
**UNITED NATIONS CONFERENCE ON TRADE
AND DEVELOPMENT**

**FOREIGN DIRECT INVESTMENT AND
PERFORMANCE REQUIREMENTS:
NEW EVIDENCE FROM SELECTED
COUNTRIES**



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Preface

The continuous globalization of the world economy poses new challenges for the governance of economic activities. This is particularly the case in the area of foreign direct investment. Investment and trade liberalization have provided greater freedom to transnational corporations to organize their production activities across borders in accordance with their own corporate strategies and the competitive advantages of host-countries. Countries today view inward foreign direct investment as an important means of integrating their economies with international markets and expect it to contribute to their economic development. Nonetheless, openness alone is not always sufficient for the expected benefits to materialize. In order to narrow the gap between the objectives of host countries and transnational corporations, governments use a variety of policy measures.

Performance requirements can be an important policy tool in this context, to enhance the benefits of, and address concerns related to, inward FDI. Their role in policy-making is still controversial, however. Many developing countries seek to preserve their right to utilize them, arguing that they should have the right to use tools that were available to developed countries when they were industrializing their economies. Developed countries, on the other hand, tend to associate performance requirements with interventionist strategies of the past and question their effectiveness.

In response to a request made by the Commission on Investment, Technology and Related Financial Issues at its sixth session, the present volume is meant to contribute to the debate on performance requirements by bringing new empirical evidence to bear on the subject. To this end, the volume presents four developing country case studies and a review of the experience of developed countries. The focus of

the analysis is on performance requirements that are not prohibited by the WTO Agreement on Trade-Related Investment Measures, but may be addressed in various agreements at the bilateral or regional levels.

A handwritten signature in cursive script, reading "R Ricupero", with a horizontal line underneath.

Geneva
October 2003

Rubens Ricupero
Secretary-General, UNCTAD

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CHAPTER I

THE OVERALL PICTURE

A. Introduction

Foreign direct investment (FDI) can play a significant role in the development process of host economies. In addition to providing capital inflows, FDI can be a vehicle for obtaining foreign technology, knowledge, managerial skills, and other important inputs; for integrating into international marketing, distribution and production networks; and for improving the international competitiveness of firms and the economic performance of countries. However, neither inflows of FDI nor the benefits from such inflows are automatic.

While more and more countries welcome inward FDI, increased attention is being given to policies that can enhance the development benefits of such investment. There is considerable variation in the "quality" of FDI, and the associated impact of such inflows on host countries. Similarly, some host country environments are less conducive to positive impacts from FDI, irrespective of the strategy or operational behaviour of transnational corporations (TNCs). For example, weak domestic capabilities in a country hamper its ability to reap the benefits of inward FDI and limit knowledge spillovers.¹ On the other hand, in countries with relatively inefficient domestic enterprises inward FDI may provide examples of best practice, spurring a rise in the productivity of local competitors. At the same time, it also risks crowding out domestic firms. In some situations, as when domestic enterprises are relatively uncompetitive, this may be desirable from an economic efficiency perspective. In other cases, crowding out may lead to increased market concentration. Anti-competitive behaviour and restrictive

¹ See e.g. Haddad and Harrison, 1993; Kokko et al., 1996; Aitken and Harrison, 1999; De Mello, 1999; and Xu, 2000.

business practices on the part of TNCs may also result in welfare losses.² The commercial interests of TNCs do not always coincide with a host country's developmental objectives, for example with regard to sourcing behaviour and reallocation of profits through transfer pricing practices.

Among the range of policy options available to governments to optimize the impact of FDI, this volume focuses on a specific set of instruments that have been and still are applied by many countries – performance requirements. Performance requirements are stipulations, imposed on investors, requiring them to meet certain specified goals with respect to their operations in the host country. They are and have been used by developed and developing countries together with other policy instruments, such as trade policy, screening mechanisms and incentives, to enhance various development objectives. There are divergent views as regards the effectiveness of performance requirements to achieve this end. While some experts regard them as an essential instrument in a country's FDI policy package, others tend to argue that their impact on investments is at best limited and at worst costly and counter-productive.³

Performance requirements may cover all aspects of investment. They can be imposed at the point of FDI entry and subsequent expansion or, as is increasingly the case, as a condition for the provision of some kind of advantage. In UNCTAD parlance, performance requirements are one kind of so-called "host country operational measures", with the main other measures being various restrictions (UNCTAD, 2001a). In principle, performance requirements can be divided into three categories (table I.1): the first category consists of those that are explicitly prohibited by the WTO Agreement on Trade-Related Investment Measures (TRIMs) because

² Recent empirical literature suggests that FDI under certain conditions may in fact be immiserizing (Fry, 1992; Agosin and Mayer, 2000; Kumar and Pradhan, 2002; Carkovic and Levin, 2002).

³ See, for example Kumar, 2001; Rodrik, 1987; Guisinger et al., 1985; and Moran, 2002.

they are inconsistent with Articles III and XI of GATT/1994; the second includes requirements that are explicitly prohibited, conditioned or discouraged by interregional, regional or bilateral (but not by multilateral) agreements; and the third category covers requirements that are not subject to control through any international investment agreement (IIA).

Table I.1. Categories of performance requirements

Category	Performance requirement
Prohibited by the TRIMs Agreement	Local content requirements
	Trade-balancing requirements
	Foreign exchange restrictions related to the foreign-exchange inflows attributable to an enterprise
	Export controls
Prohibited, conditioned or discouraged by IIAs at bilateral or regional levels	Requirements to establish a joint venture with domestic participation
	Requirements for a minimum level of domestic equity participation
	Requirements to locate headquarters for a specific region
	Employment requirements
	Export requirements
	Restrictions on sales of goods or services in the territory where they are produced or provided
	Requirements to supply goods produced or services provided to a specific region exclusively from a given territory
	Requirements to act as the sole supplier of goods produced or services provided
	Requirements to transfer technology, production processes or other proprietary knowledge
	Research and development requirements
Not restricted	All other performance requirements

Source: Adapted from UNCTAD, 2001a, p. 3.

In this volume, the focus of the analysis is on selected performance requirements that fall into the second category, notably those linked to joint ventures or domestic equity; exports,⁴ technology transfer, research and development (R&D) and employment and training.⁵ The purpose is to assess the experience of a number of countries that have used such requirements to optimize the development impact of FDI.

As indicated, none of these measures are prohibited at the multilateral level but are forbidden in various bilateral or regional contexts (UNCTAD, 2001a, pp. 34-35; UNCTAD, 2003).⁶ For example, *joint venture requirements* are restricted in the association agreement between the European Community and Chile and the free trade agreement between the EFTA States and Singapore in services industries where market commitments are undertaken (Article 24), and the North American Free Trade Agreement (NAFTA) forbids *domestic equity requirements* (Art. 1102(4)). *Employment requirements* are prohibited under the bilateral investment treaty (BIT) between Japan and the Republic of Korea. Moreover, Article 1106(1) of NAFTA proscribes among others the imposition or enforcement of mandatory requirements and the enforcement of any undertakings or commitments to *export* a given level or percentage of goods or services; and to *transfer technology, a production process or other proprietary knowledge* to a person in its territory.⁷ Similar

⁴ In the case of export requirements, it is important to note that linking such requirements to the receipt of a subsidy is prohibited under the WTO Agreement on Subsidies and Countervailing Measures for developed countries and generally for middle-income developing countries as of 1 January 2003.

