Regulation of Foreign Investment in Historical Perspective

HA-JOON CHANG

Based on a historical survey, the article argues that during their early stages of development, now-developed countries systematically discriminated against foreign investors. They have used a range of instruments to build up national industry, including: limits on ownership; performance requirements on exports, technology transfer or local procurement; insistence on joint ventures with local firms; and barriers to 'brownfield investments' through mergers and acquisitions. We argue that, only when domestic industry has reached a certain level of sophistication, complexity, and competitiveness do the benefits of non-discrimination and liberalisation of foreign investment appear to outweigh the costs. On the basis of this, the article argues that the currently proposed multilateral investment agreement at the World Trade Organisation is likely to harm the developing countries' prospects for development.

Cet article basé sur une enquête historique argumente que, durant les premières étapes du développement, les pays actuellement développés prenaient systématiquement des mesures discriminatoires envers les investisseurs étrangers. Ils utilisaient une série d'instruments pour permettre à l'industrie nationale de se développer: limitations sur la propriété; conditions de performance touchant les exportations, transferts de technologies ou approvisionnement local; joint-ventures en participation avec les entreprises locales; limitations au rachat d'entreprises existantes (brownfield investments) à travers des fusions

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ou acquisitions. Nous soutenons que les bénéfices de la non-discrimination et de la libéralisation des investissements étrangers n'en dépassent les coûts qu'au moment où l'industrie domestique est arrivée à un certain niveau de sophistication, de complexité et de compétitivité. Sur la base de cette découverte, l'article argumente que l'accord multilatéral sur les investissements, proposé actuellement par l'Organisation Mondiale du Commerce, risque de léser les perspectives de développement des pays en développement.

I. INTRODUCTION

During the past several years, the developed countries have been stepping up their efforts to install a multilateral investment agreement (MIA) that prevents countries from controlling foreign direct investment (FDI), and possibly portfolio investments.

Initially, this was mainly pursued through the OECD, where it was proposed that the developed countries adopt an MIA to which willing developing countries are also allowed to sign up. When this move was thwarted in 1998, the main battleground on this issue was moved to the World Trade Organisation (WTO). As one of the 'Singapore issues', the possibility of an MIA comprising all member countries is now seriously discussed. While the push for an MIA at the WTO is in retreat for the moment following the collapse of the Cancún ministerial meeting, the issue is bound to come back in one way or another.

There are a number of well-known reasons for opposing an MIA. First, unlike what its proponents often argue, an MIA is unlikely to lead to increased flows of foreign investment, especially into developing countries. Second, it will merely add to, rather than replace, the patchwork quilt of over 2,000 bilateral investment treaties. Third, the WTO agenda is already overloaded, to the detriment of developing country participation. Fourth, the promises of flexibility for developing countries will be undermined by the realities of negotiations, where the developing countries are routinely subject to bullying and deceit. And last but not least, there is a lack of balancing obligations on home countries and investors.

This article adds another, rather compelling in our view, reason to this already long list. Based on a historical survey of the experiences of the US, the EU member states and the East Asian economies, it argues that during their early stages of development, now-developed countries systematically discriminated between domestic and foreign investors in their industrial policy. They have used a range of instruments aimed at foreign investors to build up national industry. These included: limits on foreign ownership; performance requirements on exports, technology transfer or local procurement; insistence on joint ventures with local firms; and barriers to 'brownfield investments' through mergers and acquisitions.

The main 'demandeurs' of investment negotiations, the EU and Japan, insist that non-discrimination, and in particular national treatment (there are fewer problems with most favoured nation treatment), should be a central aspect of any MIA. However, our historical survey shows that, only when domestic industry has reached a certain level of sophistication, complexity, and competitiveness do the benefits of non-discrimination and liberalisation appear to outweigh the costs. As a result, countries generally move towards a greater degree of non-discrimination and liberalisation as they develop. In that sense, non-discrimination is better seen as an *outcome* of development, not a cause. Therefore, an MIA founded on this principle is likely to harm the developing countries' prospects for development.

While the exact nature of the overall strategy and the exact mix of tools to be used can, and need to, vary across countries, and while the recent changes in global economic and political conditions have influenced the desirability and the feasibility of different strategies differently, history clearly shows the importance of the policy space for developing countries (of yesterday and today) to use a wide range of measures to regulate foreign investment.

II. FOREIGN INVESTMENT REGULATION IN HISTORICAL PERSPECTIVE

The United States

1. Overview

From its early days of economic development to the First World War, the US was the world's largest importer of foreign capital.[1] The eminent business historian Mira Wilkins states that during the 1875–1914 period, the US was 'the greatest debtor nation in history' despite its rise as one of the major lender countries in the international capital market at the end of this period [*Wilkins, 1989: 144*].

Given the country's position as a net importer of capital, there was naturally a lot of concern with foreign investment. While many Americans accepted the necessity of foreign investment and some sought it out enthusiastically, there was also a widespread concern with 'absentee management' [*Wilkins, 1989: 563*], and, further, foreign domination of the American economy.

The fear of foreign investment was not confined to the 'radicals'. For example, the *Bankers' Magazine* of New York remarked in 1884:

> It will be a happy day for us when not a single good American security is owned abroad and when the United States shall cease to be an exploiting ground for European bankers and money lenders. The tribute paid to foreigners is . . . odious . . . We have outgrown the necessity of submitting to the humiliation of going to London, Paris or Frankfort [*sic*] for capital

> has become amply abundant for all home demands. [*Bankers' Magazine, No. 38, January, 1884, cited in Wilkins, 1989: 565*]

According to the same magazine, the great majority of Americans believed it was 'a misfortune to have its [the country's] public, corporate, and private securities abroad' [*No. 33, April, 1879, cited in Wilkins, 1989: 915, note 67*].

Even Andrew Jackson (the seventh President of the US, 1829–37), a well-known advocate of small government and therefore something of a hero among American free-marketeers today, amply displayed anti-foreign feelings. He famously vetoed the renewal of the federal government charter for the country's second quasi-central bank, the (Second) Bank of the USA, largely on the grounds that 'many of its stockholders were foreigners' [*Wilkins, 1989: 61–2, 84; Garraty and Carnes, 2000: 255–8*].[2] When he exercised his veto in 1832, he said:

> . . . should the stock of the bank principally pass into the hands of the subjects of a foreign country, and we should unfortunately become involved in a war with that country, what would be our condition?. . . Controlling our currency, receiving our public moneys, and holding thousands of our citizens in dependence, it would be far more formidable and dangerous than the naval and military power of the enemy. If we must have a bank . . . it should be *purely American*. [*as cited in Wilkins, 1989: 84*, *italics original*][3]

Others would go even further. On the eve of the de-chartering of the Second Bank of the USA (SBUSA), the Jackson government moved federal government deposits to other banks. One of these banks, the Manhattan Bank, was foreign owned but, not being a federally chartered bank like the SBUSA, it did not ban foreign shareholders from voting (which was the case with federally chartered banks – see below). Therefore, *Niles' Weekly Register*, one of the leading magazines of the time, found it scandalous that 'IN THIS BANK THE FOREIGN STOCKHOLDERS VOTE!' [*No. 45, 16 November, 1833, cited inWilkins, 1989: 84, capitals in original*]. Another article that appeared two years later in this magazine [*No. 48, 2 May, 1835*] neatly sums up the dominant American feeling at the time: 'We have no horror of FOREIGN CAPITAL—if subjected to *American management*' [*cited in Wilkins, 1989: 85, italics and capitals original*].

One important point to note is that all these concerns about foreign investment were expressed despite the fact that the importance of foreign investment in the US at the time was far less when compared to that in today's developing countries. For example, inward FDI stock of the US in 1914 was 3.7 per cent of gross domestic product (GDP) [*Held et al., 1999: 275, Table 5.13*]. In contrast, the same figure for developing countries was 4.8 per cent in 1980, 10.5 per cent in 1990 and 19.9 per cent in 1995 [*Crotty et al., 1998: Table 3*].

