend to limit ownership together with restrictions on dividend remittances, fees and royalties and interest rates, have raised considerably the temptation for the firm to transfer profits via the pricing of goods. Robinson (p. 323) argues, "one of the weakest parts of any entry control system is the demonstrable inability of a government to police transfer prices".[22/] Faced with such problems, developing countries must struggle to find a balance in terms of what to legislate, how rigidly to do so, and how much leeway to offer their representatives in negotiations with potential foreign investors. The answers are obviously complex, and countries such as Mexico will continue to legislate maximum levels of foreign ownership (49%), and waive then whenever they find it to be in the "national interest."

IV

THE NEGOTIATION PROCESS

Negotiation has been variously defined as "a use of common sense under pressure to achieve the objectives of one organization interacting with another organization" (Kapoor and Fayerweather, 1976, p. 30); "a process in which explicit proposals are put forward ostensibly for the purpose of reaching an agreement on an exchange or on the realization of a common interest where conflicting interests are present" (Iklé , 1964, p.); and " a process whereby two or more parties attempt to settle what each shall give and take, or perform and receive in a transaction between them" (Rubin and Brown, 1975, p.2). To this concept of an exchange, Strauss (1978) adds that negotiation processes are entwined with other behavioral processes involving manipulation and coercion. The more specific case of negotiations between an international corporation and an LDC government can be seen in the context of what Schelling (1960, p. 5) calls a "mixed-motive game": a certain ambivalence of one player's relation to the other player, a mixture of mutual dependence and conflict, of partnership and competition. Most international conflicts are in his view variable-sum games where the total gains to the participants are not fixed in such a way that more for one inexorably means less for the other. There is, as we argued earlier, common interest in reaching outcomes that are mutually advantageous. Kapoor (1975) has argued that the negotiator must develop a broader perspective that includes the larger context within which he negotiates and how this context changes over time, while remaining aware that each group retains an unconscious reference to its own culture values.

A useful framework for the analysis of any negotiation process is suggested by Strauss (1978), where he considers systematically: <u>the subprocesses</u> of negotiation, such as the making of trade-offs, compromises through bargaining, deals and secret bargains, ironing out of residual agreements, public statements, renegotiations, etc.; and the <u>structural context</u> in which the negotiation takes place, including such salient structural properties as the number of negotiators and their relative experience, whether they are one-shot or multiple negotiations, the relative balance of power established by the respective parties, the nature of the "stakes"; the overt or covert character of transactions; and the options to avoid or discontinue negotiation, i.e., the costs of a stalemate [23/] The issues are numerous and complex. We will deal here only with three of the most important subprocesses where both some useful generalizations can be made and their impact on the outcome is seen as major. Most structural issues, however, are so particular to any one negotiation situation that little can be gained by considering them in the abstract.

The Making of Trade-offs

This is one of the most important negotiation problems host country governments and firms have to deal with. Raiffa (1978) has noted that controversial trade-offs are those that usually involve highly incommensurable attributes: economic efficiency and safety, health, environmental protection, distributional equity (both spatially and temporally), desired independence from foreign pressures, or attitudes towards the use of market mechanisms. Those "value" trade-offs play an important role in major strategic investment choices, and are at the core of the problem of defining the host country objective function. But he also argues that quantification is certainly possible in the domain of qualitative choice. By looking at trade-offs between qualitative objectives (with outcomes A,B, C and (D) and other objectives, one can often quantify and interpret strengths of preference within one objective, even if there is no underlying, objectively quantifiable measurement scale.

An important element in negotiations is the discovery of acceptable zones of agreement. Raiffa cautions that even if in the abstract there is a zone for agreement, the negotiating team might not recognize it exists, because negotiators often make exaggerated demands in the hope of getting better scores on their objectives of concern. Expectations also distort the picture, in the sense of what Schelling calls pure bargaining: bargaining in which each party is guided maninly by his expectations of what the other will accept. But, with each negotiator guided by his own expectations, while knowing the other is too, expectations can become compounded. There is, therefore, a need for the "co-ordination" of expectations.

To deal with those problems, some researchers (e.g., Barclay and Peterson, 1976) have applied multi-attribute utility (MAU) models to negotiations: a methodology which tries to focus on asymmetries of interest between the two parties in order to find treaties (or agreements) that are better for both. One starts with an assessment of each side's "importance weights", that is, a set of numbers which add up to 100 and represent the relative importance of the difference between one side completely winning on an issue versus the other side gaining it all. Second, utility perferences are assessed for each side that apply to all intermediate positions on each issue. Next, the utility curves are weighted by the importance weights. It is then possible to find a particular subset of all agreements, the Pareto optimum set, for which one party's utility cannot be increased without decreasing the utility to the other. Any outcome which is worth less to either side than no agreement at all can be eliminated. Finally, the Nash solution is found to be the best treaty or agreement that satisfies four criteria: it is Pareto optimum; it gives equal utility to both parties if the negotiation is symmetrical; it does not change if either or both parties rescale the utilities in a linear fashion; and it is independent of irrelevant alternatives. Good treaties are those which give side A more on those issues which are more important to side A, and give side B more on those issues which are more important to side B. (See the Appendix for a concrete example.)

An important distintion must be made concerning the specific characteristics of renegotiations which require that they be treated differently. Vernon (1977) and Stoever (1979), among others, have argeed that when the parties are closely bound by past experience the problems common to all negotiations are intensified: it raises the cost to both sides of failure to reach agreement; the company may believe that it should still be rewarded for past risks taken, while the government feels that profits should be lower since future risks are decreased; relative costs and benefits are distorted by time, such as the loss in the value of a new technology once it has been successfully transferred, etc. This suggests that the utility preference curves underlying trade-offs in the MAU model are very much a function of time and experience.

