PART THREE

POLICY ISSUES

Chapter VII

Liberalizing foreign-direct-investment policies

Introduction

Since the early 1980s, more and more countries have changed their policies on foreign direct investment (FDI), with a view towards encouraging and facilitating it.[1] Developing countries, in particular, are increasingly turning to FDI as a source of capital, technology, management practices, know-how, access to markets and other resources that are vital for sustained economic growth. This trend has become more widespread during the early 1990s, as more developing countries and economies in transition have joined the process of liberalization (table VII.1).

These liberalization efforts at the national level have received further impetus in 1993 from a number of important developments at the international level. The number of bilateral treaties for the promotion and protection of FDI concluded by developed countries has increased from 506 in January 1993 to 570 in January 1994 (table VII.2 and annex table 6). The North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States was ratified. (The implications of NAFTA for the pattern of FDI were analyzed in UNCTAD-DTCI, 1993a). In addition, efforts continue at the Organisation for Economic Co-operation and Development to formulate a broader investment instrument (box VII.1). Finally, the most important development was the conclusion of the Uruguay Round of Multilateral Trade Negotiations. This chapter looks first at the implications of the Uruguay Round agreements for FDI before turning to the broader issue of the concept and status of the process of liberalization of FDI policies.

A. Implications of the Uruguay Round for foreign direct investment

The Uruguay Round negotiations were completed on 15 December 1993 and the results were formally adopted in Marrakesh on 15 April 1994. Chief among them is the *Agreement Establishing the World Trade Organization* to which a number of agreements on trade in goods, trade in services and on trade-related aspects of intellectual property rights are annexed. Individual country ratification of these agreements is now underway, the common objective being their entry into force by 1 January 1995, or as early as possible thereafter.

The Final Act of the Uruguay Round contains a package of economic reforms that touches on key economic transactions within the global economy (GATT, 1994). Foreign direct investment, however, was not explicitly negotiated in the Uruguay Round, although a number of the issues discussed there had a notable investment dimension. The effect of the Uruguay Round on FDI is, therefore, partly indirect, arising from an overall strengthening of investors' confidence in the world trading system; the dynamic impact of freer trade on growth and, hence, on FDI; and the impact of tariff reduction on trade and investment. But the effect is also direct, namely where the agreements specifically deal with FDI.

The conclusion of the Uruguay Round is of major importance for the investment climate around the world, both domestic and foreign. Failure to conclude the Round would have been a serious blow to business confidence and would have signalled a risk of trade wars. On the other hand, its successful conclusion is a significant boost for business confidence in the international economy today. Indeed, the general strengthening of the trading system and the extensive liberalization of market access that has been negotiated should open up new possibilities for productive and mutually beneficial investments, both foreign and domestic, in line with the location advantages of countries.

It has been estimated that *annual* increases in national incomes brought about by the trade-liberalization measures of the Final Act as a result of increased efficiency are of the order of at least $230 billion by 2005 (measured in 1992 dollars) (François, McDonald and Nordström, 1993, p. 10). Estimates that have been published on the impact of the results of the Uruguay Round on world

Table VII.1. Liberalization measures, 1991 and 1992
(Number)

Item	*Year* 1991	*Year* 1992
Number of countries that have introduced changes in their investment regimes	35	43
Number of changes	82	
Of which:	80	79
· In the direction of liberalization	2	79
· In the direction of control	-	-

Source: UNCTAD-DTCI, 1993a, UN-TCMD, 1992a.

trade have been based on analytical approaches that do not take into account the dynamic effects on, for example, confidence, investment and growth. There are significant benefits in terms of boosting foreign investors' confidence associated with the conclusion of the Uruguay Round. These intangible benefits are dynamic and go beyond estimates of the initial impact of the Final Act provisions on world growth. By raising investors' confidence in the multilateral framework governing international trade, the Uruguay Round is expected to influence positively FDI, especially those types of investment (such as export-oriented or efficiency-seeking) for which the free movement of intermediate and final goods is an important consideration for investing abroad.

Table VII.2.
Bilateral investment treaties concluded by developed countries during 1993 [a]

	Treaties concluded during 1993						
Country	*Total number concluded until January 1993*	*Africa*	*Asia*	*Latin America and the caribbean*	*West Asia*	*Central and Eastern Europe*	*Total number as of January 1994*
Australia	7	-	1	-	-	2	10
Austria	14	-	-	1	-	1	16
Belgium-Luxembourg	34	-	-	-	-	1	35
Canada	6	-	-	-	-	-	6
Denmark	20	-	1	2	-	3	26
Finland	19	-	-	2	-	-	21
France	52	1	-	4	-	1	58
Germany	81	-	1	1	-	6	89
Greece	6	1	-	-	-	2	9
Iceland	-	-	-	-	-	-	-
Ireland	-	-	-	-	-	-	-
Italy	25	-	1	3	1	-	30
Japan	3	-	-	-	-	-	3
Netherlands	40	-	-	-	-	-	40
New Zealand	1	-	-	-	-	-	1
Norway	12	-	-	1	-	-	13
Portugal	5	-	-	-	-	1	6
Spain	9	-	1	1	-	-	11
Sweden	21	-	1	1	-	-	23
Switzerland	56	1	-	2	-	3	62
Turkey	22	-	-	-	1	2	25
United Kingdom	50	-	1	4	-	4	59
United States	22	-	-	1	-	2	25
Total	506 [b]	3	7	23	2	28	570 [bc]

Source: UNCTAD, Division on Transnational Corporations and Investment, based on information provided by Governments.

a For bilateral investment treaties signed after 1993, see annex table 6.

b Including a bilateral investment treaty between Japan and Turkey.

c Including a bilateral investment treaty between Finland and Turkey.

Box VII.1. A new multilateral investment agreement?

For the past several years, the OECD has been examining the feasibility of developing a new multilateral investment agreement. This effort has been prompted by the view that, while existing arrangements have been instrumental in promoting liberal investment regimes, the new international investment environment requires a single, comprehensive set of rules on FDI. It is meant to underpin the continued flow of FDI to the benefit of the world economy.

The OECD has been actively promoting the liberalization of FDI flows among its member countries for many years. Its existing instruments -- the Code of Liberalization of Capital Movements and Current Invisible Operations (1961) and the OECD Declaration of International Investment and Multinational Enterprises (1976) which includes a national treatment commitment -- have contributed substantially to the development of a favourable climate for international investment flows. While there would be certain benefits in simply combining these instruments, this would only partially address today's investment concerns. The OECD has embarked, therefore, on an effort to provide a strong, unified set of rules for FDI that would also generate greater liberalization and extend disciplines to new areas. By setting high standards of liberalization and investment protection, such an agreement is also meant to provide a model for developing countries which are rapidly becoming important FDI partners. The multilateral character of the agreement would obviate the need for reciprocity measures. At their annual meeting in June 1994, OECD ministers expressed their support for this endeavour as a contribution to strengthening the multilateral system and called for a report in 1995. [a]

It is recognized that only a broad investment instrument providing for a satisfactory balance of commitments between countries can attract the necessary support. Substantial progress has been made so far in defining the principal elements of a new agreement. These could include:

- Commitments equivalent to those of an international treaty.
- National treatment for both establishment and post-establishment.
- Liberalization rules not only for governmental measures directly affecting FDI but also, perhaps, new disciplines for dealing with, for example, restrictions resulting from the practices of private companies, governmental measures affecting individual investors or the nationality of corporate managers or members of executive boards, the freedom of key personnel to transfer from one branch of a company to another, monopolies and concessions, privatization, and so-called informal barriers to market access.
- Firm undertakings concerning measures taken at all levels of government, including states and provinces.
- Investment protection provisions, including conditions for expropriation and compensation, and rules on intellectual property.
- Formal dispute settlement arrangement which would provide procedures for state-to-state and also, possibly, investor-to-state, disputes.

OECD has an accumulated experience in developing and applying multilateral investment rules. As liberalization is already very advanced in most OECD countries, it is reasonable to expect that the highest standards of liberalization and investment protection could be achieved. It is envisaged, however, that an OECD agreement would be open to signature by non-member countries.

Business and labour have expressed support for a new multilateral investment agreement. The OECD's consultative process with the social partners ensures that the views of the international business and labour communities will be taken into consideration when elaborating the agreement.

a OECD, "Press release: Meeting of the OECD Council at Ministerial Level, Communiqué", 8 June 1994, mimeo.

It has been estimated that merchandise trade after the implementation of the Uruguay Round provisions will be around 12 per cent higher than in their absence (François, McDonald and Nordström, 1993, p. 11). Given the increasing complementarity between trade and investment flows as a result of the regional core-network and complex integration strategies pursued by TNCs that entail considerable intra-firm trade in components and other intermediate activities of the production process (including services), trade liberalization is likely to be accompanied by higher investment flows. On the other hand, enhanced market access to exporters dictated by the reduction of protectionist measures reduces the need for undertaking investments to service local markets. Nevertheless, serving domestic markets through FDI as opposed to trade has considerable advantages in terms of access to better information, proximity to customers and quick responses to changes in local tastes. Therefore, the reduction of trade barriers is unlikely to diminish the importance of these investments as a means of accessing domestic markets.

Turning to the Uruguay Round instruments of particular relevance for FDI, the *Agreement on Trade-Related Investment Measures* (TRIMs); the *General Agreement on Trade in Services* (GATS); and the *Agreement on Trade-related Aspects of Intellectual Property Rights, including Trade in Counterfeit Goods* (TRIPS) contain provisions directly affecting FDI.[2]

1. The principal relevant agreements

(a) *Trade-related investment measures*

Although this was one of the three new areas that was taken up in the Uruguay Round, the outcome of the negotiations on the TRIMs Agreement is undoubtedly much more modest than that in Services and TRIPs. In fact, the Agreement does not add to existing GATT obligations; rather it clarifies and provides a procedure that should ensure more effective compliance with the national treatment obligations of GATT (requiring that imports receive no less favourable treatment in regard to measures affecting their internal sale and use than that accorded to domestically produced goods), and with GATT rules on the prohibition of import and export restrictions (Article XI, "General Elimination of Quantitative Restrictions").

It was already clear at the outset of the negotiations that the mandate given in Punta del Este in 1986 did not envisage taking up directly key investment issues, such as the rights of establishment, national treatment of foreign companies and compensation in the event of nationalization. However, a long discussion did take place as to what were the trade-related investment measures that should be the subject of negotiation. In addition to the two major categories of measures that are explicitly covered by the final agreement, namely, domestic content and trade-balancing requirements, a substantial list of other measures was proposed by some countries for coverage. These included export-performance requirements, technology-transfer requirements, local equity requirements, remittance restrictions and investment incentives. In response, many developing countries suggested that improved international disciplines and forms of international cooperation should be negotiated with regard to restrictive business practices since, in their view, many of the measures in question were employed to offset such practices. By the time the Ministerial meeting was held in Brussels at the end of 1990, the differences in the area of TRIMs remained so wide that there was still no common negotiating basis. During the course of 1991, when the present text was negotiated, the major issue was whether export performance requirements would also be covered; this would have been an addition to the existing GATT rules and was not agreed upon in the end.

The TRIMs Agreement first clarifies that certain types of investment measures applied to enterprises, figuring on an "Illustrative List", are inconsistent with Articles III and XI of GATT. These essentially concern local content and trade-balancing requirements, but also cover restrictions on exports by enterprises. While such measures frequently arise in the context of FDI, TRIMs rules apply equally to measures imposed on domestic enterprises. The rules also apply both to measures affecting existing investments and to those applying to new investments. Second, the Agreement requires that all TRIMs inconsistent with GATT Articles III and XI and which cannot be justified under an exceptions provision in GATT, be notified to the World Trade Organization within 90 days of entry into force. Such measures, although inconsistent with existing GATT obligations, will then benefit from a period of time during which they will have to be phased out (two years for developed countries, five years for developing countries and seven years for the least-developed countries). Measures that can be justified under an exceptions provision -- notably, those relating to balance-of-payments measures -- are not affected by these rules. Moreover, these countries will have the possibility of obtaining an extension of the transition period where they can demonstrate particular difficulties. To avoid distortions of the conditions of competition between new investments and established enterprises already subject to a TRIM, members may apply the same TRIM to a new investment during the transition period. The third important feature of the TRIMs Agreement is that it provides for a review within five years, in the context of which consideration will be given to whether the Agreement should be complemented with provisions on investment and competition policy.