In other words, if many people in the US in the nineteenth and the early twentieth century were concerned with the impacts of foreign investment, their counterparts in developing countries should be concerned way more.

In order to ensure that foreign investment did not lead to loss of national control in the key sectors of the economy, much federal and state legislation was enacted in the US since its independence until the mid-twentieth century, when it became the world's top economic nation. And as the main sectors that received foreign investments during this period were in finance, shipping, and natural resource extraction (agriculture, mining, logging), the legislation was concentrated in them.

2. Federal Legislation

Navigation. One of the first acts of the new Congress upon independence was an imposition in 1791 of differential tonnage duties between national and foreign ships [*Wilkins, 1989: 44*]. Similarly, a navigation monopoly for US ships for coastwise trade was imposed in 1817 by the Congress [*Wilkins, 1989: 83*]. This continued until the First World War [*Wilkins, 1989: 583*].

Finance. In the financial sector, legislative provisions were made in the charter for the country's first quasi-central bank, the First Bank of the USA (FBUSA) in 1791 to avoid foreign domination. Only resident shareholders could vote and only American citizens could become directors. And thanks to these provisions, the Bank could not be controlled by foreigners, who owned 62 per cent of the shares by 1803 and 70 per cent by 1811. Despite this, when its charter was up for renewal in 1811, the Congress did not re-charter the Bank 'in large part owing to fears of foreign influence' [*Wilkins, 1989: 38-9, 61, the quote is from p. 61*]. A similar provision against voting by foreign shareholders was made for the SBUSA, when it was given the federal charter in 1816 [*Wilkins, 1989: 61*].

In addition, the 1864 National Bank Act also required that the directors of national (as opposed to state) banks had to be Americans [*Wilkins, 1989: 455*] – this lasted even after the introduction of the Federal Reserve System in 1913 [*Wilkins, 1989: 583*]. This meant that 'foreign individuals and foreign financial institutions could buy shares in U.S. national banks *if* they were prepared to have American citizens as their representatives on the board of directors'. And therefore '[t]hat they could not directly control the banks served as a deterrent to investment' [*Wilkins, 1989: 583, italics original*].

Land. From the early days of independence, many state governments barred or restricted non-resident foreign investment in land [*Wilkins, 1989: 45*]. However, particularly strong feelings against foreign land ownership developed following the frenzy of land speculation by foreigners in the frontier areas in the 1880s. In 1885, the *New York Times* editorialised against 'an evil of considerable magnitude—the acquisition of vast tracts of land in the Territories by English noblemen' [*New York Times, 24, January, 1885, cited in Wilkins, 1989: 569*].

Reflecting such feelings, the federal Alien Property Act (1887) and 12 state laws were enacted during 1885–95 with a view to control, or sometimes even altogether ban, foreign investment in land [*Wilkins, 1989: 235*]. An 1885 resolution passed by the New Hampshire legislature read: 'American soil is for Americans, and should be exclusively owned and controlled by American citizens' [*Wilkins, 1989: 569*]. The 1887 federal Alien Property Act prohibited the ownership of land by aliens or by companies more than 20 per cent owned by aliens in the territories (as opposed to the states), where land speculation was particularly rampant [*Wilkins, 1989: 241*].[4] However, it must be noted that due to the lack of disclosure rule on ownership, it was practically not possible to check upon the identities of all the corporate owners and therefore the law was not totally effective [*Wilkins, 1989: 582*].

Natural Resources. There was less hostility towards foreign investment in mining than towards that in land, but still considerable ill-feelings existed [*Wilkins, 1989: 572–3*]. Federal mining laws in 1866, 1870, and 1872 restricted mining rights to US citizens and companies incorporated in the US.[5] In 1878, a timber law was enacted, permitting only US residents to log on public land [*Wilkins, 1989: 581*]. Similarly to the Alien Property Act, these laws were not totally effectual against foreign corporate investment, owing to the difficulty of checking company ownership [*Wilkins, 1989: 129*]. In 1897, the Alien Property Act was revised to exempt mining lands.

Manufacturing. Restrictions on foreign investment in manufacturing were relatively rare as such investment was not very important until the late nineteenth century, by which time the US had managed to build up a robust position in many sectors of manufacturing behind the world's highest tariff barrier.

However, there were still concerns about the behaviour of transnational corporations (TNCs) in manufacturing, especially transfer pricing. For example, a US government investigation in the wake of the First World War expressed grave concerns that the German TNCs were avoiding income tax payment by understating their net earnings by charging excessively for technology licences granted to their American subsidiaries [*Wilkins, 1989: 171*].

Interesting in relation to FDI in manufacturing was the 1885 contract labour law, which prohibited the import of foreign workers. This applied also to national companies, but it obviously affected foreign firms more, especially in relation to the import of skilled workers [*Wilkins, 1989: 582–3*]. Many TNCs did not like the law because it restricted their ability to bring in skilled workers from their headquarters.

3. State Legislation

Some of the state laws were even more hostile to foreign investment than the federal laws [*Wilkins, 1989: 579*]. In addition to the state laws that had existed from early independence banning or restricting non-resident foreigners' investment in land, 12 new state laws were enacted during 1885–95 to control, or even prohibit, foreign investment in land (see above) [*Wilkins, 1989: 235*]. In addition, there were a number of state laws that taxed foreign companies more heavily than American companies. There was also a notorious Indiana law in 1887 withdrawing court protection from foreign firms [*Wilkins, 1989: 579*].

The New York state government took a particularly hostile attitude towards foreign investment in finance, an area where it was rapidly developing a world-class position (a case of infant industry protection, one might say). A New York law in 1886 required foreign insurance companies to have 2.5-times the minimum paid-up capital of American companies [*Wilkins, 1989: 580*], while another law required all certified public accountants (CPAs) to be American [*p. 580*]. The New York state also instituted a law in the 1880s that banned foreign banks from engaging in 'banking business' (such as taking deposits and discounting notes or Bills). The 1914 banking law banned the establishment of foreign bank branches [*Wilkins, 1989: 456*]. These laws proved very burdensome on foreign banks. For example, the London City and Midland Bank (then the world's third largest bank, measured by deposits) could not open a New York branch, when it had 867 branches worldwide and 45 correspondent banks in the US alone [*Wilkins, 1989: 456*].

On the whole, federal government condoned anti-foreign state laws. Wilkins writes:

> The State Department and Congress did give an implicit green light to antiforeign *state* government laws. Neither was responsive to intermittent diplomatic inquiries from London, requesting the federal government to muzzle state legislators. The Secretary of State John Hay replied (in 1899) in a very standard manner to one such request that was related to discriminatory taxes against foreign fire insurers: "Legislation such as that enacted by the State of Iowa is beyond the control of the executive branch of the General Government". [*Wilkins, 1989: 584, italics original*]

4. Lessons from the US Experience

To sum up, in contrast to its strong support for foreign investment liberalisation today, when it was a capital-importing country, the US had all kinds of provisions to ensure that foreigners invested in the country but did not control its economy. For example, the US federal government had restrictions on foreigners' ownership in agricultural land, mining, and logging. It discriminated against foreign firms in banking and insurance, while prohibiting foreign investment in coastal shipping. It demanded that all directors of national banks be American citizens, while depriving foreign shareholders of voting rights in the case of federally chartered banks. It also prohibited the employment of foreign workers, thus implicitly disadvantaging foreign investors that wanted to import skilled labour from their home countries.

At the state level, there were even more restrictions. In addition to restrictions on land ownership, many states taxed foreign companies more heavily and some even refused them legal protection. Much state legislation in the financial sector was even more discriminatory. Some states imposed more strict capital base requirements on foreign financial institutions, and some even totally banned entry into certain financial industries (for example, New York state laws banning foreign bank entry). The federal government condoned such laws and refused to take action against state governments even when there were pressures from foreign investors and governments to do so.