Smith and Wells (1976) analyzed the transition from traditional mining concessions (from 1900-1950) to the modern concession (late 60s and 70s). Whereas the former used royalties as the initial basis for calculating financial obligations, which in the fifties were gradually replaced by direct income tax or profit-sharing plans, the modern concession includes different forms of government equity sharing and the demand for increased government control in the management of extractive operations. As a result of this evolution in relative bargaining strength, renegotiation clauses are being introduced in practically all mining contracts. But even in this field, where so many factors are relatively comparable, no contract models of universal appeal have emerged and considerable room for negotiation exists.[24/]

One mechanism that has been often suggested but seldom tried is arbitration. The MAU models discussed above can be employed to demonstrate the salutory effect of a "neutral" arbitrator in pushing the parties toward an optimum solution. By serving as a conduit for information exchange as well as by detached observance of counter-intuitive or irrational moves by either side, the arbitrator can speed up the process and make it more efficient. Yet, the one international mechanism devised for such a purpose has been seldom used. The International Centre for the Settlement of Investment Disputes (ICSID) has been recognized only by a handful of Asian countries, a larger group of African states, and practically no Latin American nations (the latter subscribing to the Calvo doctrine of non-intervention). Even when conflict arises out of contractual or technical issues, the ICSID has not been permitted to play a major role. In fundamental policy disputes, the scope for such external arbitration is severely limited.[25/]

Information

Bargaining, like poker, involves both cards and skills. Young notes that the iterative aspect of bargaining introduces a number of new questions each time, involving such factors as reputation, precedent and analogic reasoning. The rational individual takes into account the past bargaining behavior of his partners and/or considers the probable impact of his activities on future cases of bargaining. In extreme cases, he may be willing to suffer a loss in a current situation for perceived compensatory gains in the future.

In international business negotiations access to relevant information is paramount. We have emphasized already the need for a good understanding by corporate officials of national priorities. Government officials must know the company, its history, its pattern of investments and international activities, its product range and R&D interests, etc., in short, they must understand the basic strategic profile of the firm and how the proposed investment fits in that profile. Also required is knowledge about accounting methods, transfer pricing, overhead and R&D allocative methods, international prices for traded inputs, intermediate and final goods, the cost of equivalent technology and management contracts, etc., that is, all the data required for the cost-benefit analysis. This implies a vast task of information gathering and upkeeping, probably beyond the capabilities of most developing countries. International (the UN Centre for Transnational Corporations) and regional agencies (e.g., ANCOM, OPEC, ASEAN) have been increasing their efforts in this direction, and so have the instances of multilateral or private technical assistance purchased or otherwise obtained by host countries.

There are, however, certain problems in the negotiation process which derive from excess information. One is, for example, the belief on the part of some countries (and some investors) that they deserve the same terms which the foreign investor granted another country (and vice versa).[26/] This is ludicrous, since the relative bargaining strength of the two countries may be quite dissimilar, either because of differences in factor endowment, investment climate or market attraction, or because the time elapsed between both negotiations has meant that market (or cost, or technological, or competitive) conditions are no longer comparable. The second problem area concerns excessive demand for inforamtion which is "interesting" to have but which is not directly relevant to the issues under discussion. There is a tendency to information overkill which represents real costs to obtain and which may in fact confuse the process further by over-burdening the company in its search and the government in its use. 27/

One issue worth noting again is the need for internal coordination of different national agencies involved in FDI decisions. Not only must they try to resolve administrative relationships that can facilitate the entry evaluation process, but they often possess the information required for analysis in a disaggregated form. For this reason as well, most observers argue for a centralization of decision making within government, with broad consultation procedures to insure that all interested parties can voice their respective preoccupations on every investment proposal.

Bargaining Skill

Once the cards are in hand and properly understood, the game will resolve on the basis of relative playing skills. The work of Atkinson (1977) and Rackham and Carlisle (1978) are indicative of the insights social scientists have made recently into the actual mechanics of negotiation. They have shown, for example, that "more effective" negotiators use less "irritators" (self-praising comments) in speech, make fewer counter-proposals during the negotiation, stick to one or two arguments on each issue, and are constantly testing their understanding of respective positions by summarizing what has been agreed and seeking further information where no agreement has yet been found.

In the international business field, both companies and governments appear to be guilty of underestimating their adversaries. Kapoor (1975) observed a lack of recognition among company officials of the weights assigned to economic and political criteria in decision-making, of the difference between approval at one level and implementation at other levels of government, of the role of personal relations and personalities in decision-making by host governments, and on the allocation required for negotiations. In terms of organizing for the negotiation, he noted the insufficient attention paid to planning for changes in negotiation strength; the problem of interference by headquarters, often damaging the credibility of country managers in field negotiations; a weak recognition of the role of the negotiator in accommodating the conflicting interests of both parties, the loci of the decision-making authorities, and the strength of the competitors; and very little attention to training executives in the art of negotiating. Wells (1977) has made many of these same arguments in evaluating corporate negotiating experience.

Yet, more and more the MNC manager must be capable of negotiating with an increasingly complex set of social partners. We need to learn a great deal more about these processes in order to reach any normative conclusions and translate them into training programs.

V

A CONCLUDING FRAMEWORK

The foregoing review suggests two primary objectives for further research in this field:

1. Analyze the effect of different national systems designed to control foreign direct investment on the efficacy of the FDI process and on the attainment of national development objectives.

2. Explore the behavioural aspects surrounding the FDI negotiation process in order to isolate those practices which seem to facilitate it from those that appear to be detrimental to it.

Presupposing a prior process of analysis within the firm that leads it to consider a particular country for investment <u>and</u> taking as given an existing set of national priorities and objectives, our goal should be to examine what happens when the twain meet.