(b) Trade in services

The *General Agreement on Trade in Services* is of the greatest direct relevance to FDI because it covers four modes of delivery in its definition of trade in services, with commercial presence being the mode most directly linked with FDI. The modes of delivery are:

- supply from the territory of one country into the territory of another;
- supply in the territory of a country to the service consumer of another country;
- supply by a service supplier of a country, through presence of natural persons in the territory of another country;
- supply by a service supplier of one country, through commercial presence in the territory of another country. "Commercial presence" is defined as any type of business or professional establishment, including through the constitution, acquisition of maintenance of a juridical person or the creation or maintenance of a branch or representative office. It covers, therefore, FDI.

The provisions regarding commercial presence for the supply of services in a country's territory of companies and other persons of other member countries (FDI measures) concern most importantly the right of establishment and the treatment of such persons once established.

There are three categories of provisions in GATS with respect to measures affecting trade in services, including those carried out through the commercial presence of the supplier of another member country:

- The first set of provisions is applicable to all trade in services. The principal requirement is to give most-favoured-nation treatment to member countries, that is, to give treatment no less favourable than that accorded to similar services and service providers of any other member country. This obligation is subject to a once-off list of negotiated exceptions attached to the agreement that is subject to regular review and, in principle, must be phased out within ten years. Other obligations relate to matters such as the prompt publication of all laws and regulations and measures of general application affecting trade in services; the administration of all measures in a reasonable, objective and impartial manner; the availability of prompt, objective and impartial review and appropriate remedies of administrative decisions affecting trade in services at the request of an affected service supplier;

and the encouragement of mutually agreed, harmonized international criteria for the authorization, licensing or certification of service suppliers. With a view to ensuring that measures relating to qualification requirements, technical standards and licensing requirements do not constitute unnecessary barriers to trade in services, the Council for Trade in Services is required to develop any necessary disciplines.

- The second category of provisions concerns the specific commitments relating to market access and national treatment contained in the Schedules of Concessions of each of the member States. Market-access commitments relate to such matters as limitations on the number of service suppliers, on the total value of service transactions or assets and on the total number of services operations or quantity of service output, as well as commitments on measures that restrict or require specific types of legal entities or joint ventures through which a service supplier may supply a service or which limit the participation of foreign capital. Provision is also made for additional commitments to be negotiated, including those regarding qualifications, standards or licensing matters. The concession to give services and service suppliers of other member States national treatment in respect of a given service and mode of supply of that service is dependent on the inclusion of such a commitment in the Schedule of a member and is subject to any conditions or qualifications set out therein. Moreover, these Schedules also contain concessions with respect to market access through the various modes of supply, including that of commercial presence. Where specific commitments have been made, additional general requirements also apply: for example, the requirement to notify to the Council for Trade in Services any new laws, regulations or administrative guidelines significantly affecting trade in services and the requirement not to restrict international payments and transfers for current transactions, except in the event of balance-of-payments difficulties, in which case such restrictions will be limited, temporary and subject to conditions.

All members of the World Trade Organization are required to have Schedules of Services commitments. Close to 100 countries have already submitted them, and they have been attached to the *Agreement Establishing the World Trade Organization*. Least-developed countries have been given an additional period to submit their Schedules. The Schedules annexed in the Agreement differ considerably in length and coverage from country to country. It was recognized in the guidelines for the negotiation of initial commitments during the Round that such commitments by developing countries could be less comprehensive than others. No detailed analysis which would permit any general conclusions about the extent to which FDI issues are covered has as yet been made, but commitments on this subject are commonly found in the Schedules.

- The third category of substantive provisions in GATS consists of those found in various annexes relating to particular sectors of trade in services, including movement of natural persons, air transport, financial services, maritime transport and telecommunications. These provide exceptions, clarifications or additions to the general obligations in a way that takes into account the specific characteristics of services trade in those areas.

The Agreement is conceived as a framework that will permit the progressive liberalization of services trade through further negotiations. Although the initial commitments already attached to the Agreement are sizeable, further negotiations will take place at five-year intervals. Moreover, ministerial decisions taken at Marrakesh provide for negotiations in a number of areas, including those on the movement of natural persons, financial services, maritime transport and basic telecommunications, to resume without delay.

The Agreement is intended to facilitate the increasing participation of developing countries in world trade by providing for the negotiation of specific commitments on such matters as access to technology on a commercial basis, improved access to distribution channels and information networks and the liberalization of market access in services industries and modes of supply that are of special export interest to them. It also requires developed countries to facilitate access by service suppliers of developing countries to necessary commercial and technical information. The Agreement recognizes that offers of market access by developing countries may be subject to conditions relating to these objectives, for example, on such matters as the strengthening of their domestic services capacity and transferring technology on commercial terms; it further provides flexibility for developing countries to pursue their own development priorities and open fewer industries or to liberalize fewer types of transactions in further negotiations, thus making explicit their right to extend market access in line with their development situation. Special provisions are made for the least developed countries.

(c) *Trade-related aspects of intellectual property rights*

The TRIPs Agreement does not deal directly with investment issues. However, it does deal with one important aspect of the legal environment affecting the conditions under which FDI takes place, namely, the protection of intellectual property, and this is an aspect that is particularly important for a number of knowledge-intensive industries (UN-TCMD, 1993b). The Agreement covers the main areas of intellectual property rights -- copyright and related rights, trademarks, geographical indications, industrial designs, patents, layout-designs of integrated circuits and undisclosed information or trade secrets. In respect of these areas it contains two main sets of substantive obligations:

- It lays down minimum standards of substantive protection of each category of rights that must be available in the national law of each member country. It does this by requiring that the substantive obligations of the main World Intellectual Property Organisation Conventions, the Paris Convention for the Protection of Industrial Property and the Berne Convention for the Protection of Literary and Artistic Works must be complied with, and by adding a substantial number of additional obligations on matters where these Conventions are silent or seen as being inadequate.
- The Agreement, for the first time in international law, requires member countries to provide within their national law effective procedures and remedies for the enforcement of intellectual property rights, whether through the normal civil judicial process, through customs action against imports of counterfeit and pirated goods or through criminal procedures in respect of wilful counterfeiting and piracy on a commercial scale.

Developed countries are required to meet their obligations under the Agreement within one year of its entry into force; developing countries within five years; and least developed countries within eleven years, with the possibility of an extension. Special transition arrangements apply in situations whereby a developing country does not presently provide product-patent protection in a particular area of technology, such as pharmaceuticals or agricultural chemicals.

Although the TRIPs Agreement is not designed to be a harmonization instrument -- it lays down minimum standards and does not get into detail in questions of procedures -- it will have the effect, over time, of leading to a closer similarity in the level of protection given to intellectual property in countries around the world and, therefore, in this aspect of the legal environment, affect foreign investors.

(d) *Government procurement*

The revised agreement on government procurement may be of some relevance to FDI issues since it not only requires that there must be no discrimination with respect to other signatories in procurement covered by it against foreign products, services and supplies, but also that there must be no discrimination in covered procurement against locally established suppliers on the basis of degree of foreign affiliation or ownership or on the basis of the country of production of the goods and services being supplied by it.

The disciplines of the new agreement apply to the procurement specified in each member country's Schedule, which concern not only central government procurement of goods, but have also been expanded to the procurement of goods and services, including construction services, by central and sub-central government entities, as well as by public utilities. Compared to the existing agreement, the coverage of procurement under the new agreement will be a tenfold increase, to something in the order of $400 billion dollars. The procurement agreement is a plurilateral agreement in terms of the parlance of the World Trade Organization, that is, joining the agreement is optional for members of the World Trade Organization. The initial membership is likely to be less than that of the previous agreement, limited (with two exceptions) to the industrial world. The signatories of the agreement, however, hope that it will be possible, progressively, to expand its membership.

In the areas of intellectual property and trade in services, as in the area of trade-related investment measures, questions of restrictive business practices or anti-competitive practices were an important element in the negotiations. Both, the TRIPs and GATS Agreements contain provisions recognising that certain business practices may restrain competition and thereby have adverse effects on trade or impede the transfer and dissemination of technology. The TRIPs Agreement specifically recognises the right of members to take appropriate measures, consistent with its provisions, to prevent or control such practices. Moreover, both Agreements also contain provisions on consultations between members about the control of anti-competitive practices and cooperation through the supply of relevant information.

2. Dispute settlement

The Uruguay Round also reached agreement -- in the form of an "Understanding on Rules and Procedures Governing the Settlement of Disputes" -- on strengthening dispute-settlement mechanisms. The understanding does not specifically focus on FDI, but it is applicable to all areas covered by the World Trade Organization (more automatic adoption of panel reports and the possibility to request the review of a panel report by an Appellate Body). This mechanism is, of course, important for appreciating the legally-binding nature of the substantive obligations. The dispute-settlement system has been substantially reinforced, notably by the elimination of the means by which it has been possible for losing parties to be able to delay or block the dispute-settlement process. This has been done, on the one hand, by the introduction of stricter time limits for the different stages of the dispute- settlement process and, on the other hand, by providing that panel and Appellate Body reports and decisions authorising any eventual suspension of concessions against a member country failing to bring itself into compliance will be considered adopted unless there is a consensus against that adoption. The stages of dispute-settlement mechanism are: consultations between member countries; establishment of panel; first and second panel hearings; circulation and adoption of panel report; any review by the Appellate Body. The implication is that matters related to FDI, to the extent that they will arise in the World Trade Organization, are likely to be subject to disciplines that are backed up by effective dispute-settlement procedures.

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During the course of the Marrakesh meeting, many ministers took the opportunity to put forward suggestions for new items for inclusion in the work programme of the World Trade Organization. In this context, a substantial number of ministers, representing a broad spectrum of countries, both developed and developing, suggested an examination of the issue of trade and competition policy. This represents a significant development since, in the past, including during the Uruguay Round, there has frequently been considerable reticence on the part of some delegations about taking up the question of restrictive business practices.

B. The process of liberalizing foreign-direct-investment policies

While there are differences in the scope and depth of the liberalization instruments mentioned above, almost all of them share a common purpose, namely, to liberalize existing restrictions on FDI flows and the operations of transnational corporations (TNCs). In fact, in spite of the absence of a multilateral framework for FDI (Fatouros, 1994), unilateral, bilateral and regional efforts towards the liberalization of national FDI frameworks have led to a remarkable level of *de facto* convergence of government policy approaches towards FDI among countries from all regions.[3] Yet, the actual process of liberalization has been far from homogeneous. There are still considerable differences in the nature, breadth and depth of the measures taken, reflecting different political, economic and social priorities, as well as different degrees in the dismantling of State controls and planning and confidence in the ability of governments to guide businesses.

The process of FDI liberalization is embedded in a broader liberalization movement covering international trade in goods, external financial transactions, transfer of technology, the strengthening of intellectual property protection and, recently, services and some aspects of labour movement. Indeed, the trend towards the liberalization of FDI policies can be explained as a natural extension of a broader tendency to pursue greater economic efficiency through the elimination of market distortions caused by discriminatory governmental measures. Thus, the process of liberalization of FDI policies needs to be seen as part of the broader process of liberalization of international markets and cross-border movements of factors of production that is taking place simultaneously, to a varying extent, in many parts of the world. This process both allows the further development of -- as well as receives additional impetus from -- the emerging integrated international production system (chapter III): on the one hand, the liberalization of international economic transactions is a condition *sine qua non* for the integration of international economic activity and, on the other hand, new policy areas become subject of international attention and harmonization as integration deepens (Ostry, 1992).