What are the lessons that we can derive from the historical experience of the US in relation to foreign investment policy? The first important point to note is that, despite its often-draconian regulations on foreign investment, the US was the largest recipient of foreign investment. This questions the common contention that foreign investment regulation is bound to reduce investment flows. It should be mentioned that contemporary empirical evidence also shows foreign investment regulations to have only a marginal, if any, influence on the determination of foreign investment decisions [*for example, see the review in Kumar, 2001: 3,156*]. In particular, the large foreign investment inflow into China, with its numerous regulations on foreign investment, shows that regulations are not a major determinant of foreign investment. Therefore, it is simply erroneous to believe that an MIA will increase foreign investment.

The second, and more important, point is that, despite its strict regulations on foreign investment (as well as manufacturing tariffs that were the highest in the world), the US was the fastest-growing economy in the world throughout the nineteenth century up until the 1920s. This questions another common contention that foreign investment regulation will harm the growth prospect of an economy. When combined with the fact that many other developed countries that we shall review below also performed well despite strict regulations on foreign investment, it seems more reasonable to conclude that a well-crafted regime of foreign investment regulation can help, rather than hinder, economic development.

The More Advanced European Economies: the UK, France and Germany

1. Overview

Until the early twentieth century, the UK, France and Germany (together with the Netherlands and Switzerland) were mostly suppliers of capital to the less developed countries, including the US, Canada and Russia. Therefore, during this period, the main concern for these countries, especially the UK from the late nineteenth century when it was rapidly losing its industrial supremacy, was how to control 'excessive' outward foreign investment rather than how to control inward foreign investment.

In the few decades following the end of the Second World War, however, controlling inward foreign investment became a major new challenge for these countries. If they were to close the newly emergent technological gap with the US, they had to accept American investment, especially FDI (Servan-Schreiber [1967] is the most prominent work of the time on this issue).

Until the 1980s, given that these countries did not adopt laws explicitly discriminating against foreign investors except in sensitive areas (for example, defence, cultural industries), the most important element in their control of foreign investment was their foreign exchange control, which gave their governments the ultimate say in foreign investment. Of course, this does not necessarily mean that their governments used the control to the same effect. For example, the UK, even before the adoption of its pro-FDI policy under Margaret Thatcher, took a more permissive attitude towards FDI and rarely used its foreign exchange control law (1947–79) to influence FDI, except in its early years [*Young et al., 1988*], whereas France was more active in the management of its FDI flows. However, there were also other mechanisms of control.

First, in all of these countries (except the UK after the 1980s), the significant presence of state-owned enterprises (SOEs) in key sectors in the economy has acted as an important barrier to FDI.[6] Also, while not technically SOEs, some of their key enterprises have had significant government ownership – for example, the state government of Lower Saxony is the biggest shareholder of Volkswagen, with a 20 per cent share ownership. Moreover, even when privatising some of the SOEs in the 1980s, the French government was careful to ensure that control of these enterprises remained French by reserving a significant proportion of shares for 'hard core' (*noyau dûr*) institutional investors close to the government [*Dormois, 1999: 79*].

Second, in the case of Germany, the barriers to hostile take-over, due to the presence of close industry–bank relationships as well as to the power of labour exercised through the supervisory board,[7] have acted as a significant obstacle to FDI. Given that in the UK, where hostile take-over is easy, the bulk of FDI has consisted of 'brownfield' investment based on take-overs rather than 'greenfield' investment, FDI in Germany could have been considerably higher without the above-mentioned defence mechanisms against hostile take-over.[8]

Third, all these countries, including the ostensibly FDI-friendly UK, have used informal performance requirements for key FDI projects. For example, in the UK, since the 1970s in certain industries, a variety of informal 'undertakings' and 'voluntary restrictions' were used to regulate foreign investment [*Young et al., 1988*]. These were mostly, although not exclusively, targeted at

Japanese companies, especially in automobiles and electronics. According to Young *et al*.,

> [i]t is widely believed that [all investments by Japanese electronics giants in the 1970s and the early 1980s – Sony in 1974, Matsushita in 1976, Hitachi and Mitsubishi in 1979, Sanyo and Toshiba in 1981] were subject to some form of voluntary restraint agreement with the Department of Industry on local sourcing of components, production volumes and exporting, but details are not publicly available. Several of the companies reported particular difficulties in implementing local procurement policies and in the slow build up of production which they were allowed. [*Young et al., 1988: 224*]

This prompted one observer to remark in 1977 that 'every Japanese company which has so far invested in Britain had been required to make confidential assurances, mainly about export ratios and local purchasing' [*Financial Times, 6 December, 1977, as reported in Young et al., 1988: 223*]. When Nissan established a UK plant in 1981, it was forced to procure 60 per cent of value added locally, with a time scale over which this would rise to 80 per cent [*Young et al., 1988: 225*]. Also '[t]here is much evidence that successive ministers in the Department of Trade and Industry have put pressure on [Ford and GM] to achieve a better balance of trade, although details in timing and targets are not available' [*p. 225*]. Young *et al*. observed in 1988 that 'limited use of performance guidelines (if not explicit requirements) are effectively now regarded as part of the UK portfolio' [*p. 225*].

2. Lessons from the Experiences of the UK, France and Germany

To sum up, the UK, France and Germany did not have to control foreign investment until the mid-twentieth century, as they were capital-exporting countries before that. However, when faced with the challenge of an upsurge in American investment after the Second World War, they used a number of formal and informal mechanisms to ensure that their national interests are not hurt. Formal mechanisms included foreign exchange control and regulations against foreign investment in sensitive sectors such as defence or cultural industries. At the informal level, they used mechanisms such as the SOEs, restrictions on take-over, and 'undertakings' and 'voluntary restrictions' by TNCs in order to restrict foreign investment and impose performance requirements.

The tightening of foreign investment regulation after the Second World War by these three countries reflected the changes in their status in the international investment game. As they switched their positions as net foreign investors with the US, they adopted restrictions on foreign investment that they had criticised when the US had used them.

This suggests that countries should use, and indeed have used, different policies towards foreign investment according to their status in the international investment flows. Given that developing countries are almost always at the receiving end of these flows, they need, and should be allowed to have, significantly more restrictive approaches towards foreign investment than do the developed countries.

The Less Advanced European Economies: Finland and Ireland

In this section, we examine Finland and Ireland – two countries that were among the poorest in Europe until a generation ago but have become star performers through very different policies towards foreign investment, the former very restrictive and the latter very permissive (although not as hands-off as many people believe).

1. Finland

Finland is often overlooked as one of the economic miracles of the twentieth century. Until the late nineteenth century, Finland was one of the poorest economies in the Europe. However, it is today one of the richest. According to the authoritative statistical work by Maddison, among the 16 richest countries of today, only Japan (3.1 per cent) achieved a higher rate of annual per capita income growth than that of Finland (2.6 per cent) during the 1900–87 period [*Maddison, 1989: 15, Table 1.2*].[9] Norway tied with Finland in the second place, and the average for all 16 countries was 2.1 per cent.[10]

What is even less well known than Finland's impressive growth performance is the fact that it was built on the basis of a regime of draconian restrictions on foreign investment – arguably the most restrictive in the developed world. As a country that had been under foreign rule for centuries[11] and as one of the poorest economies in Europe, Finland was naturally extremely wary of foreign investment and duly implemented measures to restrict it (all information in the rest of this sub-section is from Hjerppe and Ahvenainen [*1986: 287–95*], unless otherwise noted).

Already in 1851, Finland established a law prescribing that any foreigner, Russian nobles excepted, had to obtain permission from the Tsar, then its ultimate ruler of the country, to own land. Added to this were the 1883 law that subjected mining by foreigners to licence, the 1886 ban on banking business by foreigners, and the 1889 ban on the building and operation of railways by foreigners. In 1895, it was stipulated that the majority of the members on the board of directors of limited liability companies had to be Finnish. All these laws remained valid until at least the mid 1980s.