<u>Concerning the Efficacy of National Control Systems</u>

We have argued above that a critical determinant of the extent of FDI's positive contribution to the host country's development is that such investment be properly channeled. In order to do this, development objectives must be clearly identified and their priorities established. Futhermore, the efficiency with which these objectives are communicated to the potential investor will have a profound effect on the negotiating process and its outcome. Both of thse relationships will, in turn, depend on the degree of internal consensus in the government and on the mechanisms chosen to represent and impress official views on foreign firms considering investment opportunities. Thus, a series of initial propositions can be tentatively formulated subject to further investigation:

1. Given a set of national development objectives, the more explicit these are made, and the more specific various priorities and trade-offs are stated, the easier should be the task of government negotiators in evaluating alternative proposals and (presumably) the more effective the process itself.
2. Whatever national administrative mechanisms are chosen to deal with foreign investment proposals, flexibility should be preferable to rigidly set requirements, although limits will always need to be imposed on the basis of broad political considerations. A system of flexible

guidelines should tend to maximize net benefits over a broad range of foreign investment proposals when compared with more rigid systems, ceterus paribus.

3. A centralized administrative body responsible for FDI decisions should be better able to interpret national priorities and gather the information and data necessary for its intervention than ad-hoc negotiation procedures. Such a body should also be in a better position to profit from accumulated experience in analyzing the potential investor's objectives and constraints, thus obtaining a truer picture of the limits within which an agreement must take place.

Concerning the Efficacy of the Negotiation Process

Information is the key variable here. Not only does it affect the ability of the country to evaluate the net benefits obtainable from the investor under different assumptions, but it is also critical for the investor to adjust its offer in order to enhance those contributions which are most important to the host country. To this effect:

1. Given their traditional opposition and conflicting interests (e.g., private gains vs. public good), and their suspicion of each other's motives, the partners in a negotiation are led to pursue maximum or minimum strategies which are clearly satisficing in nature. They may, for example, strive to get the maximum out of the minimum which the other party is willing to grant, and offer a minimum of the maximum

demanded by the adversary. Our analysis of asymmetric preference functions in multi-criteria negotiations indicates that this kind of behaviour is far from optimal. Thus, more accurate information about relative priorities on both sides of the negotiation should lead to agreements where both joint and individual gains are optimized.

2. The content and manner of communication of these priorities should have a major impact on the process. For example, information on other agreements reached by the firm (or similar firms) in other circumstances can be extremely useful to the host nation as long as it maintains a clear perspective on the different circumstances which could lead to different final agreements. Equally, the prospective investor should benefit greatly from knowing the pattern of agreements that the host country has reached with previous investors. To the extent that any such pattern is consistent with stated policy priorities, negotiations should be facilitated by such flow of information.

3. The relative level of development of the country, apart from its effect on the quality of the investment climate, will influence the availability and quality of economic data against which the proposal must be evaluated. Yet, the more advanced (and the larger) the country, the more complex its economy and the more difficult to judge the extent of secondary effects. In general, however, relatively more advanced, culturally homogenous and smaller countries should have a more objective (and, therfore, more rational) basis for negotiation.

4. The quality of the documentation required should influence the quality of the analysis. Thus, a sophisticated (but not necessarily a longer) and objective analysis should facilitate the negotiation process.
5. The use of external advisors with broad experience in different fields and circumstances should facilitate communication and, therefore, the negotiation.

Other Issues

Many other factors will affect the efficacy of the negotiation process. For example:

1. There will be dramatic differences in the nature of the negotiation process as a function of the circumstances surrounding the investment proposal; that is, the structural variables. Factors such as the sector (more or less sensitive), the size and importance of the project, the level of political stability at the moment, the presence or absence of economic difficulties (e.g., a balance of payments crisis), the nationality of the investor, etc., will facilitate or hinder the negotiations in purely circumstantial, yet critical ways.
2. A pro-active FDI policy, that is, one that actively searches for potential investors that fit particular development projects or needs, should be more efficient than one which simply relies on externally initiated proposals.
3. The use of experienced negotiators on both sides should facilitate the process. Also, questions of setting, atmosphere, tactics, etc., will undoubtedly affect the process and the results in many complex ways which

are both difficult to isolate and impossible to measure. These tenuous conclusions are clearly not exhaustive. They derive from the general proposition that the more objective and explicit the process, the greater are its chances of success, and that information is the essential element for the attainment of objectivity. A more efficient process of negotiation will presumably lead to more satisfactory results for all sides and, by extension, to more stable agreements and a better investment climate. In the end, uncertainty might be reduced, investment increased, and development enhanced.

Table 1

Comparison of FDI Profiles for Export-Oriented and Local Market-Oriented Investments

Characteristics	Export-Oriented Investment	Local-Market Oriented Investment
Motivation	-investment compelled by competitive pressures: price and import competition; -seek low-cost sources of inputs (e.g., wages).	-maintain market position against internal threats; -respond to public pressures; -defensive investment.
Evaluation criteria	-wage differentials; -labor peace and docility; -political stability; -incentives and absence of controls.	-market size and growth; -protection against imports; -competition; -political risk and stability.
Structure	-vertical.	-horizontal.
Financing	-one-third of total finance provided by foreign equity; -high use of foreign debt.	-one-fourth equity financing; -high use of domestic capital sources.
Return	-average 30% on equity.	-average 20% on equity.
Reinvestment	-relatively little.	-over 50% on average.
Ownership	-high degree of foreign control (usually 100%).	-more local participation and non-equity arrangements.
Technology	-intermediate products, assembly operations; -labor intensive steps.	-varies widely, problems in scaling down plants to local requirements.
Earning stream	-integrated into product flows to world markets; -transfer prices critical.	-dividend payments and royalty and management fees; -overhead allocations.
Bargaining power	-high for the firm; -investor has wide range of potential alternatives.	-high for the larger countries; -dependent on uniqueness of FDI contributions to local economy.