While the trend of liberalizing FDI policies is pervasive, it is -- in its present strength and depth -- also relatively recent. There is still considerable lack of clarity as to its actual character and contents. The next sections seek therefore to clarify the meaning, and distinguish the various elements that constitute the notion, of liberalization of FDI policies and to examine how far that process has changed investment frameworks worldwide. The precise impact of liberalization on FDI flows and its relative importance compared to that of other factors and conditions that influence these flows is a separate issue that is *not* addressed here. The chapter does not also draw specific policy conclusions -- whether to recommend liberalization policies and, if so, under what conditions -- since these can only be reached after examining their effects in specific country and industry cases, having taken into account the risks that are often associated with them. However, it can be expected that, to the extent that FDI frameworks become similar as liberalization proceeds, specific differences that remain -- other conditions being equal -- may influence decisions as to the location or expansion of investment projects.

1. Conceptual issues

(a) *Delimiting the notion of liberalization*

While the focus of this chapter is on the process of liberalizing FDI policies, this process needs to be seen in the broader context of a liberal domestic economy. A liberal economy is generally understood as one in which policy and legal distortions to the allocation of resources by the market are minimal, with the government having the responsibility to ensure the proper functioning of markets. The removal of policy distortions regarding international transactions is an integral part of a liberal economy as it allows the realization of maximum gains from these transactions. One type of such transactions is FDI, the focus of this chapter. Establishing a liberal domestic economy and liberalizing international economic transactions -- including FDI -- are, therefore, conceptually and functionally interrelated and mutually supportive.

Liberalization can, as a first approximation, be equated with the elimination of governmental measures that are restrictive or discriminatory and, thus, market distorting. Total governmental control is generally incompatible with the very notion of the market; yet, total liberalization, in an extreme sense, could imply the absence of a functioning legal system. A normative framework is indispensable for ensuring the proper functioning of a market economy, and this entails the application of rules and controls. At the same time, liberalization is a dynamic process, moving in a certain direction. A country's pertinent policies and measures at a particular point in time can therefore only be described as more (or less) liberalized. As a result, the reference to a "liberalized regime" in what follows should be understood to mean "reasonably liberalized", that is to say, a regime that has gone a long enough way on the road to liberalization, so as to exhibit characteristics such as those enumerated later.

The concept of liberalization in the area of FDI denotes the tempering or removal of those market distortions that result from (a) restrictions applied specifically (and hence discriminatorily) to foreign investors; and (b) the granting or withholding of incentives and subsidies that discriminate in favour or against TNCs. It is possible to operate throughout with such an approach to the notion of liberalization, describing all elements of the liberalization process in the area of FDI in terms of the removal of restrictions or discriminatory treatment. Despite its consistency, however, this approach is of limited usefulness because it ignores facets of the liberalization process that are normally understood as involving the establishment of certain standards regarding foreign investors. In particular, key elements of the liberalization process, such as the grant of national treatment to TNCs, lose something of their particular character and function. It is therefore useful to proceed on the basis of the notion that an essential aspect of the liberalization process involves the adoption of certain positive standards.

Furthermore, the overall beneficial effects of the liberalization process depend, to a considerable extent, on the presence and, where necessary, the strengthening of controls aimed at ensuring the proper functioning of the market and promoting broader economic and social concerns. For instance, rules to assure competition and prevent abuse of market power need to be an integral part of a reasonably liberalized investment regime, as does the existence of an adequate regime for the protection of intellectual property. Similarly, prudential supervision of certain activities, such as banking and financial services, is necessary to ensure the reliability, stability and safety of the national financial system. The need to have appropriate health, safety, environmental and consumer standards is another illustration of necessary controls. And disclosure of information becomes more important for governments, consumers and other groups, since they have to be able to act in an informed manner. Meant to facilitate the function of the market, laws and regulations in these and other areas provide the framework within which enterprises conduct their affairs. In order to be beneficial, the liberalization of FDI policies should be accompanied by the kinds of legal and policy controls that are compatible with it, or indeed may be conditions for it.

A clear distinction must also be drawn between policies aimed at liberalizing FDI and policies aimed at creating a favourable investment climate and, especially, attracting or promoting FDI. The distinction is not an easy one in practice. The two types of policies are closely linked, in a means-to-end relationship: a principal aim of current liberalization measures is to attract FDI. Liberalization, however, is not the only possible method to attract FDI, nor is it necessarily the most effective one under all conditions. In the past (and, in many cases, still today), a variety of restrictive measures (typically, tariff protection) have been used in order to attract FDI. In fact, favouring FDI can be as interventionist a policy as regulating it -- as, for instance, in the case of incentives and privileges offered selectively to TNCs.

A further difficulty in distinguishing between the two types of policies lies in the fact that, in addition to removing obstacles and restrictions to FDI, the liberalization process also includes a number of measures that are specifically addressed to FDI and reflect its special characteristics (e.g., special provisions for the free transfer of funds outside a host country).

In sum, a working definition of the FDI liberalization process includes the avoidance of discriminatory market-distorting measures by tempering or eliminating restrictions on, and special incentives to, TNCs by governments, the establishment of certain positive standards of (equal) treatment and protection for foreign affiliates and the introduction of certain controls and prudential supervision to ensure the proper functioning of the market (figure VII.1). The present discussion focuses first on the restrictions and special incentives to be eliminated or tempered, and then proceeds to the standards of a liberalizing FDI regime, to conclude with a summary appraisal.

(b) Removal of distortions

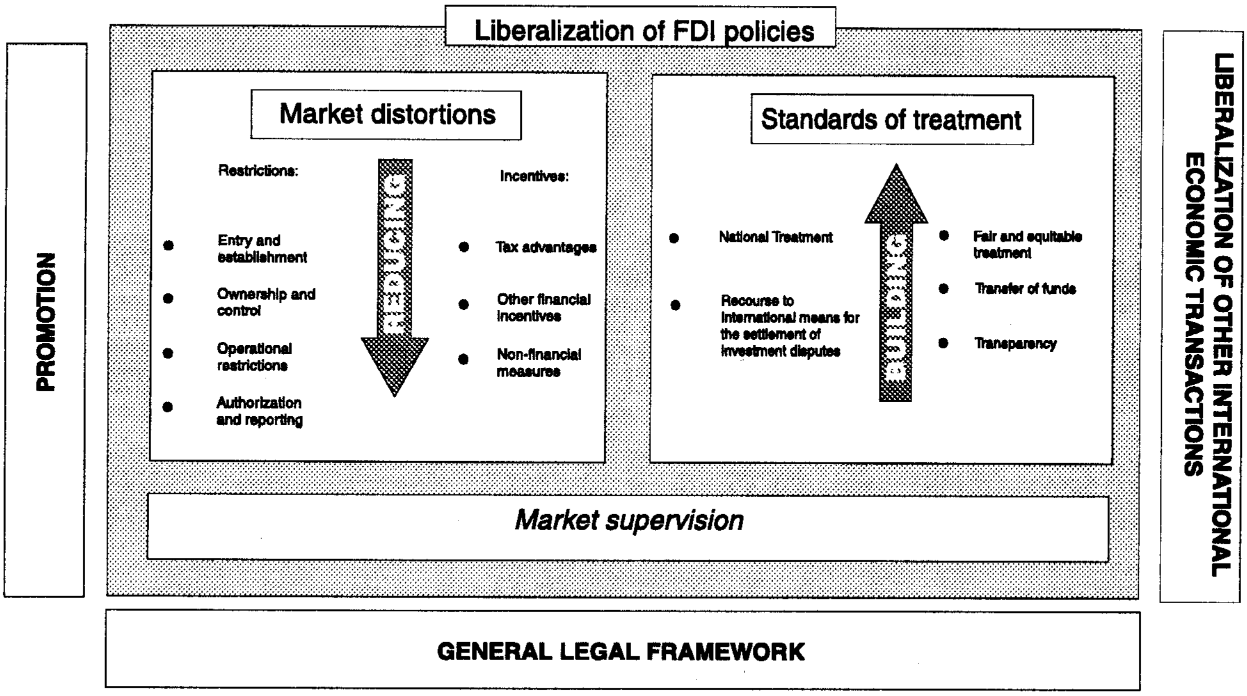
(i) Restrictions

Any classification of restrictions on FDI is, to some extent, arbitrary, since fully consistent criteria do not exist. Particular measures and policies usually have more than one purpose or effect, so that significant overlaps between categories cannot be avoided. All that can be attempted here is to review a number of policies and measures that are of importance, with an emphasis on their rationale and function.

Entry and establishment. A first category of restrictions whose elimination is the hallmark of a liberalized FDI regime is that of restrictions on entry and establishment of FDI. Such restrictions generally seek either to limit FDI or to channel it in order to determine or influence its likely effects, with a view to ensuring that the economy andor certain important sectors are not dominated by foreign affiliates. The underlying rationale is the desire to keep the principal benefits from FDI in the hands of nationals of the host country and simultaneously exercise decision-making control over the use of that country's assets. Foreign affiliates are assumed to be less likely to act in response to considerations of host-country national interest, and to be less subject to national governmental or political influence or control. (Proponents of liberalization challenge, of course, both the validity of such assumptions and the desirability of ensuring a degree of national control.)

The explicit purposes of such restrictions vary. One major category is the protection of national security, public order and vital national interests. These considerations tend to be regarded as natural exceptions to the general principles of liberalization and, as such, it is unlikely that they will disappear in the foreseeable future. Since, in the absence of an international

Figure VII.1. Main elements of a favourable investment climate



Source: UNCTAD, Division on Transnational Corporations and Investment

framework for FDI, the determination of what constitutes a matter of public order, or a threat to national security and vital national interests, is left to the discretion of the host country, such considerations may be interpreted narrowly or more broadly. And as this is the most widely accepted and the most "respectable" ground for restrictions on FDI, host countries may sometimes invoke it in order to exclude investments not wanted on other grounds. Restrictions on entry may also be directed at specific countries, as part of policies adopted for political reasons. The economic and social objectives of the host country are another major category of purposes served by such restrictions. In developing countries, in particular, restrictions on FDI are often used to promote specific development objectives.

No country today excludes FDI altogether. Restrictions on entry are generally partial. Typically, they are intended either to exclude or limit FDI from specific industries or activities, or to determine specific characteristics or influence of investments. Such restrictions tend to be justified on the basis of the strategic importance of the activities involved for the host economy or, sometimes, with reference to particular industries or geographical locations, on national security grounds.

Ownership and control. A second category or form of restriction affecting FDI are ownership requirements, especially limitations on the percentage of equity foreign investors are permitted to own in local enterprises (in all sectors or more often in specified industries or activities) or requirements of local participation in the management of an enterprise (e.g., creation of joint ventures). A variety of methods has been used to ensure local participation in the internal decision-making of foreign affiliates.

Other restrictions of a similar character may also be imposed. Fade-out (disinvestment) requirements and requirements concerning the reinvestment of profits fall essentially in the same general category of direct restrictions on FDI, although they are no longer in use.

Operational restrictions. Restrictions may also be imposed on a foreign affiliate concerning its operations after it has been established. Their purpose is to reduce negative impacts and increase the benefits to be derived by the local economy from the operation of a foreign affiliate and to determine in specific terms some of the precise effects of such operation.

Such requirements may involve limitations on the employment of foreign managerial, technical or (less frequently) other types of personnel, priority employment of local labour and, in some instances, restrictions on access to local raw materials and supplies. They may also involve the imposition of performance requirements aimed at the promotion of exports, import substitution, or the encouragement of local production (e.g., through local content requirements). Such requirements may be imposed at the time of entry as a condition for allowing the investment, or they may, more often, be linked to the offer of positive inducements, such as tax incentives; some of them had recently become more common, as substitutes for more rigid entry requirements. After the conclusion of the Uruguay Round agreement on trade-related investment measures, they have become subject to effective international disciplines (Greenaway, 1992, Guisinger, 1989; Symposium on TRIPs and TRIMs, 1990; UNCTC and UNCTAD, 1991).