After independence from Russia, restrictions on foreign investment were strengthened. In 1919, it was stipulated that foreigners had to get special permission to establish a business and guarantee in advance the payment of taxes and other charges due to the central and the local states. In the 1930s, a series of laws were passed in order to ensure that no foreigner could own land and mining rights. It was also legislated that a foreigner could not be a member of the board of directors or the general manager of a firm. Companies with more than 20 per cent foreign ownership were officially classified as 'dangerous companies' and therefore foreign ownership of companies was effectively restricted to 20 per cent. As a result, while there was considerable foreign borrowing, there was little FDI during this period, a pattern that persisted at least until the 1980s.

There was some liberalisation of foreign investment in the 1980s. Foreign banks were allowed for the first time to found branches in Finland in the early 1980s. The foreign ownership ceiling of companies was raised to 40 per cent in 1987, but this was subject to the consent of the Ministry of Trade and Industry [*Bellak and Luostarinen, 1994: 17*]. A general liberalisation of foreign investment was made only in 1993, as a preparation for its EU accession.[12]

2. Ireland

Ireland is often touted as an example showing that a dynamic and prosperous economy can be built on the basis of a liberal FDI policy. Its impressive economic performance, especially during the recent period, earned it the titles of 'Celtic Tiger' or 'Emerald Tiger', following the 'miracle' economies of the 'East Asian Tigers' (Korea, Taiwan, Singapore and Hong Kong).

After the exhaustion of early import substitution possibilities and the ensuing industrial stagnation in the 1950s, Ireland shifted its industrial policy radically from an inward-looking to an outward-looking strategy (for further historical backgrounds, see O'Malley [*1989*]). The new policy regime focused on encouraging investment, especially in export industries, through financial incentives. The main incentive schemes used were: 1) capital investment grant, which required the recipient firms to be internationally competitive; 2) exemption of tax for profits earned from export sales above the 1956 level (the law had no new recipients since 1981 and was abolished in 1991); and 3) accelerated depreciation [*O'Malley, 1999: 224–5*]. In addition to encouraging investment, these schemes were also intended to reduce regional disparity by offering higher grant rates for investment in less developed regions. Additionally, the government established industrial estates in poor regions at its own expense [*O'Malley, 1999: 225*].

While this policy regime did not favour foreign enterprises *per se*, it had a certain degree of bias for foreign enterprises, as they typically had higher export orientation. The existence of this bias towards TNCs, however, should not be interpreted as the same as having a totally *laissez-faire* approach towards FDI. According to the 1981 US Department of Commerce survey, *The Use of Investment Incentives and Performance Requirements by Foreign Governments*, 20 per cent of US TNC affiliates operating in Ireland reported the imposition of performance requirements, in contrast to the 2–8 per cent in other advanced countries (8 per cent in Australia and Japan, 7 per cent in Belgium, Canada, France, and Switzerland, 6 per cent in Italy, 3 per cent in the UK, and 2 per cent in Germany and the Netherlands) [*Young et al., 1988: 199–200*].[13] However, it is true that the investment grants disbursed during this period were rather unfocused and therefore did not deliver the best value for money [*O'Sullivan, 1995; O'Malley, 1999*].

The post-1958 industrial policy ran out of steam by the late 1970s. FDIs continued to be mostly in low value added sectors, while they failed to create many linkages with indigenous firms. By the mid 1980s, there developed a sense of crisis in the country, when employment in indigenous firms experienced a rather sharp decline (about 20 per cent) since the peak of 1979, while employment in foreign firms had more or less stagnated since the late 1970s [*O'Sullivan, 1995; O'Malley, 1999; Barry et al., 1999*]. As a result, there was another policy shift in the mid 1980s towards a more targeted approach, especially towards the development of indigenous firms. The new policy regime was set out most clearly in the 1984 *White Paper on Industrial Policy* [*O'Malley, 1999: 228*]. According to O'Malley, the White Paper recognised that:

> ...there were limits to the benefits that could be expected from foreign investment and that the relatively poor long-term performance of indigenous industry called for a greater focus of addressing that problem. More specifically, policy statements since 1984 have referred to a need for policy towards indigenous industry to be more *selective*, aiming to develop larger and stronger firms with good prospects for sustained growth in international markets, rather than assisting a great many firms indiscriminately. *Policy was intended to become more selective*, too, in the sense of concentrating state supports and incentives more on correcting specific areas of disadvantage or weakness which would be common in indigenous firms (but not so common in foreign-owned firms), such as technological capability, export marketing and skills. It was intended to shift expenditures on industrial policy from supporting capital investment towards improving technology and export marketing. [*O'Malley, 1999: 228; emphasis added*]

As a result, after the mid 1980s,

> ...the award of [capital investment] grants was increasingly dependent on firms having prepared overall company development plans. With a view to obtaining better value for state expenditure, the average rate of capital grant was reduced after 1986, *performance-related targets were applied as conditions for payment of grants*, and there was the beginning of a move towards repayable forms of financial support such as equity financing rather than capital grants. [*O'Malley, 1999: 229; emphasis added*][14]

An increasing share of government grants was directed to capability-upgrading activities (for example, research and development, training, management development) rather than simple physical investment [*Sweeney, 1998: 133*]. Moreover, the government started explicitly targeting industries into which they wanted to attract FDI – emphasis was given to industries such as electronics, pharmaceuticals, software, financial services, and teleservices [*Sweeney, 1998: 128*].

Following the re-direction of FDI policy, there was a rise in high-quality FDI, with stronger linkages to indigenous firms. Largely as a result of this, the economy started to boom again. Manufacturing employment, which fell by 20 per cent during 1979–87, rose by 13 per cent during 1988–96, in large part due to the increase in FDI but also due to the improvement in the performance by indigenous firms [*O'Malley, 1999: 230*].

3. Lessons from the Experiences of Finland and Ireland

Finland and Ireland are arguably among the most impressive cases of industrial transformation in the second half of the twentieth century in Europe. However, their respective policies towards foreign investment could not have been more different, at least until Finland's accession to the EU in 1993 – Finland basically blocking any significant foreign investment, while Ireland aggressively seeking it out.

The comparison of these two polar cases raises two important points. The first is that there is no one-size-fits-all foreign investment policy that works for everyone. Finland built its economic miracle under arguably one of the world's most restrictive policy regimes *vis-à-vis* foreign investors, while Ireland benefited from actively courting and working with TNCs.

The second is that, however 'liberal' a country may be towards foreign investment, a targeted and performance-oriented approach works better than a hands-off approach, which is recommended by the developed countries today. Even in the case of Ireland, a combination of carrots and sticks has been used *vis-à-vis* the foreign investors since the early days, and it was only when it got the balance between the two right that the country started to truly benefit from FDI.

The East Asian Countries

1. Japan

Japan's restrictive stance towards FDI is well known. From the Meiji period on, it has tried its best to discourage FDI and go for technology licensing whenever feasible. Even during the first half of the twentieth century, when Japan took a more permissive stance towards FDI than either before or after – for example, the American TNCs dominated the automobile industry during the time – FDI remained small in scale and much of it remained joint ventures [*Yoshino, 1970: 346*].

Between the Second World War and the mid 1960s, when there was some liberalisation of FDI, the FDI policy regime remained extremely restrictive. In particular, before 1963, foreign ownership was limited to 49 per cent, while in some 'vital industries' FDI was banned altogether. Consequently, FDI accounted for only 6 per cent of total foreign capital inflow between 1949 and 1967 [*Yoshino, 1970: 347*].

There was some relaxation in policy over time, but it was a very slow and gradual process. After 1963, foreign ownership of over 50 per cent was allowed, even in some hitherto prohibited 'vital industries' [*Yoshino, 1970: 349*]. However, 'each investment application had to go through individual screening and was rigorously examined by the Foreign Investment Council' [*p. 349*]. And 'the criteria for screening foreign investment were stated with characteristic vagueness, giving the government officials and the Foreign Investment Council considerable latitude' [*p. 350*].