⁵ Prohibited performance requirements, such as those related to local content and trade-balancing conditions, will, however, be briefly referred to in the following analysis.

⁶ Training requirements are not restricted in IIAs but will still be included in the analysis as they are closely linked to employment requirements.

⁷ An exception is when the requirement is imposed or the commitment or undertaking is enforced by a court, administrative tribunal or competition authority to remedy an alleged violation of competition laws or to act in a manner not inconsistent with other provisions of the NAFTA (Article 1106(1f)).

provisions are also found in a number of Canadian and United States BITs with different countries. Requirements linked to R&D are restricted, for example, the United States BITs with Trinidad and Tobago as well as that with Bolivia. The prohibition of a wide range of performance requirements is also contained in the 2002 Agreement between Singapore and Japan for a New Age Economic Partnership.⁸ Some BITs between developing countries also regulate the use of performance requirements. This applies, for example, to BITs between El Salvador and Peru (1996), the Dominican Republic and Ecuador (1998), and Bolivia and Mexico (1995). The same applies to the free trade agreements between Chile and Mexico (1999), and between Chile and the Republic of Korea (2003).

Most of the requirements mentioned above are only prohibited when applied as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment. In most cases, such as under the United States BITs and the Singapore-Japan Agreement, the parties are allowed to impose conditions in these areas for the receipt or continued receipt of various benefits and incentives.⁹

This review is based on four case studies that have been commissioned by UNCTAD to examine the use and impact of performance requirements in developing countries. The four countries – Chile, India, Malaysia and South Africa – represent a mix of small and large economies with different approaches to FDI-related policies. While all of them have used mandatory and/or voluntary requirements to influence the behaviour of investors, the emphasis chosen differs considerably, often reflecting different development

⁸ Conversely, the 1994 Treaty on Free Trade between Colombia, Mexico and Venezuela explicitly allows the imposition of requirements to locate production, generate jobs, train workers or carry out research and development (Article 17-04).

⁹ This, however, does not apply to export performance requirements, since export subsidies are generally prohibited by the WTO Agreement on Subsidies and Countervailing Measures (SCM).

objectives. The four case studies are complemented by a review of the use of performance requirements in developed countries.

The structure of this chapter is as follows. After this Introduction, the next section B addresses the underlying rationale for using performance requirements and highlights some theoretical studies of such measures. Section C reviews how the incidence of requirements has evolved over time. Section D summarizes some key findings from the four case studies and the review of experiences of developed economies with regard to the relevant performance requirements. In the final section, some overall conclusions are drawn and possible options are discussed with regard to the future treatment of performance requirements in the context of international investment agreements.

B. Rationale for using performance requirements

The economic rationale for applying a performance requirement depends on the objective of the measure. In general, the role of such requirements is to address some form of market or policy failure related, for example, to the presence of positive or negative externalities, information asymmetries and/or sluggishness on the part of the TNC in responding to opportunities prevailing in the market.¹⁰ Local content, export, joint venture and other requirements have been imposed to offset or pre-empt restrictive business practices in the form of, for example, market allocation, price fixing, exclusive dealing and collusive tendering (Puri and Brusick, 1989). Sometimes performance requirements have been used to remedy distortions created by government intervention elsewhere in the economy. For

¹⁰ The mere existence of TNCs is itself a manifestation of market failures, as TNCs have firm-specific ownership advantages over other firms, enjoy scale and scope economies, internalize deficient markets for information and skills, and have privileged access to finance. All these aspects contradict the requirements of perfect competition. It is far from clear that the interaction between efficient internal markets of TNCs and the deficient ones of host developing countries automatically lead to mutual benefits (UNCTAD, 1999, p. 316).

example, countries that have adopted an import substitution strategy have often tried to counterbalance the anti-export bias with the introduction of export performance requirements.

Given the possibility of conflicting interests between investors and host countries, requirements have also been used to tilt the distribution of gains from investments in favour of the latter. Governments have sometimes applied performance requirements to achieve macro- or microeconomic development goals or to affect the distribution of benefits among regions or the population at large. In some cases, the imposition of requirements may create rents that tend to benefit relatively small but well-organized interest groups in society at the expense of the larger public.

In sum, specific objectives for imposing performance requirements include:

- strengthening the industrial base and increasing domestic value added;
- generation of employment opportunities;
- linkage promotion;
- export generation and performance;
- trade balancing;
- regional development promotion;
- technology transfer;
- avoidance of restrictive business practices;
- generation and distribution of rents;
- various non-economic objectives, such as political independence and distribution of political power.

Among the performance requirements often used in the past are local content requirements (which are now prohibited by the TRIMs Agreement). Theoretical as well as empirical studies show diverging results, and views vary on the role of local content requirements as a development tool. With regard to their welfare impact, theoretical models produce different results depending on the

model specifications and on whether one is considering world welfare, that of the home country or that of the host.¹¹ Where tariffs or other forms of protection cannot be removed and/or oligopoly exists, performance requirements may improve host-country welfare by reducing the market power of TNCs and increasing local sourcing.

Empirical evidence is also mixed. Some studies show that local content requirements have been effectively used to overcome information asymmetries and other market failures to prompt TNCs to source locally, license the local manufacture of components that it may not do otherwise, identify nascent local capabilities and provide them with know-how and technology (Kumar, 2002b). One author (Balasubramanyam, 1991) concludes that the development of local supplier capabilities far outweigh the short-run welfare losses that local content requirements may impose. Meanwhile, a number of other studies have concluded that local content requirements can be a costly and inefficient policy tool in terms of resources allocation and growth (see e.g. WTO/UNCTAD, 2002, pp. 28-29 for a summary).

The effectiveness of such requirements is likely to be context-specific. When used carefully, with offsetting measures to ensure that suppliers face competitive pressure and have access to the technology and skills they need to improve their capabilities, they can contribute to fostering efficient capabilities. If used in a protected setting, with little pressure to invest in building competitive

¹¹ For example, Richardson (1993) showed (using a general equilibrium model) that effective local content requirements will induce foreign firms to increase their own domestic production of the component input and induce capital flows thus furthering the process of industrialization of host country. Using a long-run macroeconomic model, another study concluded that a more restrictive content protection policy lowers the stock of capital and employment while raising the current account balance (Kim, 1997). Lahiri and Ono (1998) use a partial equilibrium model to show that, when a country imposes a profit tax and a local content requirement to compete for FDI, the effects on its employment and its price level depend on the number and relative efficiency of domestic firms. Meanwhile, applying a duopolistic model, yet another study concluded that local content requirements reduce world welfare, world output, and the source country's welfare, although they may up to a point increase the host country's employment (Davidson et al., 1985).

capabilities, they tend to contribute to the development of inefficient suppliers that saddle the economy with outdated technologies or redundant skills (UNCTAD, 2001b, p. 169; Kumar, 2002b).

In developed countries, performance requirements have historically been employed to deal with four broad types of concerns related to the political and economic consequences of a substantial TNC presence: the micro- and macroeconomic impact, issues of income distribution, maintenance of political independence and distribution of political power (chapter VI). While most developed countries have generally taken a welcoming stance towards FDI, domestic ownership and other requirements and undertakings have frequently been used. For example, countries have commonly imposed various restrictions and requirements to preserve a significant share of certain industries for the domestic enterprise sector. There have also been fears that an excessive reliance on FDI complicates the capacity of a state to implement some of its policies. National security was only the most obvious of such questions, and led to ownership restrictions in many industries.