Sources: Summarized from various studies, particularly: Reuber (1973), Helleiner (1973), de la Torre (1974), Moxon (1975), Wells (1977a), and Nayar (1978).

Figure 1

Preferred Strategic Posture in Foreign Markets According to Market Attraction and Political Climate

Assessment of Political/Investment Climate

Market Attractiveness or degree of Fit With Corporate Strategy	Good	Unstable	Poor
High	Maximum commitment of human and financial resources and high tolerance for commercial risks: wholly-owned affiliates preferred.	Limit financial exposure while sustaining market and human investments; accept normal commercial risks; majority-owned affiliate preferred.	Minimize financial exposure consistent with market presence; aim for minority position with licensing as a long-term hedge.
Medium	Maintain high resource commitment and risk tolerance subject to better alternative investment opportunities.	Unwilling to commit significant resources; prefer to act through joint venture if necessary or appropriate.	Little interest in market presence; pursue only if possible without financial exposure of any consequence.
Low	Indifferent to market opportunities; token financial or human commitment possible; independent distributor or joint venture.	Little if any resource commitment desirable; export sales agents preferred vehicle for any market activity; licensing possible.	No interest except for occasional exports or limited licensing agreements.

Figure 2

<u>Net Benefits to the Host Country from FDI Proposals as a Function of the Level of Restrictions Imposed on Entry</u>

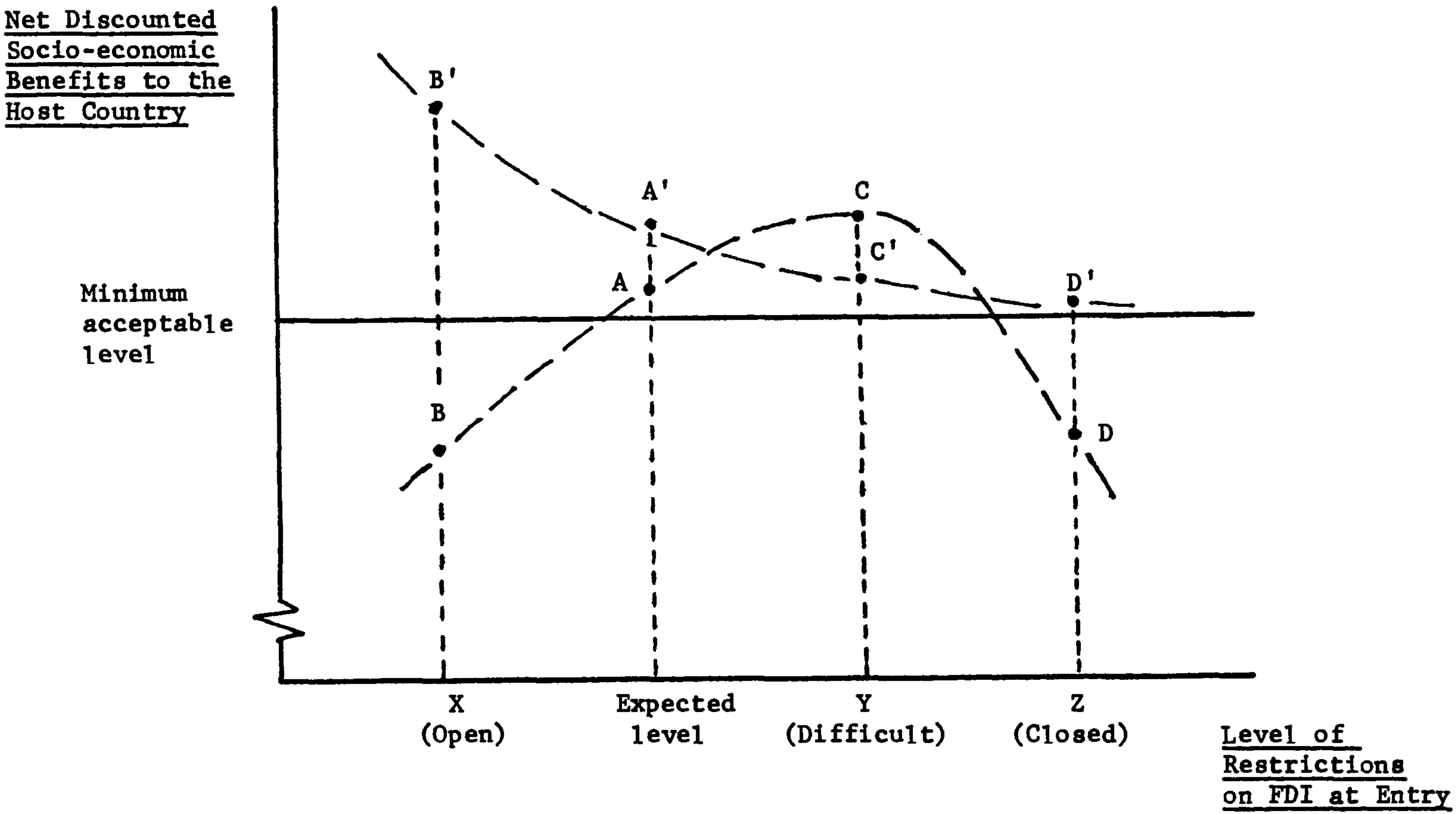


Figure 3

Total Potential Supply of FDI to the Host Country under Alternative Levels of Entry Restrictions