In 1967, FDI was further liberalised. However, even this was highly restrictive (the following details are from Yoshino [*1970: 361–3*]). The 1967 liberalisation 'automatically' allowed a maximum of 50 per cent foreign ownership in 33 industries (so-called 'Category I industries'), but this was on condition that: 1) the Japanese partner in the joint venture must be engaged in the same line of business as the contemplated joint venture, while one Japanese partner must own at least one-third of the joint venture; 2) the Japanese representation on the board of directors must be greater than the proportion of Japanese ownership in the venture; and 3) there should be no provision that the consent of a particular officer or a stockholder be required to execute corporate affairs – a hardly 'automatic' approval! And these were industries where the Japanese firms were already well established and therefore not attractive to foreign investors (for example, household appliances, sheet glass, cameras, pharmaceuticals, and so on), as proven by the fact that 'more than a year went by before the first joint venture was established' [*Yoshino, 1970: 363*]. In the 17 'Category II industries', 100 per cent foreign ownership was allowed, but these were industries where the Japanese firms were even more securely established (ordinary steel, motorcycles, beer, cement, and so on). And importantly, in both categories, 'brownfield' FDI was not allowed.

Further liberalisation in 1969 added 135 and 20 industries to Categories I and II respectively. This round of liberalisation deliberately included a number of attractive industries in order to diffuse foreign criticisms, but they were mostly unattractive to foreigners. Some strategic industries (especially, distribution, petrochemicals and automobiles) were considered as possible candidates for FDI liberalisation, but in the end the proposal was rejected. A hardly surprising decision, when the total output of Japanese industry (which was already the second largest in the world) was less than half that of General Motors, whose annual sales were larger than Japan's national budget, while the total outstanding shares of Toyota Motors at current market value were only about one-fifth of the annual profit of General Motors [*Yoshino, 1970: 366–7*].

The highly restrictive policy stance has been maintained in subsequent periods despite gradual liberalisation of FDI at the formal level. As in Germany and many other European countries, FDI was further constrained by the existence of informal defence mechanisms against hostile take-over, especially the cross-shareholding arrangements that lock up 60–70 per cent of the shares in friendly hands (major lending banks, related enterprises).

Consequently, Japan was arguably the least FDI-dependent country outside the socialist bloc. Between 1971 and 1990 (the post-1995 data are not available, but there is no indication that the situation has drastically changed), FDI accounted for only about 0.1 per cent of total fixed capital formation in the country (data from UNCTAD, various years). The developed country average was 3.5 per cent for the 15-year period before the late 1990s merger boom (that is, 1981–95).

2. Korea

While Korea has not by any means been hostile to foreign capital *per se*, it clearly preferred, if the situation allowed, for it to be under 'national' management, rather than relying on TNCs (the following heavily draws from Chang [*1998*]; for some more details, refer to *Koo [1993]*). According to Amsden, only 5 per cent of the total foreign capital inflow into Korea between 1963 and 1982 (excluding foreign aid, which was important until the early 1960s but not beyond) was in the form of FDI [*Amsden, 1989: 92, table 5*]. Even for the 1962–93 period, this ratio remained a mere 9.7 per cent, despite the surge in FDI that followed liberalisation of FDI policy in the mid 1980s [*Lee, 1994: 193, Table 7–4*].

The Korean government designed its FDI policy on the basis of a clear and rather sophisticated notion of the costs and benefits of inviting TNCs, and approved FDI only when they thought the potential net benefits were positive. The Korean government's 1981 *White Paper on Foreign Investment* provides a fine specimen of such policy vision [*see EPB, 1981*]. This White Paper lists various benefits of FDI such as investment augmentation, employment creation, industrial 'upgrading' effect, balance of payments contribution, and technology transfer, but is also clearly aware of its costs arising from transfer pricing, restrictions on imports and exports of the subsidiaries, 'crowding out' of domestic investors in the domestic credit market, allocative inefficiencies due to 'non-competitive' market structure, retardation of technological development, 'distortion' of industrial structure due to the introduction of 'inappropriate' products, and even the exercise of political influences by the TNCs on the formation of policies [*EPB, 1981: 50–64*]. It is interesting to note that this list includes more or less all the issues identified in the academic debates.

The policies towards TNCs employed by Korea have had a number of elements, but the most important was clearly the restrictions on entry and ownership. Initially, until the early 1970s, when the level of FDI was low, the government was quite willing to allow 100 per cent foreign ownership, especially in the assembly industries in free trade zones which were established in 1970. However, as the country tried to move into more sophisticated industries, where development of local technological capabilities is essential, it started restricting foreign ownership more strongly [*Lee, 1994: 187–8*].

To begin with, there were policies that restricted the areas where TNCs could enter. Until as late as the early 1980s, around 50 per cent of all industries and around 20 per cent of the manufacturing industries were still 'off-limits' to FDI [*EPB, 1981: 70–1*]. Even when entry was allowed, the government tried to encourage joint ventures, preferably under local majority ownership, in an attempt to facilitate the transfer of core technologies and managerial skills.

Even in sectors where FDI was allowed, foreign ownership above 50 per cent was prohibited except in areas where FDI was deemed to be of 'strategic' importance, which covered only about 13 per cent of all the manufacturing industries [*EPB, 1981: 70*]. These included industries where access to proprietary technology was deemed essential for further development of the industry, and industries where the capital requirement and/or the risks involved in the investment were very large. The ownership ceiling was also relaxed if: i) the investment was made in the free trade zones; ii) the investment was made by overseas Koreans; or iii) the investment would 'diversify' the origins of FDI into the country – that is, if the investment was from countries other than the US and Japan, which had previously dominated the Korean FDI scene [*for details*, *see EPB*, *1981: 70–1*].

As a result, as of the mid 1980s, only 5 per cent of TNC subsidiaries in Korea were wholly owned, whereas the corresponding figures were 50 per cent for Mexico and 60 per cent for Brazil, countries which are often believed to have had much more 'anti-foreign' policy orientations than that of Korea [*Evans, 1987: 208*].

Policy measures other than the ones concerning entry and ownership were also used to control the activities of TNCs in accordance with national developmental goals. First, there were measures to ensure that the 'right' kinds of technology were acquired on the 'right' terms. The technology that was to be brought in by the investing TNCs was carefully screened and checked whether it was not overly obsolete or whether the royalties charged on the local subsidiaries, if any, were not excessive.

Second, those investors who were more willing to transfer technologies were selected over those who were not, unless the former were too far behind in terms of technology.[15] Third, local content requirements were quite strictly imposed, in order to maximise technological spillovers from the TNC presence. One thing to note, however, is that the targets for localisation were set realistically, so that they would not seriously hurt the export competitiveness of the country – in some industries they were more strictly applied to the products destined for the domestic market.

The overall result was that, together with Japan, Korea has been one of the least FDI-dependent countries in the world. Between 1971 and 1995, FDI accounted for less than 1 per cent of total fixed capital formation in the country (data from UNCTAD, various years), while the developing country average for the 1981–95 period (pre-1980 figures are not available) was 4.3 per cent.

FDI began to be liberalised since the mid 1980s and was drastically liberalised following the 1997 financial crisis. This was not only because of International Monetary Fund (IMF) pressure but also because of the decision, right or wrong, by some key Korean policy-makers that the country cannot survive unless it allows its firms fully to be incorporated into the emerging international production network. Whether their decision was right remains to be seen.