A review of experiences in the four developing countries covered in this study suggests that the rationale for imposing mandatory or voluntary requirements is context-specific and reflects different development priorities. For example, in South Africa, the desire to create a more equal distribution of opportunities has led the Government to adopt equity requirements on investments in specified industries and to impose employment and training requirements on both domestic and foreign investors (chapter V). Similar efforts took place in Malaysia, where various requirements were used to enhance Bumiputera participation in the economy (chapter IV).

C. Incidence of performance requirements

Performance requirements have been extensively applied by a large number of countries at varying stages of development. However, the incidence has varied across countries, depending upon their development strategy, endowments of natural and other

resources, and market size, among other factors. In what follows, the patterns and trends in the use of performance requirements by developed and developing countries are summarized.

1. Developed countries

The most comprehensive (albeit somewhat old) source of information on performance requirements is that for United States outward FDI in the *Benchmark Surveys* published every five years by the United States Department of Commerce; for some years these included specific questions related to the use of performance requirements. In 1982, of a set of 17,213 United States non-bank affiliates abroad, minimum export requirements were reported by 1.5 per cent, maximum import limits by 1.6 per cent, local content requirements by 1.5 per cent, local labour requirements by 7.6 per cent, a cap on the parent's equity by 4.3 per cent, requirements to transfer technology by 3.6 per cent and trade-balancing requirements by 1.4 per cent of these firms (chapter VI).¹²

While ratios varied a good deal by country and sector, almost all the figures were below 10 per cent. For the 1970s and 1980s, the incidence of requirements was lower for developed than for developing countries. The number of requirements was particularly high in industries in which TNCs are concentrated, notably in electrical, transportation equipment (especially automobiles), chemicals, non-electrical machinery and some primary industries such as mining and petroleum.¹³

¹² Local content requirements have been employed by most developed countries from time to time, especially in the automotive industry. See e.g. OECD, 1989; Safarian, 1993; Gusinger et al., 1985; Chang, 2002.

¹³ This was confirmed in a 1982 study by the United States International Trade Commission, which found that 41 per cent of the foreign affiliates of United States TNCs in the automotive industry were subject to performance requirements, 12 per cent of the affiliates in chemical production, and 19 per cent of the affiliates in production of computer and office equipment (UNCTC, 1991).

In a survey of 74 FDI projects in four industries – food processing, automobiles, computers and petrochemicals – 38 were found subject to trade-related requirements (Guisinger et al., 1985). Although some changes in trade patterns were reported, it was not possible to determine their effectiveness because some of the "requirements" were not binding and because often it was not clear what firms would have done without the requirements since incentives were also involved.¹⁴

In a study by the Overseas Private Investment Corporation, 682 investment projects that had applied for insurance were surveyed (Moran and Pearson, 1987). The study found that 40 per cent of the projects were subject to such requirements. An interesting observation was that performance requirements in almost two-thirds of the cases were "voluntary" in the sense that they were attached to the provision of incentives.

Various assessments have shown that the use of performance requirements among developed countries has been reduced over time (Safarian, 1993; OECD, 1989). During the 1980s, FDI policies became less restrictive in many respects. By the end of the 1980s, a study by the United States Trade Representative (1989) concluded that seven developed countries still had local equity requirements, six had local content requirements, three had export requirements, three had R&D requirements, two applied product mandating requirements and one had a trade-balancing requirement (UNCTC, 1991, table 8). FDI was allowed to a larger extent in industries such as finance where it was formerly prohibited or limited. Investment review was ended or sharply limited, with screening of investors mainly being linked to the granting of incentives (Safarian, 1993).

This, however, does not mean that developed countries have given up their desire to influence the behaviour of firms. Instead, new instruments have been introduced, some of which can distort trade and have an adverse impact on third countries. There has been a trend

¹⁴ All firms subject to performance requirements received compensatory incentives.

towards using trade policy measures that achieve objectives similar to those of selected performance requirements. These include rules of origin, screwdriver regulations, voluntary export restraints and anti-dumping measures (Belderbos, 1997; Moran, 1998; Safarian, 1993). The United States had employed voluntary export restraints against Japanese exports of cars in 1981. Subsequently the European Union (EU) imposed such restraints on Japanese exports of consumer electronics. Rules of origin are used especially by the EU and NAFTA member countries, taking advantage of regional trade area exceptions that are available under Section XXIV of the GATT, to increase the local value added. Rules of origin determine the extent of domestic content a product must have to qualify as an internal product in a regional trading area and, hence, have similar effects as local content requirements.¹⁵ The EU countries have also used anti-dumping measures to regulate imports of cars and other products from Japan and South-east Asia, and the United States has used similar measures in attempting to achieve reciprocity (that is, "substantially equivalent competitive opportunities") in trade and investment with Japan and other countries (chapter VI). In the United States, provisions of the Buy American Act in some ways may have acted as local content requirements. For instance, in order to qualify as a domestic product to claim a 25 per cent price preference under the Buy American Act, a Hungarian manufacturer of buses had to buy United States made engines, transmissions, axles and tyres (Krugman and Obstfeld, 2000, p. 205). In addition to such trade policies, there

¹⁵ The objective of rules of origin in NAFTA has been to prevent "screw-driver" assembly operations from being set up within the region that could utilize low-cost inputs from outside. NAFTA rules of origin require that a substantial portion of inputs originate within the region for automobiles, electronic products (printers, copiers, television tubes), textiles, telecommunications, machine tools, fork-lift trucks, fabricated metals, household appliances, furniture, and tobacco products. The European Union has adopted domestic-content rules of origin in automobiles and other industries and has entertained proposals for even tighter requirements for printed circuit boards and telecom switching equipment. It has negotiated association agreements in Central and Eastern Europe that require 60 per cent domestic content for products to qualify for entry into the European Union (see e.g. Kumar, 2001).

has also been a proliferation of the use of locational incentives and various strategic trade and investment policies (Safarian, 1993; Moran, 2002).

Thus, the low incidence of performance requirements in developed countries in some respects hides measures that aim at achieving similar objectives.

2. *Developing countries*

Developing countries also use performance requirements (see, for example, WTO/UNCTAD, 2002), the most prominent of which have been local content requirements linked to the automobile industry (table I.2). However, local content requirements in other industries and other types of requirements have also been imposed by a number of developing countries.

Table I.2: Incidence of performance requirements among developing countries

Type of requirement	Economy
Local content in the automotive industry	Argentina, Brazil, Chile, China, Colombia, Ecuador, India, Indonesia, Malaysia, Mexico, Philippines, Republic of Korea, South Africa, Taiwan Province of China, Thailand, Uruguay, Venezuela
Local content in other industries and other performance requirements	Barbados, Bolivia, Chile, China, Costa Rica, Cyprus, Colombia, Dominican Republic, Egypt, India, Indonesia, Malaysia, Mexico, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, South Africa, Thailand

Source: Kumar and Singh, 2002, based on notifications under the TRIMs Agreement and WTO/UNCTAD (2002).