Authorization and reporting. A fourth category of measures, whose restrictive effect depends on several factors, are those concerning authorization, registration or reporting in connection with various aspects of an investment. Certain distinctions must be made in this connection:

- Restrictions on entry and ownership may be applied on the basis of a screening process, a procedure whereby an investor's projects are assessed by the competent government agency in order to grant or deny authorization to invest.
- Authorizations and permits may also be needed for a variety of other purposes of varying importance, such as transfer of technology, importation or exportation, or to operate in certain activities.
- Registration or reporting are in principle less restrictive measures than authorization. They may be intended to enhance transparency, for general purposes (e.g., statistics), or in order to cope with certain aspects or effects of an investment, for instance, when seeking to determine the amount of funds (revenues or capital) that foreign investors will be entitled to transfer outside the country, or, of course, in response to environmental or consumer-protection concerns.

The actual restrictive effect of reporting requirements depends, in large part, on the mode of operation and the efficiency of the host country's public administration. When coupled with explicit or implied requirements of authorization, they may have a restrictive effect, often depending on the degree of discretion allowed to the pertinent authorities. Bureaucratic requirements and procedures may bring about delays and other restrictive effects (Wint, 1992).

(ii) Incentives

A second category of market-distorting (and sometimes indirectly restrictive) measures consists of tax or other incentives designed to attract and encourage FDI. Broadly speaking, investment incentives are government measures designed to influence the size, location or industry of an investment by affecting its relative cost or potential for profit, or by altering the risks attached to it (OECD, 1989). Investment incentives may be aimed at foreign firms, domestic enterprises, or both. Where such incentives are available to foreign investors only, they are discriminatory in nature and, thus, introduce distortions to market mechanisms. Evidently, when they are offered to foreign investors, such measures are intended to favour and attract rather than limit FDI, and they differ significantly from those mentioned earlier.

The main categories of investment incentives include tax incentives (e.g., tax holidays, investment allowances, tax credits, lower tax rates) (Larkins, 1991); other financial incentives, such as grants, preferential loan rates, loan guarantees, tariff concessions and priority access to credits, and non-financial measures, including the provision of infrastructure and business services. The cost-effectiveness of incentives is measured by the increased levels of the desired investment attracted, less the cost to governments (e.g., in terms of the loss in revenue). A review of the evidence (e.g., Guisinger et. al., 1985) suggests that, overall, incentives do not produce an efficient allocation of investment. In fact, whether incentives are successful and effective in attracting FDI has been a matter of extensive debate (Lim, 1983; Hughes and Dorrance, 1987).

In addition, incentives frequently have indirect restrictive effects. They are usually offered only to enterprises meeting certain conditions. They therefore require application or screening procedures and may be used (as they often have been in the past) in return for performance requirements, or as an indirect means for regulating or channelling FDI. Foreign investors may nominally be allowed to invest freely in the country concerned, but investors that meet additional conditions, frequently similar to those related to entry and ownership conditions mentioned above, are, subject to various kinds of approvals, granted special treatment -- tax concessions and deferrals, exemptions from customs duties, guaranteed free transfer of funds, or guarantees against unfavourable treatment (e.g., expropriation). Where such incentive systems exist, foreign investors generally prefer to use them and avoid taking the simpler, but less attractive, route of free entry, without special promises. Control through the offer and administration of incentives may be an effective substitute for direct controls over FDI. Although it is possible to establish incentive schemes with minimal regulatory (and restrictive) effects, such practices have not in fact been much in use in the recent past.

* * *

As already mentioned, in a liberalizing FDI regime, market distortions are tempered or eliminated. But the process should not be measured in simple arithmetical terms. In other words, the real outcome cannot be found through mere catalogues or simple calculations of which and how many restrictions or incentives have been eliminated and how many still remain. The relative importance of the various measures enumerated differs widely depending on the broader legal and economic framework and the quality of public administration of the country concerned. Moreover, the situation may vary significantly between sectors. Restrictions may persist in certain sectors while others may be fully liberalized.

(c) Standards of treatment

Most of the measures listed above may be addressed solely to foreign investors, whether defined in terms of the nationality of the investors and enterprises involved, or in terms of the origin of the capital. Some market-distorting measures (e.g., entry requirements, discriminatory incentives) are almost necessarily so addressed. In other cases, however, both foreign and domestic investors may be affected; for instance, certain sectors may be closed to all private investment, reporting may be required of all investors and export requirements may be imposed on all. While equality of treatment as between domestic and foreign investors -- that is to say, for most purposes, the standard of national treatment -- is undoubtedly a very significant part of the liberalization process, it does not exhaust the process. The notions of national treatment and liberalization process are not synonymous.

National treatment. The granting of equality in the treatment of nationals and aliens, especially foreign affiliates, i.e., the national-treatment standard, is an indispensable element of the liberalization process. While there are variations in the formulation of that standard in specific instruments,[4] the basic concept of national treatment is that, in principle, foreign affiliates and domestic firms in similar situations should receive the same treatment, regarding such things as establishment, ownership and control of enterprises, full access to courts and other authorities and equal protection under the law, as well as taxation, labour law, consumer protection or protection of the environment, and free access to credit facilities, or even government aid to enterprises (box VII.2). Such a listing covers most of what is usually meant by liberalization. Limiting the access of aliens and foreign affiliates to the legal process, imposing burdensome requirements for the recognition of foreign companies, denying aliens the right to hold real property and other similar restrictive measures have sometimes been left over from earlier times, when the law treated aliens and foreign companies with a high degree of distrust. In other instances, probably a minority by now, they reflect the same effort to limit and control foreign investments that other measures described here also involve.

On the other hand, equality of treatment with host-country nationals and companies may not, in a number of cases, address some pertinent problems adequately, especially where the situation of foreign investors is significantly different from that of domestic firms, as is the case in the transfer of funds abroad. The measures needed in such cases have to move beyond mere equality of treatment, although they are generally understood as being covered by the notion of liberalization. Traditional, formal definitions of national treatment take care of most such problems by limiting application of the standard to "like situations" and by formulating the standard in terms of treatment "not less favourable than" that of nationals.

Such issues raise important conceptual and practical problems. This is particularly true in the case of **the free-transfer-of-funds requirement**. Where they still exist, exchange restrictions are general in character, that is to say, they apply to local as well as foreign enterprises. No formal discrimination against foreign investors is then necessarily involved in their application. A liberalization of FDI policies, however, is usually understood to cover the elimination of exchange restrictions to the extent that they affect FDI, on the ground that, generally speaking, the conditions of local and foreign investors and enterprises are significantly different with respect to questions of foreign exchange and funds outside the host country. For one, the headquarters, or profit centres, of local firms are by definition in the host country. At the same time, provision for the free transfer of funds means in reality, at least in principle, a guarantee to that effect. The host government undertakes not merely to allow investors to find foreign exchange, but to ensure that they find it. Moreover, procedural and other requirements, including the need for general or ad hoc authorizations and permits, generally intervene in the administration of such measures, so that in practice it is sometimes hard to distinguish between measures favouring (or privileging) investors and restricting them.

Other cases in the same broad category may be more controversial. For instance, in recent years the argument is increasingly advanced that, on lines essentially similar to those just mentioned (i.e., the specific character and needs of FDI), foreign affiliates should have free access to **international arbitration for the settlement of disputes between them and the host State**, over and above the access to the local judicial and administrative machinery which they may have through the operation of a generalized national treatment principle. The specificities of FDI to which this claim corresponds are usually not spelled out in any detail. They may be understood to refer, on the one hand, to the likelihood that local courts and tribunals may lack the specialized competence in modern business law issues that an arbitration tribunal may provide and, on the other, to the fact that, the investors not being nationals of the host country, do not normally participate in national political processes and are more likely to be discriminated against by national authorities and tribunals. At any rate, provisions on international arbitration on FDI matters, whether under ICSID auspices or otherwise, have found their way in numerous bilateral and multilateral agreements, so that the practice is becoming *de facto* established.

Similarly, a foreign investor's access to a host country's legal process and legal protection, part and parcel of national treatment as well as of liberalization, is in many instances strengthened by corresponding undertakings at the international level. To the extent that the (mostly conventional) international legal norms and concepts that have been developed, such as **fair and equitable treatment**, are now adopted in national legislation as well, it would appear that specific standards of legal protection, stronger or more specific than those applicable to nationals, are emerging.

Transparency of laws, regulations and administrative practices. The effective functioning of the liberalization process requires that reliable information about FDI policies and practices is available. Transparency relates to the need for disclosure and clarity of all government measures that affect the operation of foreign affiliates in a host country. In that sense, transparency involves the publication within a host country of relevant measures in whatever formal manner is provided by national law, and they are to be made available to interested persons within the bounds of the customs and practices prevalent in the country concerned. A gradual approach to the achievement of transparency would involve the elimination of deliberate administrative obfuscation and

Box VII.2. National treatment as defined in the General Agreement on Trade in Services of the Uruguay Round of Multilateral Trade Negotiations

One of the most recent formulations of the standard of national treatment in a multilateral instrument relating to FDI is that contained in Article XVII of the General Agreement on Trade in Services (December 1993) which was approved by consensus. Article XVII states:

"1. In the sectors inscribed in its schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.

2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service providers.

3. Formally identical and formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or services providers of any other Member."

Source: GATT, 1994.

secretiveness. Important is also a system of formal publication of laws and regulations. Notification or other special forms of publication may be feasible only with respect to limited, precisely defined issues and types of measures.

2. How far has the liberalization process gone?

A detailed survey of the current situation with respect to normative frameworks on FDI is not undertaken here. Yet, drawing on surveys and a review of other pertinent data (European Round Table of Industrialists, 1993a, 1993b; UNCTC, 1992a, 1992d, UN-TCMD, 1993b; UNCTAD-

DTCI, 1993a, 1994a; USTR, 1992; World Bank, 1992; OECD, 1992d and 1993f), it is possible to provide a reasonably faithful summary account of the extent to which the liberalization process has gone today, starting with the elimination or decrease of market distortions and moving to the establishment of standards of treatment.

(a) *Market distortions*

(i) *Restrictions*

Entry and establishment. Today, all countries admit FDI in principle, i.e., total prohibition of FDI no longer exists. On the other hand, no single country (even amongst the strongest advocates of a liberal FDI regime) grants an unrestricted right of entry to all sectors and activities. It is difficult, however, to make generalizations about the types of industries that remain restricted, as these vary considerably from country to country.

In the developed countries, some activities in the natural resources sector that had traditionally been kept in the hands of the State, have been liberalized, although many restrictions remain (e.g., in the fishing, mining, oil and energy industries). The manufacturing sector of these countries is now practically open to FDI, while many of the restrictions and regulations previously maintained in the services sector are being gradually lifted (some restrictions remain in a few, but important, services industries, such as telecommunications, maritime, land and air transport, media activities and professional services) (UN-TCMD, 1993b; OECD, 1992d; Khan, 1990) (table VII.3).

In the developing world, the picture is more complex and diverse. The liberalization process of the 1980s has been selective, with a tendency to focus mainly on export-oriented manufacturing industries, or projects involving advanced technology. Gradually, other manufacturing industries have been opened to FDI. Access to certain services industries traditionally closed or restricted to FDI has started to be liberalized, although, in general, the liberalization of services has not yet reached the levels typically found in developed countries, other than within regional integration schemes. More recently, certain restrictions in the natural resources sector have been lifted, including through privatizing what had been nationalized in previous decades (UNCTC, 1992a, 1992d; UNCTAD-DTCI, 1993a, 1994a) (box VII.3 and table VII.4).

It is likely that the process of liberalization initiated in all sectors will continue in the future, supported by regional and multilateral initiatives aimed at achieving that goal. For example, the adoption of the European Energy Charter Treaty, currently under negotiation, could have major implications for the liberalization of the energy industry of Eastern Europe. Similarly, the recently concluded agreement on trade in services within the framework of the Uruguay Round of Multilateral Trade Negotiations will provide impetus for the removal of additional restrictions in services industries, both in developed and developing countries (GATT, 1993).