3. Taiwan

Taiwan took a similar attitude towards FDI to that of Korea, and has used all the measures that Korea used in order to control FDI [*see Wade, 1990: 148–56,* and *Schive, 1993, for further details*]. However, Taiwan's FDI policy has had to be somewhat more tempered than that of Korea for two reasons. First, due to the relative absence of large domestic private sector firms, which could provide credible alternatives to (or joint venture partners with) TNCs, the Taiwanese government had to be more flexible on the ownership question. Therefore, in terms of ownership structure of TNC subsidiaries Taiwan was somewhere in between Korea and Latin America, with 33.5 per cent of the TNC subsidiaries (excluding the ones owned by overseas Chinese) being wholly owned as of 1985 [*Schive, 1993: 319*]. Second, during the 1970s, when the diplomatic winds blew strongly in favour of China, Taiwan made efforts to host big-name TNCs, especially from the US, by offering them exceptional privileges (for example, guaranteed protection against imports) in order to strengthen its diplomatic position [*Wade, 1990: 154–5*].

Despite these constraints,

> '[f]oreign investment proposals have been evaluated in terms of how much they open new markets, build new exports, transfer technology, intensify input-output links, make Taiwan more valuable to multinationals as a foreign investment site and as a source for important components, and enhance Taiwan's international political support. [*Wade, 1990: 150*]

The 1962 guidelines on foreign investment, which were the backbone of Taiwan's FDI policies, limited FDI to 'industries which would introduce new products or direct their activities toward easing domestic shortages, exporting, increasing the quality of existing products, and lowering domestic product prices' [*Wade, 1990: 150, f.n. 33*]. This meant that, like in Korea, the favoured types of FDI kept changing with the changes in the country's economic and political conditions. For example, after an encouragement during the 1960s, FDI in labour-intensive industries was discouraged or prevented in the 1970s [*Wade, 1990: 151*].

First of all, although in a weaker form than in Korea, foreign ownership was restricted. There was, in particular, a restriction on the extent to which foreign investors could capitalise on their technology. In the case of a joint venture, the technology could not be valued at more than 15 per cent of the TNC's equity contribution [*Wade, 1990: 152*]. Second, local content requirements were extensively used, although, as in Korea, they were typically less tough for export products (see Wade [*1990: 151–2*] for details on the operation of local content requirements).[16] In some cases, the government gave approval for investment on the condition that the TNC help its domestic suppliers to upgrade their technology [*Wade, 1990: 152*].

Third, export requirements were also widely used [*Wade, 1990: 152*]. This was initially motivated by the foreign exchange consequences of FDI but it was kept even after Taiwan had no more foreign exchange shortage, because it was seen as a way to 'insure that the [foreign] company brings to Taiwan a technology advanced enough for its products to compete in other (generally wealthy Western) markets' [*Wade, 1990: 152*].

The overall result was that, although somewhat more dependent on FDI than were Japan or Korea, Taiwan was one of the less FDI-dependent countries in the world. Between 1971 and 1999, FDI accounted for only about 2.3 per cent of total fixed capital formation in the country (data from UNCTAD, various years), while the developing country average for the 1981–95 period (pre-1980 figures are not available) was 4.3 per cent.

4. Lessons from the East Asian Experience

Like the US in the nineteenth century, the three largest East Asian 'miracle' economies have tried to use foreign capital under national management as much as they can, and consequently have used extensive controls on foreign investment in terms of ownership, entry, and performance requirement, throughout their developmental period. Especially Japan and Korea (until recently) relied very little on FDI, while even Taiwan, the most FDI-friendly among the three countries, was below the international average in its reliance on FDI.

Their approach was decidedly 'strategic' in the sense that, depending on the role of the particular sectors in the overall developmental plan of the time, they applied very liberal policies in certain sectors (for example, labour-intensive industries established in free trade zones in Korea and Taiwan) while being very restrictive in others. It goes without saying that therefore the same industry could be, and has been, subject to relatively liberal treatments at some point but became subject to more strict regulations (and vice versa), depending on the changes in the external environment, the country's stage of development, and the development of the indigenous firms in the industries concerned. Especially the experiences of Korea and Taiwan, which provided extensive financial incentives to TNCs investing in their countries while imposing extensive performance requirements, show that FDI brings the most benefit when carrots are combined with sticks, rather than when either carrots or sticks alone are used.

III. IMPLICATIONS: LESSONS OF HISTORY

My recent book, *Kicking Away the Ladder*, shows that, when they were in 'catching-up' positions and trying to establish their industries against the competition from the more efficient producers of the more advanced countries, virtually none of today's developed countries pursued the free trade policies that they are so eager to impose on the developing countries today [*Chang, 2002: Ch. 2*]. An examination of their policies in relation to foreign investment reveals the same picture. In short, when they were net recipients of foreign investment, all of today's developed countries imposed strict regulation on foreign investment. Almost all of them restricted entry of foreign investment. Very often, the entry restrictions were directly imposed, ranging from a simple ban on entry into particular sectors to the allowance of entry on certain conditions (for example, requirement for joint venture, ceilings on foreign ownership).

However, in some cases the scope for foreign investment was also restricted through informal mechanisms that prevented hostile acquisitions and take-overs by foreign investors ('brownfield' investment). First of all, they achieved this through the presence of SOEs or by the government holding significant minority shares in enterprises in the key sectors – for example, the 20 per cent of Volkswagen shares owned by the state government of Lower Saxony. Even when privatising the SOEs, some of these governments, notably that of France, made sure that a controlling stake was held by friendly 'core' shareholders. Others, such as the US and Finland, restricted the entry of foreign investment by regulating the forms of corporate governance – they explicitly required, at least in some key sectors, that all members of boards of directors be citizens and that non-resident foreign shareholders could not vote, which obviously discouraged potential foreign investors, who were not given control commensurate to their ownership status.

When entry was allowed, governments placed numerous performance requirements on investors. Some of the requirements were put in place for balance of payments reasons, such as export requirements, foreign exchange balancing requirements, or ceilings on licensing fees. However, most were put in place in order to ensure that local businesses picked up advanced technologies and managerial skills from their interaction with foreign investors, either through direct transfer or through indirect spillover. Local content requirements and explicit requirements for technology transfer were the most obvious ways to ensure this. Some countries, such as Taiwan, took this logic further and explicitly required foreign investors to help their local suppliers to upgrade their technology. Bans on majority foreign ownership or the encouragement of joint ventures were also ways to encourage the transfer of key technologies and managerial skills. A ban on the employment of foreigners, as used in the US in earlier times, can also increase the chance that skills are directly transferred to the locals.

Even when there were no formal performance requirements, most developed countries used them informally, as we mentioned above. And even the local contents requirement, which was made 'illegal' by the trade-related investment measures (TRIMs) agreement, is still being used by the non-Asian developed countries, albeit under a different guise. The 'rules of origin' used by the EU and the North American Free Trade Agreement (NAFTA), by specifying the local contents of products that qualify for the preferential treatment in the regional free-trade agreements, effectively set local contents requirements for foreign investors in strategic industries (although 'local' here has been expanded beyond old national borders). The EU has strict rules of origin in automobiles, semiconductors, textiles and apparel, photocopiers, and telecom switching equipment, while the NAFTA has them in relation to colour televisions, computers, telecommunications equipment, office equipment, automobiles, machine tools, forklift trucks, fabricated metals, household appliances, furniture, tobacco products, and textiles [*for further details,* see *Kumar, 2001: 3,152, Box 1*].

As in the case of trade policy, the exact strategies that were used to regulate foreign investment varied across countries, ranging from the very welcoming (but not *laissez-faire* and increasingly selective over time) strategy of Ireland to the very restrictive strategies of Finland, Japan, Korea, and the nineteenth century US in certain sectors (especially finance and navigation). In other words, there was no 'one-size-fits-all' model of foreign investment regulation. However, one common factor is that they all took a *strategic approach* to the issue of foreign investment regulation. This meant that different sectors could be subject to different policies even at the same point in time. For example, Korea and Taiwan applied liberal policies towards FDI in labour-intensive industries while applying very restrictive policies towards FDI in the more technologically advanced industries, where they wanted to build local technological capabilities.