The United States Trade Representative study referred to above found that, among 31 developing countries studied in 1989, as many as 23 used local content requirements, 17 applied local equity requirements, 16 used export performance requirements, 11 had

technology transfer requirements and 5 countries imposed R&D requirements (UNCTC, 1991, table 8). In a more recent survey of European business executives, the largest number of performance requirements and other restrictions were noted for relatively large developing countries. Requirements encountered included joint venture or domestic equity requirements; local content requirements, and more than half the respondents had encountered export requirements, (Taylor Nelson Sofres Consulting, 2000).

Still, the overall trend resembles that of developed countries. There is a tendency to rely less on mandatory requirements that force an investor to comply with certain conditions and more upon requirements linked to incentives. Surveys by the European Round Table of private investors in manufacturing indicate that the use of performance requirements in a sample of developing economies was reduced especially in the first half of the 1990s, with this trend continuing at least until 1999 (table I.3).¹⁶

Table I.3. Remaining performance requirements
(score between 0 and 6)

Economy	1992	1996	1999
Argentina	1	0.5	0.5
Bangladesh	1	0	0
Brazil	0.5	0	0
China	4	3	3.5
Colombia	1	1	1
Ecuador	1	1	1
Egypt	2	1	1
Ghana	1	1	0
Guatemala	1	0.5	0
India	1.5	1.5	1
Indonesia	3	1	0

/...

¹⁶ In the European Round Table study (ERT, 2000) performance requirements refer to those related to exports; local content and manufacturing; foreign exchange balancing or import and local sales licences that depend on export performance, etc.

Table I.3. Remaining performance requirements (concluded)
(score between 0 and 6)

Economy	1992	1996	1999
Iran	3	3	3
Kenya	2	0	0
Korea, Rep. of	0	0	0
Malaysia	3	2	2.5
México	2	0.5	0
Nigeria	3	0	0.5
Pakistan	3	3	3
Philippines	2	1	1
Sri Lanka	2	1	1
Syria	2	2	2
Taiwan Province of China	1	1	1
Thailand	2	1	1
Tunisia	0	0	0
Turkey	0	0	0
Viet Nam	0	0	0
Zimbabwe	3	0	0
Average score	1.61	0.89	0.82

Source: European Round Table (2000).

Note: The higher the score, the greater the incidence of performance requirements. The data given reflect an average situation for each country. Thus, it may not accurately mirror the situation in large economies and, in general, those with regional differences in the treatment of FDI.

The four case studies included in the present volume confirm the general tendency of a gradual removal of mandatory performance requirements and greater focus on other ways of inducing certain kinds of behaviour by the investors. The latter approach typically involves a number of incentives to which performance requirements or criteria are attached.

In *Chile*, the Government has traditionally employed relatively few performance requirements linked to the approval of investment (chapter II). Requirements have mostly been related to the provision of some incentive or other advantage. The country has used

export performance requirements linked to incentives (that are to be eliminated by 2003) and local content in the automotive industry (until 1999); some relatively broadly defined requirements are still applied for the provision of incentives for investment in high technology industries. In terms of mandatory requirements, as part of a policy mix during Chile's transition to full financial integration and a floating exchange rate regime between 1991 and 1998, investors had to comply with certain capital controls. Finally, since 1997, the Government requires an environmental impact assessment of new investment projects to encourage a more rational use of Chile's natural resources and protect the environment.

In contrast to the Chilean experience, *India* has historically been a more active user of various performance requirements (chapter III). Beyond local content regulations that were applied to the automotive industry until recently, the Government has also imposed export obligations on the larger and foreign controlled enterprises in industries reserved for small-scale enterprises. Enterprises operating in export processing zones (EPZs) and under an export-oriented units scheme also have to meet certain obligations. In 1991, indirect export obligations (in the form of dividend balancing or foreign-exchange neutrality) were imposed on enterprises producing consumer goods in view of the foreign-exchange situation. These obligations were phased out in 2000. A general limit of 40 per cent of foreign ownership was applied during the 1970s and 1980s. However, limits on foreign ownership have been gradually removed in the 1990s.

Thus, also in India, there has been a tendency to remove mandatory requirements and rely increasingly on encouragement through incentives. The overall incidence of performance requirements on FDI approvals has declined sharply over the 1990s. In 1991, 33 per cent of FDI approvals contained performance requirements. This proportion has fallen gradually to just about 9 per cent by 2000. In fact, the bulk of performance requirements imposed today in India are 100 per cent export obligations in return for several concessions and incentives. Performance requirements other than

those imposed on enterprises entering EPZs or other such schemes have more or less disappeared (chapter III).

Malaysia has followed a slightly different approach from that taken by Chile and India. Being a relatively small country, its bargaining power vis-à-vis investors has been relatively limited as compared to that of India (chapter IV). Compared to Chile, however, Malaysia has been more prone to apply performance requirements. The requirements (voluntary and mandatory) used in Malaysia have been related to exports, equity-levels, local content, employment, training and R&D. Export requirements were, for example, related to both the provision of tax incentives and linked to equity restrictions in different industries and activities. R&D requirements have been used only as a condition for incentives. Mandatory employment requirements related to the hiring of Bumiputera workers prevailed until the 1990s, and training conditions have been attached to the manufacturing licence or the pioneer status certificates in order to enhance the skills and other productive capabilities of the Malaysian workforce. Domestic equity requirements first introduced in the 1970s have been gradually relaxed over time, most recently in connection with the East Asian financial crisis. As a result, new foreign investors can currently hold 100 per cent equity, irrespective of the level of exports.¹⁷

Finally, in *South Africa*, the Government has resorted to a mix of mandatory and voluntary performance requirements to optimize the benefits from FDI (chapter V). Export, technology transfer and R&D requirements are applied in South Africa only as a condition for the attainment of some form of advantage, while the employment and training requirements as well as the domestic equity requirements used in South Africa are mandatory in character and have mainly been imposed to address racial imbalances. With the exception of the Foreign Investment Grant, to which certain

¹⁷ This relaxation does not, however, apply to activities where Malaysian SMEs have capabilities and expertise.

technology transfer requirements are attached, the other requirements are imposed in the same way on domestic and foreign investors.

3. *Explanations for the decline in incidence of performance requirements*

The review of the use of performance requirements in both developed and developing countries shows that the incidence of such policy measures has generally declined. This applies in particular to mandatory requirements not linked to incentives of various kinds. There are several explanations of this trend.

Phase out in order to comply with international commitments

The need to comply with international commitments has no doubt contributed to the decline in the use of some performance requirements. For example, in 1984, a GATT dispute settlement proceeding between the United States and Canada found that some undertakings given to the Foreign Investment Review Agency in Canada contradicted treaty obligations (chapter VI).

The WTO TRIMs Agreement, which entered into force in 1995, required governments to phase out certain types of performance requirements (see table I.1) by 1 January 1997 for developed countries, 1 January 2000 for developing countries and 1 January 2002 in the case of the least developed countries. These deadlines have prompted governments to withdraw the specified performance requirements, although six developing countries (Argentina, Colombia, Malaysia, Mexico, Pakistan and Thailand) have been granted extensions of the transition period until December 2003, the Philippines until June 2003, and Romania until May 2003 under the Agreement's Article 5.¹⁸ Similarly, in light of restrictions under the WTO SCM Agreement, developing-country WTO members (other than those listed in Annex VII of that Agreement and with the exception of those that have obtained an extension of the transition

¹⁸ See WTO Documents G/L/497 through G/L/504 and document WT/L/441.

period) have had to eliminate subsidies (related to goods) that are contingent on export performance by 1 January 2003.¹⁹

In addition, there are instances in which countries have removed requirements and/or incentives as part of their accession agreements with WTO or to comply with programmes by the IMF or the World Bank as conditions for granting financial assistance.