Ownership and control. Compulsory majority and minority shareholdings have lost importance over the years as a means of restricting the entry of FDI. Most developing countries that used to impose such restrictions across the board now generally allow full ownership of foreign affiliates. However, ownership limitations continue to be used as a means of restricting FDI in specific industries and activities. Developed countries sometimes use restrictions in shareholding to limit access in privatization cases or in services industries (e.g., telecommunication, broadcasting, air transport) that have not yet been completely liberalized. Moreover, some countries, both developed and developing, continue to impose limitations on the number of foreign firms allowed in certain industries, such as banking, financial, professional, telecommunications, air transport and broadcasting.

Table VII.3. Restrictions on main industries in developed countries, mid-1992

country	Banking	Insurance	Radio	Telecommunications (post and telephone services)	Road transport	Rail transport	Air transport	Marine transport	Mining	Oil andor gas	Fishing and fish processing	Real estate	Tourism	Audiovisual work (inclu-ding film distribution)	Publishing	Public utilities (including energy, water, gas and electricity distribution)	Gaming, casino, lottos and lotteries etc.
Australia	LR		L	L		C	L		L a	C	L a	L	L	L	L	C	L a
Austria	R	R	C	C	C	C	C	L	L	L	L	L	LR	L		L	C
Belgium	R	R		L	C	C	L	L		C	L		R			C	
Canada	LR a	RL a	L	L	C	C	L	L	L a	L a	L a	L a		L a	L a	L a	
Denmark	R	R	L	L	C	C	L	L			L					C	
Finland	LR a	R	C	L	R	C	L	L	L		L					C	C
France	LR	LR	L	L	R	C	L	L	L	R	L a		R	R	LR	L	L
Germany	LR		L	L	C	C	LR	L a									C
Greece	LR	LR	C	C	C	C	C	L	L	C	L	L	R			C	C
Iceland	L	L a	L	C		C	L			C	C	L	L			C a	
Ireland	LR	LR		C		C	C	LR			C					C	
Italy	LR	LR	C	C	C		LR	L	R		L		R			C	C
Japan	LR	L	L	L		L	L	L	C	C	L					L	
Luxembourg			C	C	L	L	L									C	
Netherlands	LR	L	L	L	C	C	L	L			L					C	
New Zealand			L	L		C	L	L			L						
Norway	LR	LR	C	L	C	C	L	L			L		L			C	C
Portugal	LR	L	L	C		C	C	R						L		C	
Spain	R	R	L	L		C	L	L				L				C	L
Sweden	L	L	L	C		C	L	L									C
Switzerland	R	L	L	C		C	L	L				L		C		L	
Turkey	LR	LR	C	C		C	L	L			L		L			C	C
United Kingdom	R	R	L	L		C	L	L	L		L		L			C	
United States	R	R a	L	L		C a	L	L	L		L	R a				L a	

Source: OECD, 1992b.

Key: L = Limited. R = Reciprocity. C = Closed (including monopolies).

Note: This table covers mainly measures upon establishment that are regarded as restrictions in the sense of OECD Code of Liberalisation of Capital Movements and not covered by the general authorization procedures.

a Measures at a sub-national level.

Box VII.3. The changing regulatory framework for foreign direct investment in mining: a study in liberalization

During the 1980s and early 1990s, major policy and regulatory changes have taken place in many countries intended to promote FDI in mining. At the same time, the introduction of stricter environmental protection requirements, especially by developed countries, has affected a number of important conditions and mining management practices.

In the early 1980s, the main features of the FDI regimes in the mining industry can be summarized as follows (Brown, 1986):

- *In developing countries:*

- Exploration by TNCs was permitted, but security of tenure linking exploration to mining was weak.
- Foreign direct investment in mining was allowed but often only with majority or minority participation by either State enterprises or local private investors.
- Ownership and control were restricted mainly in order to avoid politically unacceptable exploitation of the national resources endowment by TNCs; developing host countries firmly upheld the principle of national sovereignty over natural resources.
- The terms of an investment agreement normally included conditions aimed at fostering broader goals of national and local development.
- Fiscal regimes were designed to encourage upstream and downstream linkages to the national economy (e.g., import duties on equipment and export duties on ores and concentrates).
- Tax levels were relatively high, strict foreign-exchange controls were in effect, repatriation of profits was limited directly or indirectly and substantial withholding taxes applied to the repatriation of dividends and interest.
- Environmental obligations were minimal.

- *In the countries of Central and Eastern Europe:*

- Exploration was closed to TNCs.
- Foreign direct investment in mining was usually limited to investment agencies of other countries of the region, and involvement by private transnational mining companies was restricted to occasional sales of essential technology, equipment or purchases of surplus minerals.
- The State held the ownership rights of all mines.
- Investment decisions were based on planned industrial demand, not on profit potential.
- Where fiscal systems applied, they emphasized income distribution in such a way as to remove all economic rent.
- Environmental obligations were minimal.

- *In developed countries:*

- Exploration was open to all corporations.
- Foreign direct investment in mining was allowed (except for certain "strategic" minerals), although often the investment had to be made through a locally incorporated affiliate or through a joint venture arrangement with a local company.
- The ownership and control of an investment could reside with the foreign affiliate.
- Exploitation was guided by market economy principles.
- Tax levels were relatively low.
- Environmental obligations were moderate.

Since the mid-1980s, over 75 countries have either adopted new mineral laws, made major revisions to existing laws or are currently working on draft legislation. [a] While the basic legal frameworks applying to FDI in the mining industry vary considerably from country to country, some general trends are clearly discernible (Otto, 1992a; Gabre-Maryam, 1989; Melo, 1989; Radetzki, 1986; Waelde, 1991).

- *In developing countries:*

- *Ownership restrictions.* Increasingly, most countries favour a risk-free and competitive fiscal take, as opposed to getting involved in the mining venture through a share in the equity of a foreign affiliate. Where an equity stake is required, the trend is towards the State or a local private enterprise taking a minority participation by means of "carried interest". Under a carried-interest type of arrangement, the share of equity of the State or local enterprise is paid for through a loan from the foreign affiliate; the loan (plus interest) is repaid from the dividends of the State or local enterprise after production has started and profits are being made.[b] Governments interested in a minority equity participation have moved towards investment options which they can exercise either at the mining-decision point or after mining has commenced. Many governments have come to the conclusion that mandatory majority government equity participation requirements can lead to lower levels of sectoral investment and tax returns. Other than in exceptional "bonanza" situations, it is uncommon today to see governments asking for and receiving free equity.
- *Operational control.* The trend has been to move away from government control arising out of equity participation towards requirements imposed through legislation or agreements. For example, at the exploration stage, a government-approved exploration plan may contain, by law, a minimum expenditure requirement or performance bond.

The movement towards a more open market system is evident. Many developing countries have backed away from former policies intended to promote upstream and downstream linkages in mining. Stringent requirements for local downstream processing of minerals and high levels of import duties on essential equipment are becoming increasingly rare. Likewise, on the export side, previously high export duties on raw ores and concentrates (with the intent to encourage local processing to add value) have fallen. [c] Restrictions on the repatriation of earnings and capital originating from the mining industry have also tended to diminish.

- *Exploration rights.* The search for commercial ore bodies has become increasingly complex over time as relatively-easy-to-identify surface deposits become scarcer. Modern exploration methods and efforts require larger areas and longer time spans than did the simpler methods of the past. Most new legislation and recent agreements have taken this into account; the maximum size of an exploration area, if at all specified, is now generally larger and the exploration period is either longer or a provision is made for a succession of renewals. The security of a right to explore has been strengthened, with many codes now recognising that right as exclusive within the respective exploration area. In many cases, exploration rights are not restricted to a single, named mineral. Most of the new and emerging mining regulatory systems require either an approved exploration workplan or impose a minimum exploration expenditure requirement.
- *Linkages between exploration rights and the right to mine.* Linkages between the exploration right and the right to mine have also been strengthened in many codes. Most countries, however, do not automatically grant the right to mine to a successful holder of an exploration licence. The grant of the right to mine is usually conditional on the investor meeting a number of predefined requirements. Such requirements vary widely from country to country but, in general, address issues such as whether the investor has the technical expertise and financial means by which to commence and carry on mining. Most codes and agreements contain conditional provisions, whereby the investor must submit and gain the approval of a variety of key plans (e.g., mine plan, marketing plan, environmental protection plan, feasibility study) before a mining right is granted. In some cases, the mining right is granted but does not come into force until the requisite plans are approved. While

the approval of such plans is, in most cases, discretionary, there is a growing tendency to impose some limits on this discretionary power and afford a means of appeal or recourse to arbitration. Most new mining codes now contain increasingly detailed reporting requirements for both the exploration and mining phases.

- *Fiscal regime.* The trend has been to reduce fiscal requirements. In the 1990s, many countries appear to be moving towards adjusting the effective level of taxation to be competitive with the following emerging baseline:
  - income tax rate at around 35 per cent;
  - provision for accelerated depreciation and carrying forward losses;
  - interest and dividend withholding tax at around 15 per cent or less;
  - royalties based either on profitability or no more than five per cent of the value for base metals; and
  - low levels of, or exemption from, import and export duties.

It should be noted that fiscal systems vary considerably from country to country, but the general trend is towards an overall lower effective tax burden than that in effect during the past several decades. In some cases, developing countries have moved to attract increased investment by offering sector-specific fiscal incentives, investment guarantees, long-term tax stabilization and foreign exchange guarantees.[d]

- *Environmental obligations.* The number of environmental laws has increased considerably throughout the developing world. However, only a handful of these laws address specifically the mining industry in detail. An important objective in most mining regulatory schemes is to manage the environmental consequences of mining at a level acceptable to the host country. In a competitive environment, measures that policy makers in developing countries perceive as dissuading FDI, such as costly environmental protection regulations, may not be passed or, if passed, may fail to be implemented or enforced. The trend in developing countries during the 1980s was to put emphasis on introducing enabling legislation and not to impose burdensome regulations which might dissuade FDI.[e]
- *Legal protections and guarantees.* Mining tends to be a lengthy affair and it is recognized that there is a high likelihood that sometime during the life of a project a disagreement will arise between the foreign investor and the host country government. Many recent agreements provide for international or technical arbitration of specified disputes.[f] Additionally, many countries have now entered into various bilateral and multilateral investment treaties that accord investors some forms of protection against unilateral actions by host country governments.

The developing country nationalizations that took place in the late 1960s and early 1970s were in part caused by a belief that the TMCs were exploiting the national mineral endowment with little benefit flowing to the country (Jodice, 1980). The advent of new mining technologies which further reduce multiplier effects through reduced forward and backward linkages with the local economy may focus the attention of policy makers on the direct fiscal benefits. The risks associated with FDI arrangements, which may come to be viewed as skewed in the investor's favour can, to some extent, be managed by making provision in the laws or agreements to allow for periodic reviews to reexamine the allocation of the mining revenues between the government and the company. However, in the early 1990s, some companies have moved away from agreeing or desiring such provisions favouring instead provisions which guarantee the stability of all investment terms.

The general trends described above are not of course applicable to every developing country. While there may be similarities between the types of changes affecting investment in the mineral industry taking place in some countries, the pace of change varies considerably from country to country. Each country's approach is unique. Some developing countries have only recently begun to effectively allow FDI in mining. For example, in Asia, both China and Viet Nam initiated legislative drafting efforts in the early 1990s specifically targeted at attracting and managing FDI in mining industries. India announced a new national mining policy in 1993, partially opening up its mineral industry which until then -- and to an extent also after the policy -- remained closely regulated. In Africa, Mozambique has introduced a new mining code allowing FDI and, in the Caribbean, Cuba has also begun promoting FDI to bolster its mineral industry.