Also, over time, with changes in their economic structure and external conditions, their policy stances changed. After it had exhausted the benefits that it could gain from the inflow of export-oriented labour-intensive FDI, Ireland shifted from a rather permissive and unfocused foreign investment policy to a focused and selective one in the mid 1980s, in order to 'upgrade' the contents of FDI. As another example, Korea had a relatively open policy towards FDI in the automobile sector until the mid 1970s, but it tightened the policy afterwards in an attempt to promote domestic automobile producers. While such tightening led to the withdrawal of some foreign investors (Ford and Fiat), the policy resulted in the establishment of a spectacularly successful automobile industry.

To sum up, historical experiences of today's developed countries show that a strategic and flexible approach is essential if countries are to use foreign investment in a way that is beneficial for their long-term national interests. None of these countries pursued policies that were uncritically welcoming to foreign investment, in contrast to what many of them recommend to today's developing countries. In light of these lessons, we can conclude that the current proposals made by the developed countries in the WTO in relation to foreign investment regulation go directly against the interests of the developing countries.

IV. POSSIBLE OBJECTIONS

When criticised along the above line, the proponents of an MIA come back with a few objections that may seem plausible at first sight. However, their objections lack in logic and empirical supports.

'Times Have Changed' – The Irrelevance of History?

The most typical response to the historical criticism that we advanced above is to argue that 'times have changed'. It is argued that, thanks to globalisation in the recent periods, restrictive foreign investment policies that may have been beneficial in the past – say, in Japan in the 1960s or Korea in the 1970s – are no longer so. They argue that, with the increased mobility of capital, foreign investment is becoming more and more important in determining a country's competitive position in the world economy, and therefore that any regulation of foreign investment is likely to harm the potential host country.

One obvious problem with this argument is that there is no clear evidence that we are now living in such a 'brave new world' that all past experiences have become irrelevant. The world may have become much more globalised than, say, in the 1960s and the 1970s, but it is not clear whether globalisation has progressed so much that we have had a 'structural break' with the past. The fact that China has been able to attract a huge amount of foreign investment and benefit from it despite, or rather because of, its strategic regulation of foreign investment suggests that there has been no such clean break with past patterns. Also, in another era of high globalisation, that is, during the late nineteenth and the early twentieth century, when the world economy was as much, or even more in areas like immigration, globalised as that of today [*Bairoch and Kozul-Wright, 1996; Hirst and Thompson, 1999: Ch. 2*], the US attracted by far the largest amount of foreign investment at the time and grew the fastest in the world despite having a restrictive foreign investment policy regime.

Moreover, the current process of globalisation can be reversed, if it is not carefully managed. This is because under-regulated globalisation can lead to instability and stagnation, thereby leading to political discontents and policy reversals. This is exactly how the earlier phase of globalisation had been reversed between the First World War and the Second World War, and we have every sign that the world may be moving that way again.

We have suffered enough in the past from people who think they can transcend history and build a 'brave new world' that has an entirely new set of laws and rules. The Cambodian Communist leader Pol Pot, who declared 'year zero', may be the most extreme example of this, but the now-discredited gurus of the 'new economy' also suffered from the same delusion. We ignore history at our own peril.

'We Want to Protect the Developing Countries from Harming Themselves'

Some proponents of the MIA admit that in the past some countries have successfully regulated foreign investments for their benefits, although when they say this they are mainly thinking about the more recent examples such as Japan, Korea, and Taiwan in the post-war period, rather than the US in the nineteenth century or Finland since the mid-twentieth century. They argue, however, they still want to install an MIA because in many more cases, especially in the developing countries, foreign investment regulation has had negative effects. If left alone, they argue, many developing countries are likely to repeat the mistakes of the past, and therefore having constraints on their policy freedom will actually protect them from making mistakes.

This is a curious argument. Those who want an MIA tend to be free-market economists who criticise various interventionist policies at the domestic level for being 'paternalistic' and restricting the 'freedom of choice'. But when it comes to the choices for the developing countries, they seem to see no contradiction in taking that very paternalistic attitude that they so much criticise in other contexts. Even if strictly regulating foreign investment is likely to bring about 'wrong' outcomes – which we do not accept – one should allow countries 'the right to be wrong', if one is a consistent free-market economist who wants to preserve freedom of choice and who does not believe in top-down intervention.

'The Agreement Can Be Made Flexible Enough – We Simply Want Certainty'

Another typical response to our line of argument, which especially comes from the EU negotiators, is that the MIA need not harm the developing countries, as it can be negotiated in such a way that there is enough policy flexibility. Proponents of an investment agreement argue that developing country 'policy space' can be guaranteed by making the agreement extremely flexible. Especially emphasised is the General Agreement on Trade in Services (GATS)-style positive list approach that they propose, where the MIA would apply only to sectors that countries explicitly designate. This way, the proponents argue, countries can shut as many sectors as they like from foreign investment for as long as they want. For example, Fabien Lecroz, the EU negotiator, told non-governmental organisations at a Geneva seminar on 20 March 2003: 'you could be a WTO member, a signatory of an investment agreement, and keep your market completely closed to FDI, and with no national treatment. That is your policy choice.'

One immediate question that arises in one's mind is: if so much flexibility is allowed, why bother with an agreement? The proponents of an MIA say they still think an MIA is important because it gives certainty to foreign investors about the host country policies. They argue that enhanced certainty will help developing countries as well, because it will increase the flow of foreign investments into them.

However, when all empirical evidence shows that policy certainty is at best only a minor determinant of foreign investment flows, this is a rather curious attitude to take, given that whatever little additional investment a country attracts should come at the cost of reduced flexibility.

More importantly, the flexibility that is offered by the proponents of an MIA is a very curious sort of flexibility, as it is highly limited and one-way. It is highly limited because once you open up a sector, there is no flexibility within that sector. The only 'flexibility' that is available is regulation based on balance of payments considerations, but this is only a temporary arrangement. It is one-way, because once you open up a sector, it is going to be extremely difficult, if not completely impossible, to re-regulate that sector.

Moreover, when non-discrimination is a 'core principle' of the WTO and part of its institutional DNA, however much flexibility is initially provided, there will be an inevitable tendency for negotiators to chip away at developing countries' national policy space in this and successive rounds of negotiations, forcing them into a developmentally premature application of national treatment to FDI. The recent leak of the EU's requests under the GATS process amply justifies these fears [*World Development Movement, 2003, also see the appendix*].

'An MIA in the WTO is the Lesser of the Two Evils' – The Fears of Bilateral Investment Treaties and Regional Trade Agreements

Some developing country negotiators who are aware of the restrictions that an MIA is going to place on their countries' policy freedom still argue that they want an MIA because it is the lesser of two evils. They argue that, in the absence of an MIA, powerful countries, especially the increasingly unilateralist US, will put pressure on developing countries to adopt bilateral investment treaties (BITs), which are bound to be more restrictive than any MIA through the WTO. In addition, some countries worry that similar pressure will come through regional trade agreements (RTAs). In particular, the Latin American countries fear that they will be forced to adopt a NAFTA-style high-octane investment agreement through the negotiation for the Free Trade Agreement of the Americas (FTAA), if they are not protected by an MIA.

While it is true that BITs and RTAs can be more restrictive than an MIA, this is not a foregone conclusion. There are well-informed observers who think BITs can at least actually provide more flexibility. Kumar [*2001: 3,157*] argues that the existence of some 1,700 BITs as of 2000 is evidence that the greater flexibility that BITs give makes its conclusion easy. Also, BITs and RTAs, involving smaller numbers of parties, may be slightly more re-negotiable than an MIA.