Regional integration and bilateral agreements

A number of schemes of regional economic integration have emerged, such as the EU and NAFTA that involve deeper integration with harmonized trade and investment regimes across member states. Participation in such schemes has forced certain countries to phase out policies like performance requirements. For instance, France had to eliminate performance requirements and other restrictive FDI policies in order to comply with the provisions of EU regulations (chapter VI). Similarly, as noted earlier, a number of bilateral agreements also restrict the use of performance requirements.

Increased competition for FDI inflows

Over the past decade, governments have increasingly become engaged in policy competition for attracting FDI. As part of this they have liberalized their FDI regimes and relaxed or removed performance requirements. For example, South-east Asian countries such as Malaysia and Thailand diluted some of the performance requirements in the aftermath of the East Asian financial crisis of 1997, and India removed various restrictions as part of a new strategy to become more competitive for FDI. Remaining requirements tend to be more common when host country governments have a relatively strong bargaining position vis-à-vis investors, such as in the case of natural-resource seeking or domestic-market seeking FDI.

¹⁹ For a discussion of this issue see UNCTAD (2002).

Normal phase out as countries develop

Performance requirements may also have been withdrawn with the achievement of developmental objectives that governments seek to realize through them. The incidence of requirements in developed and middle-income countries may have fallen for this reason. Even in the case of some developing countries, certain performance requirements may have been withdrawn when a particular objective has been achieved. For instance, India phased out dividend balancing and foreign exchange neutrality requirements gradually over the 1990s as the foreign-exchange availability improved (chapter III), and the employment criteria in Malaysia to hire Bumiputeras were relaxed as the stipulated goals were met (chapter IV).

Ineffectiveness of measures

The declining incidence of performance requirements may also indicate that some governments have found some measures to be not effective in achieving the sought development objectives or that the associated costs exceeded the benefits obtained.

Changing strategies of governments

As noted above, the decline in the incidence of performance requirements does not necessarily mean that countries are less interested in influencing the impact of investments in certain directions. Rather, other policy instruments in the trade and investment area have emerged, such as rules of origin, anti-dumping and countervailing measures, voluntary export restraints²⁰ and strategic locational incentives. It may sometimes be more difficult for developing countries to have recourse to such policies.

²⁰ According to Article 11(1b) of the WTO Agreement on Safeguards, voluntary export restraints are no longer permitted.

D. Empirical effectiveness assessment of performance requirements

The effectiveness of performance requirements in meeting stipulated objectives is difficult to assess. In this section, the main findings from the four case studies are summarized with regard to the five types of requirements that have been specifically investigated. It should be stressed that the data do not allow for a full cost-benefit analysis of individual measures. For example, it is not possible to assess if the economic benefits of a given measure outweigh the costs involved in terms of administration, provision of incentives and possible distorting effects. Comparisons with counterfactual situations are also difficult.

1. Export performance requirements

Export performance requirements represent only one of a wide range of policy measures that have been applied by countries to promote export-led growth with the involvement of inward FDI. Other measures include various incentives, tariff cuts, efforts to upgrade the physical and technical infrastructure (not least in the form of EPZs), human resource development and various trade facilitation measures (see, for example, UNCTAD, 2002). This should be kept in mind when assessing the role and impact of export performance requirements.

From a theoretical perspective, it can be argued that, under perfect competition, if a firm is able to export competitively, it would do so on its own initiative to maximize its profits. Requiring it to export more than it deems profitable, would imply a need for some form of compensation (WTO, 1998). Given that firms may be operating in less than perfectly competitive conditions characterized by market segmentation and information asymmetry, export performance requirements have sometimes been applied to remedy sluggishness on the part of TNCs to seize export opportunities, as well as to deal with restrictive business practices (Moran, 1998). In countries that have embarked on an import substitution approach,

export performance requirements have also frequently been employed to counterbalance an anti-export bias. By making market access contingent on exporting, for example, TNCs might be induced to reconsider the orientation of their activities in favour of exporting. There are examples of such government interventions having led some "first mover firms" to establish new export platforms, and that has triggered similar decisions by other firms in the same industry (Moran, 1998). Some theoretical studies have concluded that, in the presence of oligopolistic behaviour and tariff distortions, export performance requirements can benefit host countries by reducing payments to foreign owners, reducing output in excess supply and by shifting profits to locally owned firms (Rodrik, 1987; Greenaway, 1991).

A detailed analysis of United States and Japanese FDI in a sample of 74 countries in seven broad branches of manufacturing over the 1982-1994 period found export performance requirements to be effective in increasing the export-orientation of foreign affiliates to third countries (Kumar, 1998, 2002a). Among the countries studied in this analysis, export performance requirements seem to have helped Malaysia succeed in expanding its manufactured exports, especially of electronic components where it now commands 10 per cent of the world market (chapter IV). In Chile too, export performance requirements were found to be useful in diversifying the country's export base (chapter II). In South Africa, export requirements form an integral part of the Motor Industry Development Programme, which appears to have been successful in promoting an internationalization of the South African automotive industry (chapter V). Similar efforts to boost exports from the textile industry, however, have been less successful. The fourth case differs somewhat from the other three. In India, export performance requirements associated with various incentives schemes and EPZs do not appear to have been particularly effective in encouraging foreign companies to set up export-oriented production. Meanwhile, some domestic-market seeking FDI, for example in the food and the automotive industries, have complied with export requirements that were imposed as a condition for market

access, resulting in some favourable externalities to the host economy in the form of long-term vertical trade linkages as well as diffusion of new technology. Furthermore, exports have continued even after the mandatory requirements expired, suggesting that companies involved have discovered new profit centres through export performance requirements (chapter III).

Other countries have also made use of various export performance requirements in their industrialization strategies. China, for example, successfully pushed foreign enterprises to export through such requirements imposed at the time of entry (Rosen, 1999).²¹ In Brazil, Mexico and Thailand, export requirements were successfully used for triggering a burst of export-focused investments in the automotive industry (Moran, 1998, pp. 53-62). In the mid-1980s, the Government of Thailand started imposing similar requirements on foreign affiliates to push them to export. That prompted the Japanese automobile producers to think of integrating Thailand into their global production networks. The development of an internationally competitive automotive parts industry in the country also attracted investments by global companies such as General Motors, DaimlerChrysler and Ford. Thailand has emerged as South-east Asia's main automotive hub, with a production capacity of one million vehicles. It exported 170,000 vehicles in 2001, making it the third largest exporter of automotive products in Asia after Japan and the Republic of Korea.²²

It is worth noting that the more successful examples of the use of mandatory export requirements are mostly related to those developing countries with fairly large domestic markets, which gave their governments a relatively strong bargaining position vis-à-vis

²¹ The proportion of exports by foreign affiliates in total manufactured exports has steadily increased over the 1990s to 45 per cent. Foreign affiliates now account for over 80 per cent of China's high technology exports (UNCTAD, 2002).