- Central and Eastern Europe

The economic reforms in Central and Eastern Europe during the 1980s and early 1990s have affected the natural resources sector and have led to important changes in the mining FDI regime and in related tax regimes. Thus, new mining laws have been adopted in Poland, the Slovak Republic and Hungary, while most other countries in Central and Eastern Europe have begun to prepare or revise new legislation allowing FDI in mining. Progress to allow FDI in mining in the successor States of the former Soviet Union has been slow (Humphreys, 1994).

A problem faced by many countries in the region is that, although FDI is now allowed in principle, in practice the necessary legislation and administrative frameworks have yet to be put in place. Furthermore, in order to commence mining, an investor has to comply not only with the mining law, but with other laws as well. These regulate important matters associated with the establishment and operation of a foreign affiliate, such as conditions of establishment, taxation, national security, labour, safety, access to land, transportation, environment and foreign exchange controls. Where new laws affecting FDI have come into force, administrative procedures are, in some cases, inadequate or lagging the legislation.

Although many of the countries in the region had allowed FDI in mining by the beginning of 1994, most have not yet defined the associated tax structures. Moreover, policy makers have been slow to develop fiscal regimes aimed at attracting FDI while ensuring reasonable tax revenues for the government. In some countries, the lack of an integrated and compatible free market legal system has been sidestepped by the use of all-inclusive mineral agreements.

- Developed countries

In developed countries, most countries with substantial mining industries (e.g., Australia, Canada, United States) allowed TNCs relatively free access to their mineral industries during the 1980s. While a few countries maintained some barriers, such as maximum foreign ownership restrictions (Australia) and kept certain "strategic" minerals off-limit to foreign investors,[g] these were not as substantial as restrictions typically imposed elsewhere in economies in transition and developing countries. However, a number of new regulatory measures aimed at protecting the environment emerged during the 1980s. Looking at the mining environmental regulations in Australia, Canada and the United States, it is clear that they are becoming increasingly comprehensive, stringent and complex and are imposing increasing restrictions and prohibitions on exploration, mining and processing. The environmental approval process is becoming more comprehensive and often leads to approval delays; liabilities and penalties for non-compliance have greatly increased, and environmental agencies are becoming more resolute in identifying and prosecuting offenders. Public attitudes are also changing in the same direction (IWGMI, 1993b, 1993c, 1992).

Fiscal trends in developed countries are not straightforward. While some countries have implemented measures to reduce effective tax rates, others have raised taxes.[h] In part, these raises may reflect policy decisions supporting a perception that the current generation of investors needs to recompense governments for cleaning up long abandoned mine sites. Even with the rises seen in the 1980s, the overall effective tax rates remain lower in the major mineral-producing developed countries than in many developing countries (IWGMI, 1993a).

Looking forward

The competition between nations for exploration and mining investment has resulted in a realisation by many countries that they must have a regulatory and fiscal system which is at least as favourable as that offered in other countries with similar geological prospectivity. Today's mineral-development market is an investor's market. Mining companies now have more options to choose from than at any time during the earlier part of the century. For those who follow the school of thought that emphasises bargaining power as a key determinant shaping the terms offered by countries to foreign mining firms (Smith and Wells, 1975), it should be noted that the power of these firms has been rising in the early 1990s, while that of governments has declined.

a According to a list compiled in February 1994 by the Centre for Petroleum and Mineral Law and Policy, University of Dundee, United Kingdom.

b Indonesia, Mali and Papua New Guinea have opted to retain terms that require an investor to offer phased equity participation to either the government or local private investors on a carried or working interest basis. This requirement typically comes into force at the mining phase rather than during exploration.

c For example, prior to 1991, Malaysia imposed high export duties on raw ores and concentrates. In an effort to promote increased FDI in the mining industry, almost all such export levies were reduced to a zero-level assessment rate.

d For example, Argentina, Colombia, Indonesia, Mexico, Venezuela and Zimbabwe have improved their mineral investment regimes in recent years (IWGMI, 1992, 1993a).

e For a description of the problems encountered in drafting and implementing environmental mining legislation in developing countries see Otto (1992b). Illustrative case studies of mining environmental regulation in Mexico and Chile highlight the difficulties of moving towards more stringent regulation in developing countries (IWGMI, 1992).

f For example, arbitration under international rules or international arbitral bodies is provided for in the 1993 version of the Indonesian Contract of Work, the 1987 MaliUtah International Syama gold project agreement and the Papua New Guinea model mining agreement.

g Such as the coal industry in the United Kingdom.

h Corporate income tax rates have decreased over the past ten years in Australia, Canada, South Africa and the United States. However, other types of taxes have risen, and some income tax deductions and credits have been reduced or eliminated. For example, Australia has imposed a royalty on gold and in Canada, the federal mineral depletion allowance has been eliminated and investment tax credits have been reduced.

Restrictions affecting the structure of control in foreign affiliates continue to be used in developing countries, and less frequently in developed countries, particularly in large investments in industries or activities of crucial strategic importance for the local economy. They are also used in cases of privatization of public monopolies in which the State continues to play a role. A common instrument of internal control is the granting of "golden" shares to the host government; this, among other things, permits the government to appoint a certain number of members on the boards of directors and to intervene if a foreign investor captures more than a certain percentage of the investment. In addition, it is still not uncommon for developing countries to impose restrictions on the national composition of management, or to require local participation in the management of a foreign affiliate.

Another modality of FDI restrictions that was used in the past by developing countries (in particular by the Andean countries, as part of the common regime for FDI promulgated by the Andean Pact) consisted of "fade-out" requirements, whereby foreign investors were obliged to pass on the investment to national hands over a specified period of time (normally 10 to 15 years). With the change of the Andean Pact regulations on this point, "fade-out" requirements have virtually disappeared (UNCTAD-DTCI, 1994a).

Operational restrictions. Restrictions on the employment of aliens are ubiquitous, most often on the basis of general legislation on immigration and employment rather than of laws

Table VII.4. Changes in the regulatory and policy framework for foreign direct investment in the mineral industry of Mexico, 1980 to 1993

Changes in policy and legislation	Changes in the fiscal regime
In the late 1980s large areas of the national territory previously designated as national mineral reserves (that is, unavailable for exploitation by foreign investors) began to be opened.	Since 1989, tax laws have been changed to recognize problems caused by inflation.
Beginning in 1988, a number of parastatal mining companies were put up for bidding to the private sector (of about 50 such companies, about 30 parastatals remain).	The withholding tax affecting foreign companies was reduced in 1989, from 50 per cent to 35 per cent.
Prior to privatization, parastatals held monopoly rights to mine several types of minerals. An increasing number may now be mined by the private sector.	Major tax reforms began in 1989 resulting in lower tax rates and a significant reduction in effective corporate tax rates.
Despite the Constitutional ownership limitation on FDI in mining operations (49 per cent for most minerals, 34 per cent for iron ore and coal), new regulations provide mechanisms whereby foreign participation can be significantly increased; since 1989, up to 100 per cent foreign ownership is possible.	The production tax of 5 per cent on base metals and 7 per cent on precious metals has been abolished.
New regulations since 1989 simplify the requirements for processing applications for exploration licences.	The tax on corporate dividends has been eliminated.
As of 1993, substantial offshore areas were opened to foreign mining companies.	Federal mining laws now restrict the ability of individual States to levy taxes on mining companies.
The overall investment process has been greatly simplified.	The annual tax on exploration and exploration concessions has increased in order to discourage the holding of property without engaging in active exploration.
Foreign participation in strategic industries (petroleum, radioactive minerals and minerals in the National Reserves) is now possible through joint venture arrangements.	

Source: based on data collected by the Centre for Petroleum and Mineral Law and Policy, University of Dundee, United Kingdom.

relating to FDI. The latter deal in many instances with issues that specifically affect FDI, in particular the employment of professional and managerial personnel. Employment matters may become the subject of performance requirements, when developing countries require employment and training of local labour as a condition for allowing an investment or for granting it special treatment (tax incentives).

Performance requirements have shown in recent years a tendency to lose their compulsory character and, instead, tend to be related to positive inducements. While data from the late 1970s and early 1980s showed a fairly widespread use of various types of performance requirements, developing countries have already been relaxing some performance requirements during the 1980s (UNCTC and UNCTAD, 1991).[5] Performance requirements can also be found in private agreements with specific investors.

There are, of course, other types of operational restrictions. One of them, important for many companies, concerns the ability of foreign affiliates to raise capital locally. Restrictions of this sort are now being lifted in a number of developing countries, at times in connection with the promotion of domestic capital markets.

Authorization and reporting. While in a considerable number of countries the laws may not impose explicit restrictions on FDI, governments may continue to exercise significant controls over entry by imposing screening procedures. Such procedures have been abolished in most developed countries and tend to disappear gradually in developing countries as well, being replaced by registration or notification. Yet, some kind of screening continues in many instances, for example, where authorization or special permission is still required for entry into specific industries or types of activities; for investments above certain amounts; or where the government reserves its right to deny entry to foreign investors on grounds of national security (UNCTC, 1992a, 1992d, 1992e; UNCTAD-DTCI, 1993a, 1994a; Wint, 1992) (table VII.5).

(ii) Incentives

Countries, both developed and developing, use a wide variety of incentives to promote their policy objectives. When incentive programmes discriminate in favour of foreign affiliates, it is to attract them to certain industries, or to link them to export promotion, structural adaptation, training or the introduction of advanced technology. Among the many types of incentives schemes, industrial estates, special economic zones, bonded areas, export processing zones, and -- more recently -- science parks, have attracted considerable attention. In addition, a broad variety of financial incentives, particularly in the form of subsidized sites, other infrastructure facilitation and business services are offered by regional and city authorities to encourage regional development. In recent years, countries have become more selective and focused in their granting of incentives, often made conditional upon certain performance requirements being fulfilled by the investor. This responds to the general perception that incentives are only a "second-best" solution to attract investment: as host countries compete with each other in the granting of incentives, these tend to cancel each other out and simply raise the rents to private investors without increasing the social benefits of the investment projects for the countries concerned.

As already noted, many countries that otherwise do not require authorization for entry have established various criteria and requirements as prerequisites for the grant of tax concessions and other kinds of privileged fiscal regimes and other incentives. The administration of investment incentives involves by necessity screening on the part of the competent authorities. Such procedures can be painless in the ideal case of a perfectly functioning civil service but, in actual cases, they can constitute problems for the foreign investor. A number of countries are moving away from special incentives, towards reformulating their overall fiscal regimes.

(b) *Standards of treatment*

National treatment. Most developed countries in principle grant national treatment unilaterally to all potential foreign investors, as part of their constitutions and basic laws (including civil and commercial codes) (OECD, 1992d and 1993f). In addition, many of them have undertaken international commitments in that respect, in the context of regional integration schemes. Moreover, in the context of regional agreements and bilateral investment treaties with developing countries, many developed countries have adopted reciprocal obligations to grant

Table VII.5. General authorization/notification procedures on foreign direct investment in developed countries, mid-1992

	Authorization required		*Notification required* [a]	
Country	*Greenfield investment*	*Acquisition*	*A priori*	*A posteriori*
Australia	X	X		
Austria				
Belgium		X		
Canada		X		
Denmark				
Finland	X	X		
France	X	X	X	X
Germany				
Greece	X	X		
Iceland	X	X		
Ireland	X	X		
Italy				
Japan			X	X
Luxembourg				
Netherlands			X	
New Zealand	X	X		
Norway	X	X		
Portugal			X	
Spain	X	X	X	
Sweden		X		
Switzerland				
Turkey	X	X		
United Kingdom				
United States			X	

Source: OECD, 1992d.

a Notification could potentially lead to modification or refusal of the investment proposal, either generally or for reasons of public order or essential security interests.