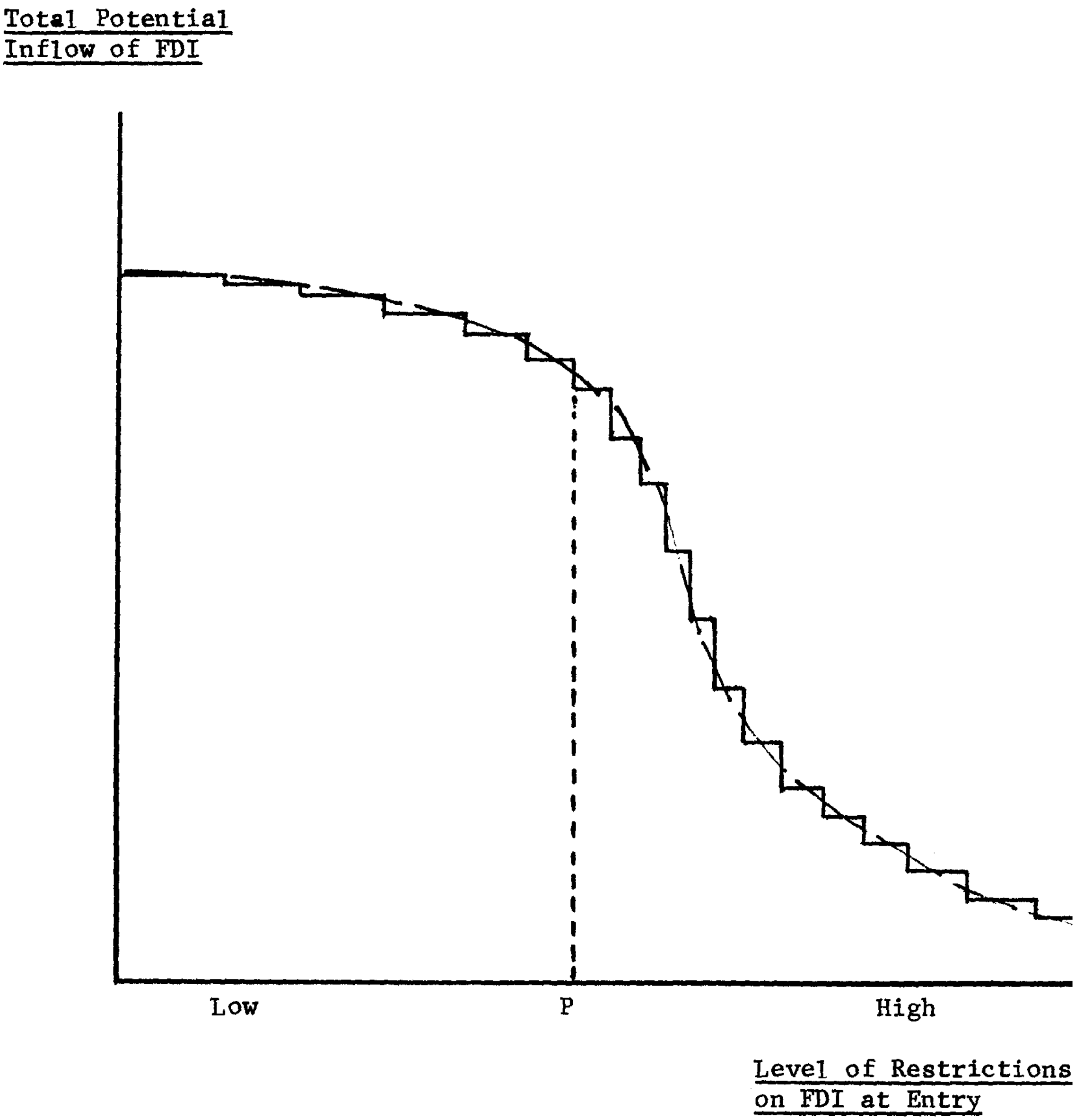
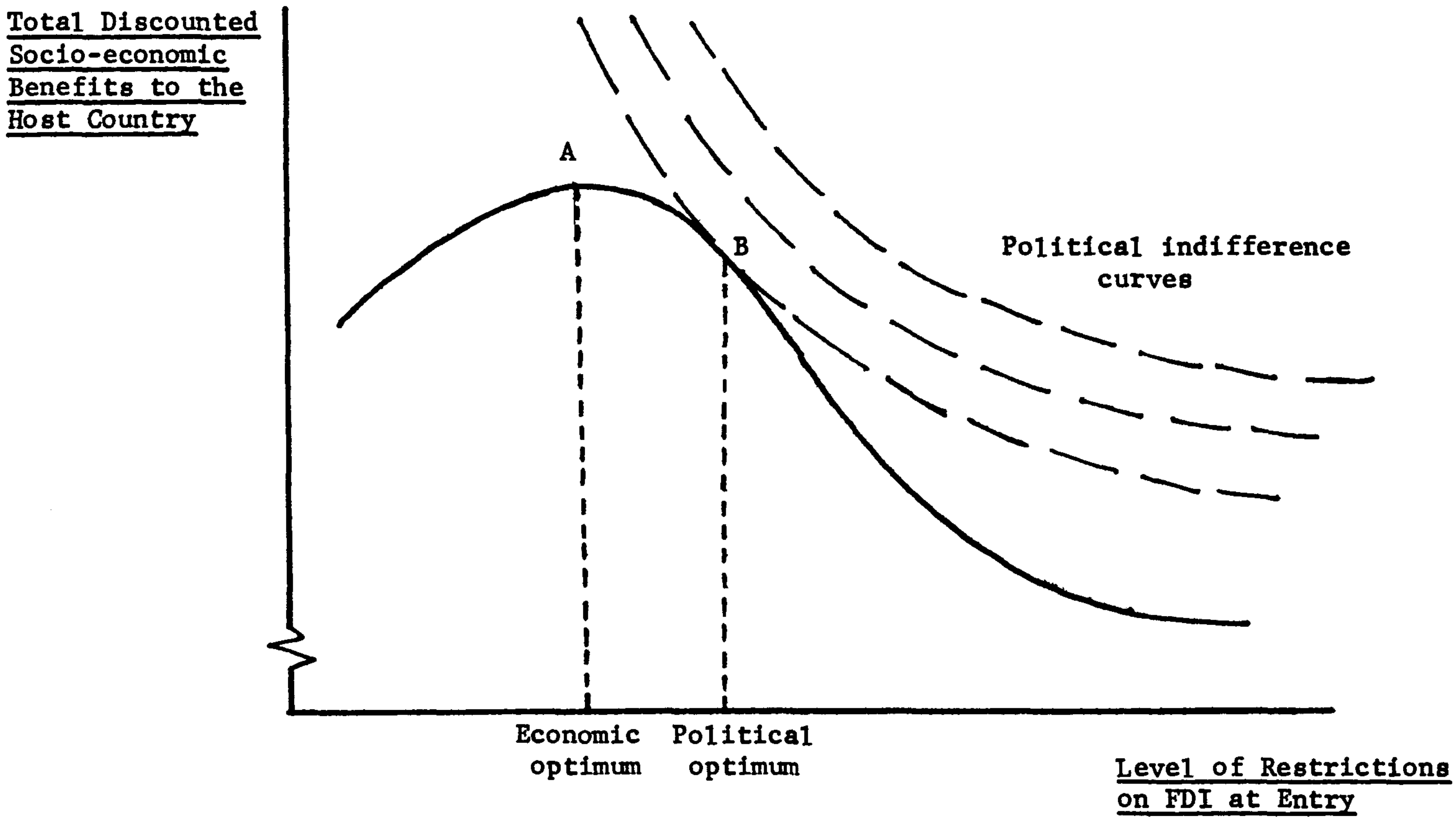