²² Honda and Toyota have recently added second shifts with Honda announcing sourcing of Honda City for the Japanese market from Thailand and Toyota, making Thailand a global production base for pick-up trucks (*Financial Times*, 6 December 2002).

foreign investors. The empirical evidence suggests that mandatory export performance requirements have been useful in moving TNCs from import substitution investments mainly in large markets to full-scale plants integrated into their regional or global supply networks. While the ability to link export performance criteria to domestic market access is likely to be less feasible in smaller economies, the process of globalization and market integration is also eroding the bargaining power of large countries in many industries. In the cases of Chile, Malaysia and South Africa, export performance requirements were closely linked to fiscal incentives or equity ownership advantages and were perceived by investors more as a positive inducement to take advantage of host-country comparative advantages than as a burden. For example, the electronics TNCs that invested in Malaysia did so from the outset mainly to supply regional and global markets, meaning that exports might have increased even in the absence of the requirements. Still, the incentives granted to export-oriented projects may have contributed to attracting and expanding such investments in Malaysia.

2. *Joint venture and equity ownership requirements*

Joint venture and domestic equity ownership requirements have been used for a number of reasons. In natural-resource-rich countries, for example, restrictions on foreign ownership have been applied to secure economic rents from the exploitation of various resources. In other cases, equity requirements have been employed by host governments to enhance the chances of technology and knowledge controlled by foreign affiliates being diffused to the domestic enterprise sector in the host country. By forcing TNCs to share the knowledge and inputs they control and bring to a host economy, it is expected that local firms would stand a better chance to access them (Blomström et al., 2000, p. 30).

Before reviewing the country experiences, a distinction should be made between *mandatory* and *voluntary* joint ventures. In the case of voluntary joint ventures, there is a commitment of resources by both partners to achieve pre-set goals. A major

contribution of local partners to the venture is usually knowledge of local market conditions and the workings of the bureaucracy. In some cases, joint ventures may provide a kind of insurance for foreign firms against unwelcome policies of the host countries because of the presence of local interests. Host countries may find an outlet for the investment of resources they possess in conjunction with the resources of the foreign firms. *Mandatory* requirements are only binding when TNCs do not have a strong enough self-interest for entering into a shared ownership of a foreign affiliate. The risk with such ventures is that they will suffer from a lack of trust and understanding between the two (or more) partners. This especially may be the case if the local partner has little to offer to the venture but is allowed to have a say in the decision-making process (Balasubramanyam, 2002).

In developed countries, domestic equity requirements and ownership restrictions have been used to reduce the level of foreign ownership and secure economic rents from activities in selected industries (notably in the primary and tertiary sectors). In Australia, for example, equity requirements imposed on the mining sector did not hinder new FDI from entering. Similarly, Norway's experience with ownership restrictions in its oil industry helped the country to capture some economic rents, and assure state participation as well as local sourcing. The Canadian experience of reducing what was perceived to be a too high degree of foreign ownership and control in its energy industry, however, did not prove as successful (Safarian, 1993; chapter VI).

In India, domestic equity requirements have helped to promote the formation of joint ventures that in some cases generated externalities in the form of local learning and quick absorption of knowledge brought in by the foreign partners (chapter III). The South African experience suggests that mandatory domestic equity requirements in selected service industries and in mining helped to ensure new opportunities for black South African-owned business, and they were not cited by investors among the most important impediments to investments (chapter V). In Malaysia, equity

requirements were generally not applied to fully export-oriented foreign affiliates while domestic-market-seeking FDI has had to comply with requirements in this area. In some instances, such foreign investors have experienced difficulties finding domestic (Bumiputera) investors for a project, which has meant that government institutions like the state economic development corporations had to take up the Bumiputera equity part. Whereas some studies have suggested that the ownership requirements deterred non-export-oriented FDI in manufacturing, they may have facilitated increased shares for Malaysian and Bumiputera equity (chapter IV).

The evidence reviewed in this volume suggests that it is difficult to implement effectively domestic equity requirements on FDI projects for the attraction of which host country governments are in a weak bargaining position. In Malaysia, the Government decided to abolish equity requirements in light of the East Asian financial crisis, as they were perceived as an obstacle to inflows of FDI. Furthermore, the review of the experience in developed countries showed that the natural resource and some service industries have been subject to ownership limitations more often than manufacturing (chapter VI). This partly reflects the fact that the bargaining position of host countries is stronger with respect to firms seeking access to natural resources or domestic markets than for those firms that have alternative sites for producing exports. More precisely, the bargaining power would be greater for a host economy with a large domestic market, weaker if TNCs are considering a site largely for exports of non-resource based manufactures, and weaker still if the host is located in a common market where alternative sites and tariff-free access are available. The fact that higher levels of foreign equity participation were permitted for export-oriented investments in India and Malaysia is an illustration of this point.

With the exception of India, the case studies reviewed in this volume did not reveal much evidence on the extent to which equity requirements have contributed to enhancing technology transfer. Some other studies have concluded that domestic equity or joint venture requirements may adversely affect the extent or quality of

technology transfer. For example, the technology employed in mandatory joint ventures has been found to be on average three to ten years behind the cutting edge of the industry and the amount of technical training provided to the local managers and workers is a fraction of that received in wholly owned counterpart affiliates (Moran, 2002).²³ Wholly owned foreign affiliates in electronics that produce for international markets have also been found to be more eager to introduce the latest production and management processes than joint ventures in the same industry oriented towards host country markets (Ernst, 1999).

At the same time, proponents of the usefulness of joint venture requirements argue that even if the content and quality of technology transfer is superior in the case of a wholly foreign-owned venture than in the case of a joint venture, the presence of a local partner may enhance the chances for local learning and diffusion of whatever knowledge is transferred. Others have stressed that a host country might retain a greater part of the profit within the country in the case of joint ventures (see, for example, Yun, 2002). The Republic of Korea, for example, imported the bulk of its technology during the period 1960-1980 through licensing contracts, minority foreign ownership and joint ventures, and did not allow majority ownership for foreign investors until 1997. Still, the country has produced a number of internationally competitive suppliers in global industries (Kim, 1997). On the other hand, the joint venture policies may tell only part of the story. The Korean international success was also much affected by original equipment manufacturing for foreign TNCs, through which important flows of production methods, quality control practices, and management procedures were channelled back

²³ For example, the number of host country employees sent to the home country of the investor for training has been noted to be systematically higher in the case of wholly owned ventures as compared to joint ventures (Ramachandran, 1993).

to local suppliers (Hobday, 2000; UNCTAD, 2002; Sachwald, 2001; Moran, 2002).²⁴

With regard to the impact of domestic equity requirements on technology transfer, the evidence overall suggests that pushing a foreign affiliate into a "forced marriage" with a local partner may deter some FDI and may also make TNCs less inclined to transfer the latest knowledge and technology to the affiliate. If a firm still goes ahead with the investment, it must be because investment opportunities are estimated to outweigh the costs of entering into a mandatory joint venture. There may of course be motivations behind the imposition of equity requirements other than the purely economic. In such situations, host countries need to weigh the overall costs and benefits of their policy in this area.