Table VII.6. Standards of treatment for foreign direct investment in bilateral investment treaties, autumn 1992 [a]

	Number of treaties that provide the standard				
Standard	*Africa*	*Asia andthe Middle East*	*Latin America and the Caribbean*	*Eastern Europe and Central Asia*	*Western Europe*
1. Admission					
a) In accordance with legislation, regulations, administrative practices and economic policies	78	78	40	51	11
b) Endeavour to admit in accordance with the laws (regulations)	0	9	0	0	0
c) In accordance with national treatment most-favoured-nation treatment standards	4	2	4	4	0
d) No admission clause	36	17	2	9	4
2. Treatment					
a) Fair and equitable treatment	99	81	46	55	14
b) National treatment (and fair and equitable treatment)	8	1	0	0	0
c) Most-favoured-nation treatment (and fair and equitable treatment)	39	86	6	59	9
d) National treatment (and most-favoured-nation treatment)	160	98	86	50	20
e) Treatment not to privileges granted on basis of customs union, taxation treaty etc.	66	66	39	56	10
3. Transfer of capital and return of funds					
a) Without delay	111	102	44	59	13
b) Instalments	19	18	15	6	5
c) Interest for delay	6	5	4	6	1
d) Rate of exchange officialmarket	29	43	25	45	6
4. Settlement of disputes					
a) Arbitration clause	111	102	46	60	11
b) Reference to ICSID	50	66	35	46	6
c) No arbitration clause	1	0	0	0	0

Source: Based on a survey of 335 bilateral treaties undertaken by the World Bank (World Bank, 1992; Parra, 1992).

a Bilateral investment treaties undertaken with the following OECD countries: Australia, Belgium and Luxembourg, Canada, Denmark, France, Finland, Germany, Italy, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom and the United States.

Table VII.7. Standards of treatment for foreign investors in selected national investment codes, December 1991

Standard	Number of codes that provide the standard: *Africa*	*Asia*	*Latin America and the Caribbean*	*Central and Eastern Europe*
1. Admission				
a) Authorization required	11	9	6	5
b) No special restrictions for entry	17	0	2	1
2. General standards of treatment				
a) National treatment	19	3	5	4
b) Fair and equitable treatment	1	2	0	0
c) No provision	8	4	3	1
3. Transfer of capital and profits				
a) Unconditional transfer	1	0	0	1
b) Transfer subject to regulations	22	4	5	3
c) Transfer subject to regulations and instalments on liquidation or only after a specified period	5	4	2	1
d) No provision	1	0	1	0
4. Dispute settlement				
a) Local courts	2	4	0	0
b) Courts or domestic or international arbitration	23	3	2	9
c) No provision	3	2	5	3

Source: Based on a survey of 51 national investment codes conducted by the World Bank (World Bank, 1992; Parra, 1992).

national treatment (Khalil, 1992) (table VII.6). As a result, there is now a broad network of international commitments on national treatment covering a large proportion of developed and developing regions.

According to a recent survey of 51 investment codes adopted by developing countries conducted by the World Bank (World Bank, 1992; Parra, 1992; UNCTC, 1988b and 1992d) (table VII.7), the overwhelming majority of the developing countries surveyed have adopted provisions to the effect that there shall be no discrimination against foreign as compared with local investors. At the same time, many of those countries have favoured a definition of national treatment as being treatment similar or equal to that given to local investors, thus excluding the possibility of granting more favourable treatment to FDI.

When a country commits itself to grant national treatment to FDI, it is normally assumed that the principle applies to all aspects of the operations of a foreign investment in the host country, unless specifically indicated by way of exceptions. The categories of exceptions may vary from country to country, but tend to be largely similar to those imposed on entry and establishment (e.g., national security, the protection of vital political and social interests, the furtherance of development objectives) (box VII.4).

Box VII.4. Restrictive measures affecting the national treatment standard in countries members of the Organisation for Economic Co-operation and Development

Recent surveys on the application of the national treatment standard among OECD countries have identified a number of areas where discrimination between foreign affiliates and national enterprises tends to be particularly significant.[a] These include:

- **Investment by established foreign-controlled enterprises.** Limitations on reinvestment are found in a number of developed countries, particularly in the natural resources and services areas. The most common are those affecting the scope of business operations and the volume and range of production. In the area of banking and financial services, limitations on the scope of business operations for established foreign affiliates are still being used.
- **Official aids and subsidies.** While the general approach in developed countries is not to discriminate between foreign and local investors regarding official aids and subsidies, at times these are granted on a discriminatory basis in order to promote local industries and activities, for example in the areas of subsidies by local authorities and those relating to research and development. The opposite is also true sometimes: foreign investors may be given advantages or facilities not available to national enterprises, typically as a means to encourage them to invest at the particular location.
- **Taxation** is another area in which the treatment of foreign affiliates and branches is often less favourable than that accorded to national enterprises in the same situations. In particular, developed countries tend to discriminate in the treatment of dividends paid abroad, the differences in tax rates applied to local enterprises and the tax treatment of branches of foreign-controlled enterprises.
- **Government procurement.** Governments often give preferences to national firms in bidding on public procurement contracts. Pertinent examples of policies pursued by developed countries include outright prohibition of foreign sourcing, formal criteria for allowing foreign sourcing, and procedures favouring procurement from national firms. In addition to the distinction between national and foreign firms, rules of origin might qualify as foreign the products of foreign-controlled enterprises established in the host country, thus excluding them for public procurement purposes. Most developed countries still continue to reserve government procurement to nationally-owned firms.
- **Access to local credit by foreign-controlled firms.** Foreign affiliates may be prevented from borrowing or raising capital in the host country and thus need to rely on foreign finance for their capital needs. Such restrictions may respond to a host country's need to avoid shortages of capital or foreign exchange, or to prudential considerations. These limitations are imposed by developed countries, although their use has diminished significantly during the past decade.
- **Access of foreign-controlled firms to communication and distribution networks** may be restricted by government measures or discriminatory practices, since many telecommunications, postal, computer networks or similar services are public monopolies. Such practices tend to be less frequent in developed countries today.

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a OECD, 1993f.

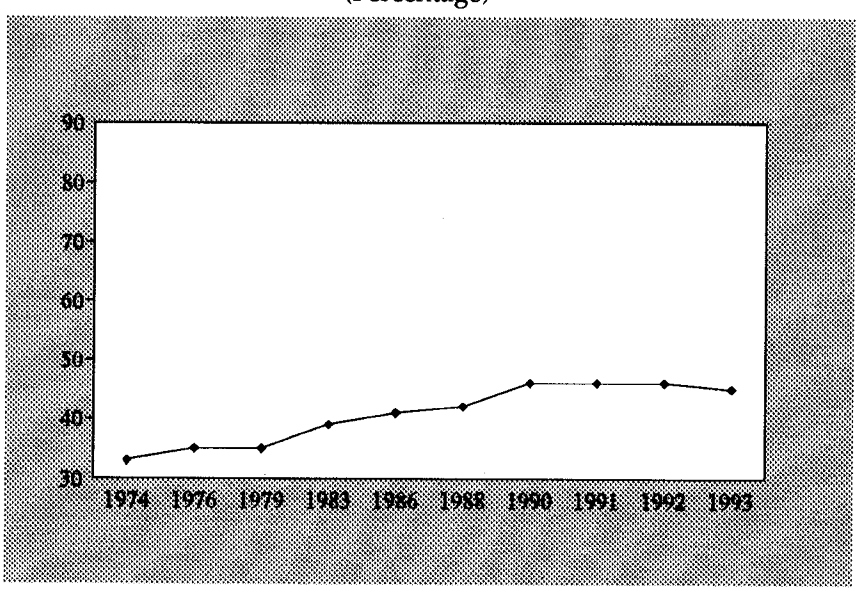
Transfer of funds. While exchange controls are far less prevalent now than they were forty years ago, they are still present today all over the world, although their precise form and extent vary widely (table VII.8).

At present, all developed countries allow, in principle, the free repatriation of the foreign capital invested. Most restrictions on transfers of profits and dividends have also been abolished in most developed countries (OECD, 1992d). With respect to the developing countries, two opposite trends concerning exchange regulations took place during the 1980s. On the one hand, developing countries faced with debt-servicing problems increased their controls in order to stem foreign exchange outflows. On the other hand, most surveys (UNCTC and UNCTAD, 1991) noted a general relaxation of foreign exchange controls, as the outcome of developing countries engaging in intense competition for FDI. According, however, to the World Bank's survey of developing countries mentioned earlier, only two of these countries grant foreign investors an unrestricted transfer of payments and capital (table VII.7). A small number of countries requires that capital be repatriated only after a specified period of time, or in instalments. The majority of the remaining countries, including countries from all developing regions, guarantees transfers of both capital and profits in principle, while making such a guarantee subject to foreign exchange regulations. Thus, an increasing number of countries have accepted, in principle, the commitments of Article VIII of the International Monetary Fund's Articles of Agreement to avoid restrictions on current payments, including remittances of profits (figure VII.2) while, at the same time, a number of these countries have continued to impose temporary restrictions on such transactions invoking the balance of payment exception authorised under the Agreement (figure VII.3).[6]

Most countries continue to screen capital movements through direct controls administered by the monetary authority. Transfers over a given amount may require the central bank's prior approval. In the event of a balance-of-payments crisis, the central bank may even withhold permission for overseas payments for an unspecified period (figure VII.4). There are also various restrictions affecting short-term capital movements.

Figure VII.2. Countries that have undertaken commitments to avoid restrictions on remittances of earnings, 1974-1993 a

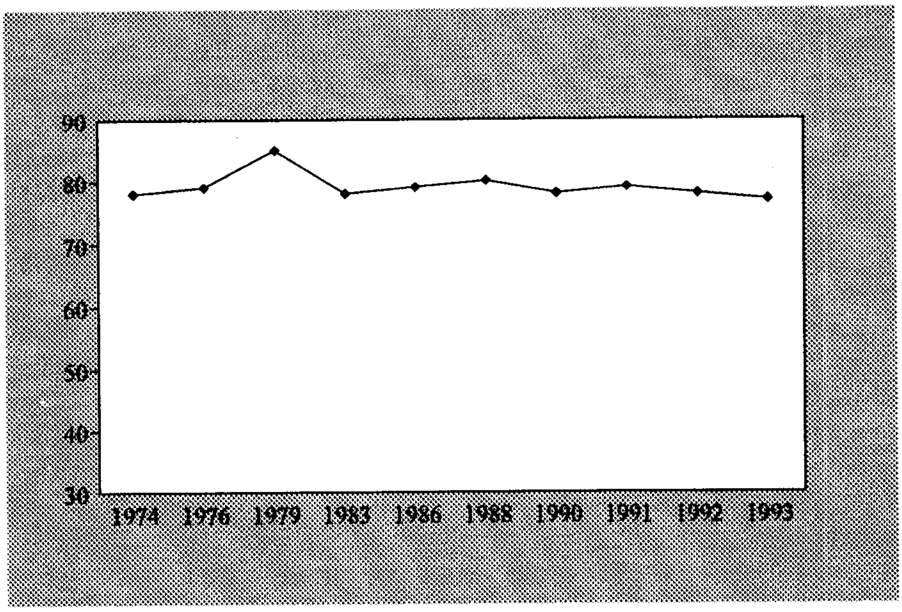
(Percentage)



Source: International Monetary Fund (1974 through 1993).

a As part of the general commitments undertaken by members on the avoidance of restrictions on current transactions under article VIII of IMF Articles of Agreement.