Figure 4

<u>Total Benefits to the Host Country from All Potential FDI Flows as a Funtion of the Level of Entry Restrictions</u>



Footnotes

[1]For a detailed discussion of these trends see Billerbeck and Yasugi (1979), the UN (1973 and 1978), the OECD (1978) and the Survey of Current Business, US Department of Commerce, various issues. For non-US investors in particular, see Yoshino, T. (1980), Business Week (1980), Heenan and Keegan (1979), Kojima (1979), Van den Bulcke (1979), Agmon and Kindleberger (1977) and Franko (1976).

[2]Many of these are in fact not all that new and may not involve any investment in the traditional sense, e.g., turn-key projects, management and marketing contracts, technology agreements, fade-out formulas, etc. For a review of these developments see Oman (1980).

[3]For a compendium of the principal works see, for example, Cover (1974), Mekeirle (1979) and UN (1977).

[4]See, for example, Aharoni (1966), Aliber (1970), Caves (1971), Vernon (1971), Hymer (1976), Buckley and Casson (1976), Lall and Streeten (1977), and Hood and Young (1979). Stevens (1974) surveyed a total of 45 studies which try to explain the multinational investment function. Most were profit maximizing models, but a few cite other rationales such as behavioral, growth, oligopolistic, market share maximization, risk minimization and portfolio theory as the basis for their theoretical construct. Also, see this Anniversary Issue for a more recent summary of the relevant theories.

[5]The literature here is extremely rich. See, for example, Franko (1971 and 1976), Stopford and Wells (1972), Dymsza (1972), Robbins and Stobaugh (1973) and Brooke and Remmers (1978). For examples of how two different sets of policies change over time in response to strategic changes, see Stobaugh (1970) and Franko (1974).

[6]Conversely, the more important the prospective investment is to the firm, the more it may be willing to give up in order to go forward with it. But not to the extent that the firm will sacrifice its ability to capture the expected gains since in that case it may be worse off with the investment than without it.

[7]The two words are used advisedly throughout this discussion. By strategy, we mean the broader, guiding choices which the government makes in organizing and directing the socio-political forces at its disposal. Policies, on the other hand, are limited to definite spheres of activity (e.g., economic) and subject to frequent change as conditions warrant.

[8]The debate was particularly acrimonious in Latin America. The main arguments can be found in Hirschman (1968), Keesing (1968) and Macario (1964). Two extensive empirical analyses were conducted almost simultaneously by the World Bank and the OECD in the late 1960s for the purpose of shedding light on the relative lack of progress in development in general. They both supported, with certain qualifications, the need for more open development policies in the future. See Balassa et. al. (1971), and Little, Scitovsky and Scott (1970) for summaries of both studies.

[9]See, for example, Sunkel (19) and Streeten (1971). Reuber (1973), p. 21, concludes: "... many of the alleged inadequacies in the performance of foreign-controlled firms are primarily determined by the size and circumstances of the host-country economy, including government policies on tariffs, competition, taxes, research and education, rather than by foreign ownership and control as such."

[10]Reuber (1973), p. 17, points out, for example, that, "Protectionist opposition to foreign investment is analogous to protectionist opposition to imports and, similarly, is sometimes manifest by cloaking vested self-interest in articulate nationalism."

[11]For a description of Mexico's policies on FDI and their changes over time, see Wionczek (1967), Wright (1971), and Bennet et. al. (1978).

[12]The argument is in many ways reminiscent of the older debate on the distribution of the gains from trade as put forward by Prebisch (1959 and 1962), and Singer (1950). For a modern interpretation see Bacha (1977). For an application of the argument of "disproportionality" to FDI see Penrose (1970).