3. *R&D requirements*

R&D activities tend to be among the forms of FDI projects most sought by investment promotion agencies. Imposing an R&D requirement – either mandatory or voluntary – is one approach that has been used by policy makers in various countries in order to maximize benefits from FDI. For example, efforts by developed countries to impose local R&D requirements as a condition of entry have been used to address concerns that excessive reliance on FDI could limit technological development, since R&D was perceived to be largely concentrated in home countries, notably in the case of TNCs from the United States and Japan (chapter VI).²⁵

In India, R&D requirements may be imposed on foreign and domestic investors alike to ensure more investment in R&D for

²⁴ This original equipment/contract manufacturing model finds strong support not least in the computer/electronics industry. As late as the end of the 1980s, 60-70% of all Korean electronics exports – including 60% of Samsung, Lucky Goldstar, and Hyundai exports – left the country via original equipment manufacturing contracts (Moran, 2002).

²⁵ Austria is one developed country that has applied performance requirements related to R&D expenditures (OECD, 1989).

absorption and adaptation of imported technology. Since 1986, some requirements have been imposed on firms to set up in-house R&D facilities or to enter into long-term consultancy agreements with any relevant R&D institution in the country, within two years of approval. Other than this general policy, R&D requirements have rarely been imposed. Moreover, requirements have tended to be minimal – like setting up an R&D centre, or having an R&D intensity of 1 per cent – and subsequently they have not been systematically monitored (chapter III).

Mandatory applications of R&D requirements, however, appear to be rare. In Chile, Malaysia and South Africa (as well as in several developed countries), R&D criteria have been imposed for the receipt of various kinds of incentives, often with limited positive results. The main problem is that a firm is unlikely to set up R&D activities in the absence of local capabilities and technical skills to absorb, adapt and develop technology and know-how. Thus, in comparison with the availability and quality of appropriately skilled labour, the provision of fiscal or financial incentives is of limited relevance for R&D investments.

4. *Technology transfer requirements*

One of the most important objectives of host governments seeking FDI is to facilitate transfer of technology. An important rationale for imposing a technology-transfer requirement on foreign firms would be to induce them to adopt technologies that are appropriate to the factor endowments of the host countries and to facilitate transfer of knowledge. At the same time, transfers of proprietary information and knowledge will hardly take place unless such transfers are in the interest of the investor.

Explicit requirements to transfer technology are relatively uncommon among the countries surveyed for this volume. Neither Chile, India nor Malaysia have used such policy instruments. Moreover, the evidence on the effectiveness of technology transfer requirements is scarce and, where available, does not suggest much

success, as illustrated, for example, by the South African case. Interviews with government officials in that country revealed that the system had so far not succeeded in attracting the hoped for levels of technology transfers (chapter V).

Other studies tend to lead to similar findings. Japanese FDI in Asia has been found to provide less intra-firm transfers of technology in host countries that apply technology transfer requirements as a condition for establishment (Urata and Kawai, 2000). An examination of United States affiliates' imports of technology from the United States to 33 host countries showed that such technology transfers were negatively related to the extent to which performance requirements were used by the host economy (Blomström et al., 2000, pp. 216-217).²⁶ In the same study, a country's level of education and the competitive pressure faced by firms were both positively related to the amount of technology transfer.

The lack of examples of the effective use of technology transfer requirements should not be surprising. There are considerable problems in enforcing and monitoring such requirements, because of the difficulties involved in objectively measuring the extent of technology transfer and also in identifying the kind of technology that would be most desirable for a given economy at a given point in time. Furthermore, as in the case of the establishment of R&D activities in a host country, successful technology transfer is crucially dependent upon local absorptive capability.

5. *Employment and training*

Employment and training requirements may be imposed for a number of reasons. The purpose may be to address various imbalances in the labour market, to induce firms to engage more actively in training and human resource development activities and/or to encourage the expansion of certain skill-intensive functions.

²⁶ However, performance requirements did not appear to exert a significant effect on technology imports embodied in machinery and equipment.

Employment or training requirements have been applied in various forms by most of the countries studied in this volume. The results have been mixed. In South Africa and Malaysia, such requirements seem to have helped in addressing some racial imbalances in the workforce – although less so at managerial levels. In terms of the promotion of training, the establishment of a skills development fund in these countries seems to have contributed to continuous improvements of human resources in areas relevant to the private sector.²⁷ Training in quality and productivity-related skills accounted for more than a quarter of the training places, facilitating progress into higher quality and higher value-added products. Other efforts, such as the double-deduction scheme for training expenditures in Malaysia, appear to have been less successful. Neither Chile nor India have imposed employment requirements on foreign investors.

Developed countries have sometimes attached employment criteria to the granting of incentives. For example, in Ireland the grant cost per job created was the key guideline for offering incentives. The grant level could increase if projects involved among other aims higher value-added and increased skill content. The follow-up that occurred was also generally made with regard to the employment goal (chapter VI).

The extent to which voluntary requirements in this area have a positive impact on the stated development objectives partly depends on the value of the efforts accruing to the investors. For example, the more interested the companies are in enhancing the skills of their own workforce (or that of suppliers and distributors), the more likely it is that they will participate in related government-sponsored activities. The interest on the part of investors is also affected by the way employment or training requirements/incentives are implemented.

²⁷ Similar efforts have also been made in other countries. In Singapore, the Skills Development Fund gives financial assistance to companies for training their workers; Thailand grants a 150% tax deduction for training expenses; other tax incentives are offered in Hungary and the Republic of Korea (UNCTAD, 2001b, p. 178).

Too much red tape and conditions attached often have a chilling effect on the investor enthusiasm (see chapter IV).

6. *Other requirements*

In addition to the performance requirements on which this survey has concentrated, examples of some others were noted in the case studies. Environmental assessments are today a mandatory requirement in Chile for all projects (whether by foreign or local investors) susceptible to having an impact on the environment. It provides the Government with an instrument to discard project proposals that are seen as environmentally harmful. To date, almost 200 projects have been rejected. During the period 1991-1998, Chile also imposed an Unremunerated Reserve Requirement on both short- and long-term capital inflows during the country's transition to full financial integration and a floating exchange-rate regime. Although such measures are currently not in force, the Government of Chile has not ruled out the possibility of applying them again in the future.²⁸

E. *Conclusions*

1. *General lessons*

This review of the performance requirements experience in selected countries, albeit limited in scope, allows for some general lessons to be drawn.

First, the evidence presented suggests that a number of the performance requirements reviewed have helped a number of countries meet different development objectives. In several instances, they have played a role in inducing TNCs to increase exports, provide training, recruit staff from targeted groups of society, etc. Obviously, some policy schemes have been more or less successful than others.

²⁸ For example, the recently concluded free trade agreement with the United States leaves open the future use of such requirements (*The Economist*, 4 January 2003, p. 43).

The effectiveness of various requirements depends on the clarity of objectives, the capability of the governments to implement various policies, absorptive capacity in terms of skills of the workforce and strength of domestic enterprises, and the extent to which the measures are compatible with other industrial and trade policies.

Second, while performance requirements have been extensively utilized by both developing and developed countries to improve the quality of FDI and to maximize its contribution to their development, their incidence has declined during the past decades. This trend reflects several factors, including the increasingly competitive environment for FDI, the need to comply with international commitments, notably in the WTO, and the introduction of new policy measures substituting for traditional performance requirements. Moreover, most of the requirements that are still used tend to be voluntary (that is, they are used as a condition for the receipt of an incentive of some kind) rather than mandatory in nature. There is also a tendency towards implementing performance requirements on a non-discriminatory basis with regard to the nationality of the investor.