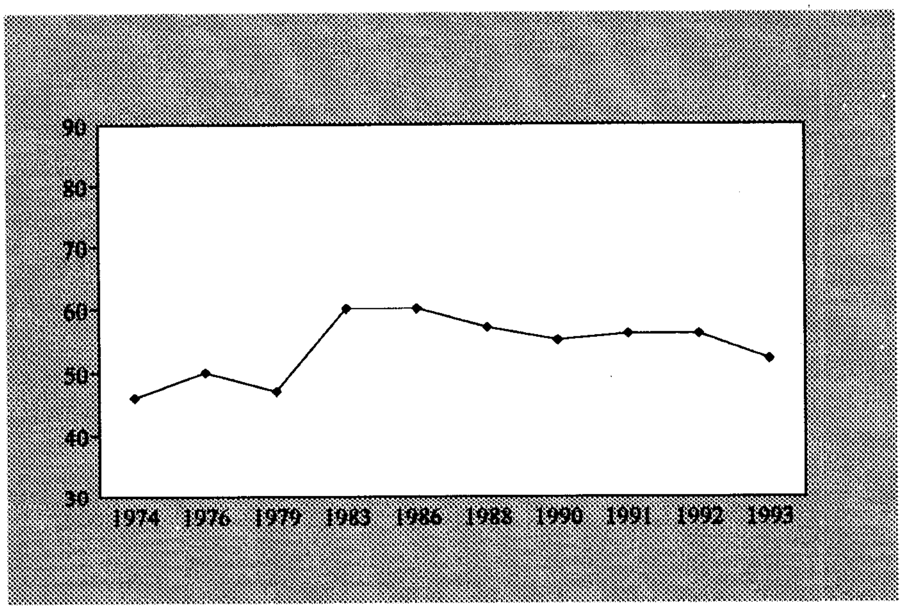
Figure VII.3. Temporal restrictions on current transactions, including repatriation of earnings, 1974-1993 [a]
(Percentage)



Source: International Monetary Fund (1974 through 1993).

a Within the exceptions allowed by IMF Agreement for balance-of-payments considerations.

Figure VII.4. Restrictions on capital transactions, 1974-1993
(Percentage)



Source: International Monetary Fund (1974 through 1993).

In addition, many countries continue to impose taxes on the remittance of profits, dividends and capital. These fiscal instruments are meant to stimulate reinvestment of profits in the host country. But outright obligations of reinvestment of profits, which were used in the past by developing countries, seem to have been discontinued.

Transparency of laws, regulations and administrative practices. In recent years, governments have made considerable efforts to publicize and disseminate information on their policy, normative and administrative frameworks relating to FDI and to ensure that this information reaches potential foreign investors. Such efforts are usually part of broader promotion activities to attract FDI. They seek to facilitate the understanding of their countries' FDI regimes by presenting the key features of such regimes in a simple and concise manner. Governments that screen foreign investors through authorization procedures have also sought to improve the transparency and efficiency of such procedures by establishing "one-stop shops" dealing with all the approval requirements. Some of these agencies are charged with both screening and promoting FDI and, thus, furnish foreign investors with relevant information to assist them in their establishment and operations. Frequently, however, the impact of these one-stop shops is negligible.

Transparency in regard to FDI can be expected to be increased as part of the implementation of the *General Agreement on Trade in Services* and the *Agreement on Trade-related Investment Measures*, negotiated as part of the Uruguay Round. These commitments underscore the fact that transparency of regulations play an essential role in the liberalization of FDI policies. Other international organizations -- such as the International Monetary Fund, the World Bank, OECD -- and various regional integration schemes routinely collect information regarding various FDI policies and measures. However, a mechanism for international transparency in all areas of FDI and for all countries does not exist, reflecting the fact that FDI is not governed by an international framework of rules that would necessitate international notification and reporting as a means of ensuring that the signatories adhere to their commitments.

(c) A summary appraisal

The wave of liberalization measures in the 1980s and 1990s has changed investment regimes considerably in today's world. The most important changes have taken place in the following areas:

- The number of industries and activities closed or restricted to FDI has been considerably reduced.
- Compulsory joint ventures with government or local private participation are now limited to a small number of "strategic" activities in a few countries.
- Fade-out requirements have virtually disappeared.
- The requirement of authorization for entry and establishment for all FDI has been generally eliminated; registration has replaced it, mainly to facilitate the repatriation of capital and remittances of profits and other current payments. In some industries (e.g., banking), authorization requirements remain, often in the context of such requirements for both foreign and domestic firms.
- Certain performance requirements have been discontinued or are now prohibited under international commitments, while others have become more focused and tend to be voluntary, required mainly in return for incentives.
- Incentives programmes tend to discriminate less in favour of foreign investors.

- While exchange controls are still in effect in many countries, there are indications that they are administered in a more liberal fashion with respect to the remittances of profits and the repatriation of capital of registered investments.
- The principles of non-discrimination and national treatment are gaining acceptance, and are in fact recognized in the basic laws of many countries, or as part of international commitments.
- Internationally acceptable standards of legal protection for foreign investors, particularly in the areas of expropriation, State contracts and settlement of disputes, are now guaranteed by the State in many countries, as part of their national legislation and increasingly through international commitments.
- Many governments have taken steps to publicize and disseminate their laws and regulations on FDI, increasing in this manner the transparency of their regulatory frameworks.
- A number of countries have adopted or are strengthening their antitrust laws, health, safety, consumer and environmental standards, and have established mechanisms to supervise international mergers and acquisitions, stock exchanges and financial markets.

A more accurate and detailed picture of the status of the liberalization process would have to be reached through a sectoral analysis of its operation. While certain broad uniformities obtain, the limits, the needs and the possibilities of liberalization differ in each of the major economic sectors.[7]

C. Beyond liberalization

The basic elements of the liberalization process reviewed above, namely, the elimination of discriminatory market-distortions, adherence to certain standards and the establishment of controls and prudential supervision to ensure the proper functioning of the market, are central, immediate and direct aspects of the policy and normative framework for FDI and TNC operations. Yet, the broader context within which foreign affiliates operate inside a host country is also relevant and, as the liberalization process progresses, becomes increasingly visible; in fact, certain aspects of the internal normative framework are essential to give meaning and effect to that process. This applies, in particular, to the broader regulatory and administrative framework and the investment climate in general:

The effectiveness of the liberalization process in the area of FDI depends on the existence of a reasonably comprehensive legal framework for business activities in general, including, for example, appropriate legislation on companies, industrial relations and insolvency (Rubin and Wallace, 1994). In fact, a properly functioning legal order, including well functioning courts, is required to provide predictability and certainty, including, for instance, respect for such basic principles as due process of law. Furthermore, reasonably well functioning administrative infrastructures are necessary to ensure the effective implementation of the legal framework within which business operates. In the absence of a reasonably complete framework and legal order, a case-by-case treatment of investments and enterprises would be necessary. In a country lacking adequate legislation on the exploitation of natural resources, for instance, each "concession" to a prospective investor would be fashioned on the basis of the State's needs at the moment, short-run conditions in the relevant market, the investor's ability to persuade local officials and other factors. The result may be a situation in which different investors in the same industry operate under different rules negotiated by contract. Subsequent investors typically try to improve on previous ones. The experience in many developing countries rich in natural resources has shown clearly the dangers of such a situation. Regardless of intentions, or fairness of approach, case-by-case treatment does not provide adequate predictability to investors and has in itself the potential for arbitrary action and for restrictions of various kinds. In such a situation, moreover, such fundamental facets of a liberalized regime as the grant of national treatment can have no precise meaning and function. Liberalization is a fragile process that needs the support of a sturdy legal framework to survive.

Given the close interlinkages between FDI, trade and the dissemination of technology, the policy framework for FDI can not be divorced from that for other international economic transactions. For the process of liberalization of the FDI framework to be effective, therefore, the frameworks for other international economic activities would have to move in the same direction. The requirements of integrated international production would make a country that takes any other approach less attractive as an investment location.

Furthermore, this is only part of what constitutes a good investment climate. Of course, certain issues like political and economic stability may not be under a government's immediate control. Similarly, the establishment of a sound macroeconomic framework, the upgrading of a country's human resources and the strengthening of its physical infrastructure may require some time. But there are a number of measures a government can take, where appropriate, with an immediate effect on the investment climate. For example, entering into bilateral or multilateral commitments to guarantee foreign investors against non-commercial risks, may boost investors' confidence. Also, a variety of promotional efforts can be undertaken to attract investment. Apart from their intrinsic value, promotion measures send positive signs of the "good will" of the host country towards foreign investors and, therefore, constitute important ingredients of a favourable investment climate. The same effects can be obtained from a positive attitude of the governments to the private sector (both domestic and foreign) which, among other things, can find its expression in privatization programmes.

Overall the liberalization of FDI regimes does not imply a weakening of the role of government, but rather a redefinition of some of its functions and the strengthening of others (Osborne and Gaebler, 1992). In particular, the process of reducing distortions and establishing positive standards occurs simultaneously with the strengthening of controls meant to ensure the proper functioning of markets and other actions aimed at improving the investment climate. Furthermore, and recalling the relative character of liberalization and the fact that there are more and less liberalized regimes, it must be stressed that a description or even an analysis of the liberalization process cannot involve a quest for perfection. It would be difficult to define in clear terms what constitutes a perfect investment regime, in terms of liberalization, even from the viewpoint of a single investor, and even more so if one had to take into account the interests of other investors, domestic as well as foreign, and the long-term interests of the countries concerned. Lastly, the nature of the FDI liberalization process depends on the concrete circumstances in each country and each industry and needs to take into account that the introduction of liberalization often entails a number of risks. Liberalization should, therefore, be introduced with care. Different industries may need to be approached differently, keeping in view the specific situation and objectives of a given country.

The liberalization process is a policy process; like all such processes, it involves difficult choices between desirable outcomes and trade-offs between objectives. Any discussion must accept that it necessarily involves trends and patterns, and moves in areas of approximation and uncertainty.

Conclusions

While the process of liberalization has led to a certain convergence of the characteristics of FDI regimes, numerous -- and at times considerable -- differences remain. These differences, in turn, become more important for the decisions by TNCs on where to invest. As a result, efforts to attract FDI can lead to "policy competition" which, in the final analysis, may be detrimental to the interests of the countries involved.

Such competition could potentially be carried into more policy areas than in the past, since the increasingly integrated nature of international production elevates more and more policies that concern the production process from the domestic to the regional or international domain. This internationalization of part of the domestic policy agenda poses new challenges for policy makers and, in particular, increases the need for policy coordination among governments. It also points to a potential role to be played by international organizations. Exchanges of experiences among governments about their FDI and related policies would be one way to increase the transparency in regard to these processes.

Finally, the FDI liberalization process, by its very nature, leads to an increased role of the market and, hence, the principal actors in the market, including TNCs. This, in turn, raises the question whether this increased role is -- or should be -- accompanied by increased responsibilities, especially social responsibilities. The next chapter addresses this issue.

Notes

1. Foreign direct investment is defined as follows: "Direct investment -- reflecting the lasting interest of a resident entity in one economy (direct investor) in an entity resident in another economy (direct investment enterprise) -- covers all transactions between direct investors and direct investment enterprises. That is, direct investment covers the initial transaction between the two and all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated. Direct investment transactions (abroad and in the reporting economy) are subclassified into equity capital, reinvested earnings, and other capital (intercompany transactions)..." (IMF, 1993a, para. 177, p. 41; see also OECD, 1992a). A foreign-resident affiliate (hereafter "foreign-affiliate") of a TNC may be an enterprise incorporated in the host country (a subsidiary or associate company) or an unincorporated branch.

2 For a more detailed examination of the drafts of these Agreements, see UN-TCMD, 1992.

3 It should be noted, however, that many countries started the liberalization process in the context of bilateral investment treaties and regional schemes; indeed, it is in the context of these commitments that the highest levels of liberalization have been achieved. The liberalization process discussed here involves national measures, as well as bilateral, regional and (when applicable) multilateral instruments.

4 For an in-depth analysis of the various elements involved in the definition of the standard of national treatment, see UNCTC (1990).

5 For instance, Andersson (1989) and Globerman (1988) found some evidence of general relaxation of host country performance requirements already in the early 1980s.

6 Article VIII of the International Monetary Fund's Articles of Agreement prescribes general obligations for Members with respect to the avoidance of restrictions on current payments, including remittances of profits, avoidance of discriminatory currency practices, convertibility of foreign-held balances, furnishing of information, consultation between Members regarding existing international agreements, and collaboration regarding policies on reserve assets.

7 For a detailed study of the characteristics of liberalization in the services sector, see UNCTAD-DTCI and World Bank (1994).