[13]A diversified sampling would include Vernon (1968), Gabriel (1972), Reuber (1973), Barnett and Müller (1974), Bos, Sanders and Secchi (1974), Lall and Streeten (1977), Hawkins (1979), Parry (1980), and Frank (1980). The UN (1973 and 1978) studies cite most other relevant analyses.

[14]Two of the main methodologies are the Little and Mirrless (1969) so-called "OECD Method", and the "UNIDO Method" found in UN (1972). For an evaluation of their role in determining FDI contributions to development, see Little and Mirrless (1974), and Lall and Streeten (1977): pp. 159-80 for an example of the method in use, and pp. 49-53, 85-86, and 184-88 for a discussion of its limitations. Lal (1975), pp. 37-93, also has an excellent section on the principal issues involved in applying the C-B methods to evaluating FDI in developing countries. A more recent discussion of these issues can be found in Cody, Hughes and Wall (1980).

[15]See, for example, Stopford and Wells (1972), de la Torre (1974), and Penrose (1976). Reuber (1973), pp. 185-86, makes the same points: "General policies that treat all investments the same way may have differential effects. For example: (1) policies that insist on (local) majority ownership ... seem likely to discriminate against vertical type export-oriented investment in favor of horizontal type locally-oriented investments; (2) given the role of the size of the market, it is evident that for a large majority of developing countries, horizontal type investments in many industries are not very practical. Most developing countries wishing to attract foreign investment in industries which are capital intensive, will have to think in terms of vertical type export-oriented investments unless they are prepared to pay whatever subsidy may be necessary to meet the supply price of capital. On the other hand, if such countries wish to attract vertical type investments, it may be necessary to accept some of the characteristics of this type of investment, such as relatively high levels of foreign control and a relatively weak bargaining position vis-a-vis the foreign investor. Moreover, this is the type of investment where such problems as profit transfer via pricing policies become extremely important and may require substantially different policies than pursued in the past."

[16]The vertical axis represents a composite of the results obtained from the appropriate cost-benefit analyses, accounting for alternative resource uses, and corrected for any perceived externalitites. Also, there may be an explicit weight function in the calculations which corrects for any suspected distortions in the data or in the parameters, or which over-penalizes certain undesirable results and rewards particularly useful contributions.

[17]The connecting dotted line is obviously of no significance since no continuous function is assumed to exist for any one firm's reaction. In fact, the firm's reaction is probably closer to a step function as major changes in restrictions induce discrete changes in parent company policy towards the affiliate.

[18]It would be relatively easy to complicate matters further by introducing a time horizon. Presumably, as the country grows it becomes more attractive to foreign investors and the reaction functions of these would tend to shift upwards and to the right. It should be noted also that changes in government policy (e.g., a decrease in the level of protection) may have a uniformly positive effect on all prospective investors' contributions. Finally, the model assumes no collusion on the side of the investors, a hotly debated issue as can be seen in Newfarmer and Mueller (1975) and Knickerbocker (1976).

[19]Smith and Wells (1976) observed the same trend in the mining sector. Many recent agreements call for the foreign investor to make significant contributions to a "development fund" (New Guinea) or bring in auxiliary manufacturing industries (Malta). See pp. 111-12.

[20]This is akin to the trade-offs between political and economic objectives discussed in Section I. Penrose (1971) argued along the same lines that the feeling of controlling one's own destiny is a source of "psychic utility" and, therefore, a legitimate political objective.

[21]We must not lose sight in the discussion of the fact that such an analytical framework is both time and country dependent. The relationship proposed in Figure 3 is going to be drastically different for Brazil than for Botswana; for Singapore than for India. Second, as time brings about changes in market attractiveness and in the investment climate, the relationships will shift to reflect these basic changes in the underlying functions. This is one of the reasons for which time-limited arrangements have been recommended, particularly in the extractive sector where the changes tend to be rapid.

[22]One of the best known examples is Vaitsos' study of the Colombian drug industry (1974).

[23]To this analysis of structural factors, Young (1975) adds our previous notion that in real-world situations the relevant actors are mostly complex collective entities rather than individuals. He notes (p. 396) that the external behavior of a collective entity is apt to fluctuate as a function of changing fortunes in its internal bargaining process, and that the members which form such entities often experience role conflicts that affect participation in the decision-making processes of the collective entity and, therefore, the external behavior of the collective entity itself. If a common set of objectives exists and is made explicit, it can serve as the basis for resolving internal conflict. If not, the battle may be lost before it starts.

[24]For a discussion of these issues see UN (1978), pp. 118-20, and Smith and Wells (1976), passim. The former (Table V-1, pp, 314-17) has a listing of some recent negotiation case histories in the petroleum and non-fuel mineral sectors.

[25]One should emphasize the total lack of enthusiasm for international initiatives (codes of conduct, harmonization policies, etc.) that Robinson (1976) found among the thirteen developing countries in his sample (pp. 332-34).

[26]See UN (1978), p. 115, fn. 275, for an example of one proposed contract where the investor insisted on a "most-favored-company" clause whereby it would obtain all benefits and concessions the government might make in the future to other foreign investors in the same field.

[27]See Penrose (1978), UN (1978), pp. 137-42, and Lall and Streeten (1977), p. 216, on some of these issues.

Appendix

A simple example can illustrate the use of multi-attribute utility models in negotiations. Assume that the demands of the host country in relation to a particular foreign investment proposal are as follows:

- -60% of local domestic capital in the affiliate;
- -two government representatives on the Board of Directors; and
- -a corporate tax rate of 50% on earnings.

The prospective investor, on the other hand, argues for the following limits and concessions:

- -no more than 40% domestic capital participation;
- -no government representatives on the Board; and
- -a corporate tax holiday for a minimum of five years.