Moreover, it is not as if the developed countries are going to give up existing BITs and RTAs or stop pushing for new ones, if an MIA is agreed in the WTO. The MIA will simply be an add-on, rather than a replacement for BITs and RTAs. Indeed, the experience with the trade-related intellectual property rights (TRIPS) agreement shows that, once adopted, a multilateral agreement tends to be interpreted as a 'floor' in bilateral negotiations, thereby raising the standards expected in bilateral agreements [*Kumar, 2003: 223*]. The likely result is that the MIA will form the floor and developing countries will be put under pressure to concede even more policy freedom in BITs.

V. CONCLUDING REMARKS

My historical examination shows that the developed countries did not use the liberal foreign investment policy that they ask of the developing countries, when they were developing countries themselves. Although there were important differences in terms of the overall strategies and the exact policy tools used across countries, most of today's developed countries used formal policy measures and informal restrictions in order to align the interests of foreign investors with their national interests, when they were mainly receiving FDI.

The US, now a champion for the rights of foreign investors, used to regulate foreign investment quite heavily until the early twentieth century. As another example, when the UK, France, and Germany became net capital-importers after the Second World War, they introduced a lot of formal and informal regulations on foreign investment. As members of the EU, they are now among the strongest advocates of MIA. Japan and Korea used to regulate foreign investment very heavily, although they are now strong advocates of MIA.

Of course, the changes in the global economic conditions make it neither feasible nor necessarily desirable for the developing countries to exactly replicate the strategies used by the developed countries in the past [*for a detailed discussion, see Lall, 2003*]. Technological changes have made the minimum entry requirements into industries higher. This means that the kind of 'autonomous' strategy pursued by countries like Japan, Finland, and Korea that did not welcome TNCs may be less feasible now. At the same time, with the emergence of global production networks in certain industries, there may be a higher chance than before that developing countries can develop through a tighter integration into the existing TNC networks.

Even considering these changes, however, restricting the measures of foreign investment regulation is likely to severely limit the development prospect of developing countries, as there is a clear limit to developing technological and organisational capabilities through 'non-autonomous' integration into the global production networks organised by TNCs [*Lall, 2003*]. Historical experiences of the developed countries also support this view.

Unfortunately, many of these measures have become 'illegal' due to existing agreements in the WTO such as the TRIMs agreement or the GATS. And already the review of TRIMs and the negotiation for GATS-2 are threatening to make illegal even more of those measures that are still available. If an MIA is added on top of this, virtually none of the measures used by now-developed countries in the past will be available for the developing countries. And even if countries can come up with some novel policy measures, they are likely to be thwarted by the all-powerful principle of 'national treatment' that is at the heart of the MIA proposal.

History never repeats itself. However, we ignore a pattern in history that has manifested itself over and over again at our peril – in our case, the need to regulate foreign investment in the earlier stage of economic development. The developed countries should stop pushing for an MIA and allow the developing countries a greater policy space in terms of the regulation of foreign investment. If the developed countries get their way in pushing for a comprehensive ban on foreign investment regulation, as well as a virtual elimination of industrial tariffs and subsidies, the developing countries will be condemned to low-productivity activities in the foreseeable future.

NOTES

1. Even until as late as 1914, when it had caught up with the UK and other leading nations of Europe, the US was one of the largest net borrowers in the international capital market. The authoritative estimate by Wilkins [*1989: 145, Table 5.3*] puts the level of US foreign debt at $7.1 billion, with Russia ($3.8 billion) and Canada ($3.7 billion) trailing in distance. Of course, at that point, the US, with its estimated lending at $3.5 billion, was also the fourth largest lending country, after the UK ($18 billion), France ($9 billion), and Germany ($7.3 billion). However, even after subtracting its lending, the US still has a net borrowing position of $3.6 billion, which is basically the same as the Russian and the Canadian ones.
2. However, the Second Bank of the USA was only 30% owned by foreigners, as opposed to 70% in the case of the First Bank of the USA, its predecessor (1789–1811) [*Wilkins, 1989: 61*].
3. Wilkins [*1989: 84, n. 264*] says that similar remarks were made by politicians in the debate surrounding the renewal of the charter of the First Bank of the USA.

4. At the time the territories were North Dakota, South Dakota, Idaho, Montana, New Mexico, Utah, Washington, Wyoming, Oklahoma, and Alaska. The Dakotas, Montana, and Washington in 1889, Idaho and Wyoming in 1890, and Utah in 1896 acquired statehood, and thus stopped being subject to this Act.
5. The 1866 law said that '[t]he mineral lands of the public domain . . . are hereby declared to be free and open to exploration by all citizens of the United States and those who have declared their intention to become citizens, subject to such regulations as may be prescribed by law, and subject also to the local customs or rules of miners in the several mining districts' [*Wilkins, 1989: 128*].
6. According to the authoritative study by the IMF published in 1984, the average share of the SOE sector in GDP among the industrialised countries as of the mid 1970s was 9.4%. The share was 10.3% for West Germany (1976–77), 11.3% for the UK (1974–77), and 11.9% for France (1974) – all above this average.
7. In Germany, corporations are governed not simply by the board of directors, but also by the supervisory board, which contains an equal number of representatives from the workers and from the management (with the casting vote on the management side). This is called the co-determination system and has been a foundation stone of Germany's 'social market economy' after the Second World War.
8. During the 1970s and 1980s, Germany's FDI as a share of Gross Domestic Capital Formation (of course, the two numbers are not strictly comparable) was just 1–2%, whereas the corresponding figure ranged between 6 and 15% in the UK. The figures are calculated from various issues of the UNCTAD *World Investment Report*.
9. The 16 countries are, in alphabetical order, Australia, Austria, Belgium, Canada, Denmark, Finland, France, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland, West Germany, the UK, and the US.
10. Despite the massive external shock that it received following the collapse of the Soviet Union, which accounted for over one-third of its international trade, Finland ranked at a very respectable joint-fifth among the 16 countries in terms of per capita income growth during the 1990s. According to the World Bank data, its annual per capita income growth rate during 1990–99 was 2.1% (the same as that of the Netherlands), exceeded only by Norway (3.2%), Australia (2.6%), and Denmark and the US (2.4%).
11. From the twelfth century until 1809, it was part of Sweden, then it existed as an autonomous Grand Duchy in the Russian empire until 1917.
12. See: www.investinfinland.fi/topical/leipa_survey01.htm, page 1. Interestingly, the government investment-promotion agency, Invest in Finland, emphasises that 'Finland does not "positively" discriminate foreign-owned firms by giving them tax holidays or other subsidies not available to other firms in the economy' [www.investinfinland.fi/topical/leipa_survey01.htm, page 2].
13. Interestingly, according to McCulloch and Owen [*1983: 342–3*] the same survey reveals that over one-half of all foreign subsidiaries in Korea and Taiwan benefit from some form of investment incentive. This is high even by the standards of the developed countries, which were in the 9–37% range as reported in table 6.1 of Young et al. [1988*: 200*] (Japan 9%, Switzerland 12%, Canada and France 18%, Germany 20%, Belgium 26%, Italy 29%, UK 32%, Australia 37%). Given that Korea and Taiwan are countries that were also infamous for imposing tough performance requirements (see below), this piece of evidence, together with the Irish example, suggests that both carrots and sticks are needed for a successful management of FDI.
14. In light of the fact that Ireland was already a country with a high level of performance requirement for TNCs before these changes (see above), it seems reasonable to conclude that performance requirements for the recipients of state grants (domestic or foreign) must have become even greater.
15. For example, the Korean government chose in 1993 the Anglo-French joint venture (GEC Alsthom) organised around the producer of the French TGV (high-speed passenger train), as the partner in its new joint venture to build the country's fast train network. This was mainly because it offered more in terms of technology transfer than did its Japanese and German competitors who offered technologically superior products [*Financial Times*, 23 August 1993, as cited in *Chang, 1998: 108*].

16. For example, the 1962 Guidelines subjected industries such as refrigerators, air conditioners, transformers, televisions, radios, cars, motorcycles, tractors, and diesel engines to local content requirements [*Wade, 1990: 150–51, f.n. 33*].

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