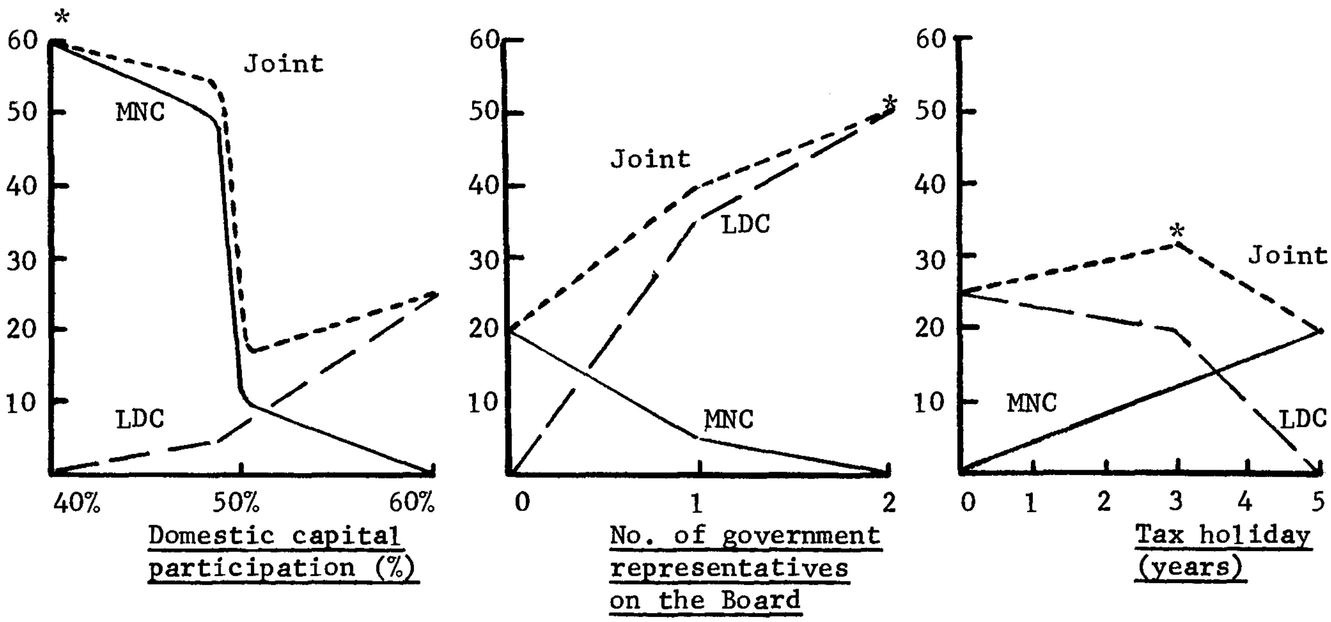
Each party then assigns "importance weights" to each of these issues, keeping in mind that each weight represents the importance of the difference between the respective positions of each party and not the absolute importance attached to the issue itself. Assume that this results in the following distribution of weights for the three issues under negotiation:

	MNC	LDC
-local participation	60	25
-government representation	20	50
-tax treatment	20	25

By attributing a weight of 50 to government representation on the company's board and a weight of 25 to local capital participation, this should not be interpreted to mean that the government considers local participation one-half as important as having representatives on the Board. Instead, it means that the government negotiators consider the change from the MNC position to their position on the representations issue to be twice as important as the change from the MNC position to the government's position on the ownership issue. These importance weights can also be interpreted in terms of indifference judgments. For example, the government position implies that it would be indifferent about an agreement in which it had won the representation issue and lost the other two issues, and an alternative agreement in which its position on both local participation and tax liability was upheld but lost completely on the question of government representatives to the Board.

The next step would consist of assessing each party's utility distribution on each issue under negotiation. The relative importance of intermediate positions, adjusted for the overall importance weights, could then be represented as in the graphs below. The MNC's reluctance to yield majority control, for example, shows in its utility curve for that issue. On the other hand, the firm appears to have a linear attitude with respect to the question of a tax holiday. The government's satisfaction with Board representation also appears not to be greatly affected if only one official is permitted, but it drops rapidly afterwards.*

*Since this issue cannot be resolved except for integer units, the analysis needs a slight modification. For simplicity, it is handled here as if it were a continuous relationship.



The asterisks in these graphs indicate the position yielding the maximum possible joint utility on each issue. One could envisage two likely solutions summarized in the following table:

	Outcome A: Maximum Joint Utility			Outcome B: Splitting the Difference		
	Final Agreement	Scores MNC	Scores LDC	Final Agreement	Scores MNC	Scores LDC
Participation	40%	60	0	50%	10	7
Representation	2	0	50	1	5	35
Tax holiday (yrs.)	3	12	20	2½	10	21
Totals		72	70		25	63

The first agreement is found by obtaining the "maximum joint utility" solution (a Pareto optimum one) on each of the issues under negotiation; the second outcome is the result of "splitting the differnece" on all issues. The results are obvious: when there are asymmetric preferences, the optimal solution is difficult to find, but it does not lie in seeking compromises on each issue. Negotiators on both sides should evaluate instead their own and their opponent's utility preferences which may lead them to concede completely on certain issues while standing fast on those important questions where they may gain full concessions.#

#It should be noted that most symplifying assumptions made thus far can be dropped without major problems. A troublesome exception is the problem of providing false information on relative preferences to the opposition. For more on this see Young (1975), pp. 392-93. Another kink is introduced by the interplay of legal and illegal bargaining tactics, e.g., the making of surreptitious and obviously secret agreements, the flaunting of official rules assumed to be "above" the negotiations, corruption, etc.

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