Third, to the extent that mandatory requirements are applied, they are typically related to domestic-market seeking and resource-seeking FDI. The bargaining power of host countries is stronger with respect to firms seeking access to natural resources or domestic markets than to firms that consider a number of potential sites for export production. There are consequently few examples of mandatory requirements imposed on export-oriented manufacturing.

Fourth, the ability of a country to use certain requirements depends on its economic importance, mainly in terms of market size. Even among developed countries, the smaller ones (such as Belgium and Ireland) have generally relied more on "voluntary" requirements than on stringent mandatory criteria imposed at the point of entry. Similarly, while India has been able to leverage its large domestic market to require market-seeking foreign investors to start exporting, such obligations would be more difficult for a smaller economy to

impose. At the same time, developing countries may lack the capacity to apply some of the strategic trade and investment policies that are used increasingly by developed countries to achieve similar objectives as certain performance requirements.

Fifth, in the context of their international commitments, countries often face a delicate balancing act in weighing the potential benefits that can be attained from the imposition of performance requirements against the risk of deterring FDI, or of reducing the quality of the FDI that is attracted. The use of domestic ownership requirements is a case in point. Countries using such measures may aim at facilitating a greater diffusion of whatever technology that arrives, but at the same time they risk deterring the most desirable types of investments. In the case of Malaysia, for example, the Government's desire to enforce strict requirements on investors entering the country had to be balanced against the risk of negatively affecting the attractiveness of the location as an export base. The optimization of benefits from investment through the use of requirements and incentives therefore requires a good understanding of how they might influence corporate behaviour in different industries.

Sixth, even "voluntary" performance requirements seem to be effective only when other determining factors for an investment are in place. For example, the use of R&D requirements and incentives has generally not generated any tangible results if skilled people available for employment in R&D or technology-intensive activities are lacking. Similarly, if the administration of a certain incentive and requirement scheme is perceived to be too cumbersome, the value for the investor to participate in the scheme often sharply diminishes.

Finally, should countries decide to apply performance requirements with the aim of achieving certain objectives, the effectiveness of such measures will depend partly on the capacity of the countries to implement them and monitor their impact. The implementation and monitoring of performance requirements involve administrative costs and may require major information gathering

efforts. In Canada, for example, the agency in charge was staffed with more than 130 professional employees, half of whom were professional or technical staff. Even so, it had a hard time performing its tasks. Another illustration of this point is, of course, that the degree to which imposed requirements are actually monitored is often very low, and there are indications that monitoring efforts have become less stringent over time.

2. *Implications for the treatment of performance requirements in international investment agreements*

It is worth considering what implications the results from the present survey may have on the treatment of performance requirements in international investment agreements (IIAs). As highlighted in the introduction, requirements related to technology transfer, R&D, employment, domestic ownership and joint ventures are not addressed by *multilateral* agreements but may be restricted in treaties at bilateral or regional levels. Restrictions in the latter cases refer mainly to the use of *mandatory* requirements in the relevant areas discussed in this report. In the case of BITs that prohibit the use of some or all of these performance requirements as well as in the NAFTA context, parties are typically free to apply such measures provided they are linked to the receipt of an advantage. As mentioned, for example, NAFTA Article 1106(4) states that:

"Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory."

As noted above, however, subsidies contingent upon export performance are generally prohibited by the WTO SCM Agreement.

In the area of *services*, the General Agreement of Trade in Services (GATS) recognizes the right of developing countries to

regulate using performance requirements. Through its scheduling technique (that is, the "positive list" approach combined with the possibility of individual countries scheduling specific limitations to market access and national treatment), the GATS allows flexibility for countries in retaining any performance requirement.

So how could performance requirements be addressed in the context of IIA negotiations? The options facing countries can be summarized in the following alternatives:

In IIAs at the *bilateral and regional* levels, there is currently a wide variation in the way performance requirements are treated. The options for agreements at this level may be summarized as follows:

- Make no reference to performance requirements, save those covered by the TRIMs Agreement, which would be binding on all parties who are also WTO members.
- Include hortatory provisions on measures not covered by the TRIMs Agreement.
- Make cross-reference to provisions in other agreements.²⁹
- Restrict certain additional performance requirements but allow exceptions.
- Prohibit certain performance requirements that are currently not covered by the TRIMs Agreement.

At the *multilateral* level, the main instrument is the TRIMs Agreement. In principle, countries may consider leaving it unchanged or renegotiate its provisions. Such renegotiations could change the Agreement's coverage of investment measures. But to do that, countries would first have to agree on a modification of the coverage of Article 2 as regards the types of measures that would be subject to

²⁹ While the substantive effect of this technique would be the same as under the first two options, the interpretation and application of the provisions within the context of bilateral or regional investment relations could be different. This option allows for the interpretation and application of the provisions under the specific dispute settlement provisions of a given IIA (UNCTAD, 2001a, p. 73).

the prohibition set out in this Article. Currently, Article 2 only refers to measures that are deemed to be inconsistent with Articles III and XI of GATT 1994.

Renegotiation could also focus on ways to extend the transition period, or to allow for a new transition period, including criteria for phasing out inconsistent measures, that could be applied to countries at different levels of development. As already noted above, the phase out periods established under Article 5.2 have already expired for all WTO members. However, under Article 5.3, eight WTO members were granted an extension of the transition period, which will in turn expire by the end of 2003. These extensions were given on the condition that the remaining TRIMs be effectively eliminated at the end of the extended period. It should be recalled in this context that only those TRIMs that were notified in accordance with Article 5.1 of the TRIMs Agreement were eligible to benefit from the transition period in the first place.

Views diverge among countries and experts with respect to what represents the best options with regard to the treatment of performance requirements in various IIAs. Some developing country governments are in favour of reopening the TRIMs Agreement to reduce its coverage, make it more flexible and allow greater policy space for governments to decide whether to use performance requirements. For example, in a communication to the WTO, Brazil and India advocated a reopening of the TRIMs Agreement along the lines discussed above to increase policy flexibility to allow developing countries greater freedom in implementing their development policies (see box I.1). The proposal notes that one option could be to extend the range of situations in which developing countries are allowed to deviate from the provisions of Article 2.

The blanket ban on local content requirements has also been questioned (Balasubramanyam, 2002; Kumar, 2002b; Mashayekhi, 2000). It has been suggested that local content and trade balancing requirements should rather be examined on a case-by-case basis to determine whether they have a significant and adverse effect on trade

that outweighs their beneficial development impact (Mashayekhi, 2000).

Box I.1. Communication by Brazil and India on the need for an amendment of the TRIMs Agreement

In a communication to the WTO in October 2002, Brazil and India argued in favour of amending the TRIMs Agreement in a number of ways, with particular reference to its Article 9 as well as to paragraph 12 of the Doha Ministerial Declaration.

According to this communication, "history provides many examples of successful recourse to investment measures to address developmental objectives as well as to offset trade-distorting effects of certain forms of corporate behaviour - which in the case of developing countries may affect the efficient allocation of resources in a more negative way than investment measures. In addition, it must be pointed out that other currently WTO-compatible measures have revealed themselves to have a much more distorting effect on international trade, particularly in sectors of export interest to developing countries, than those related to investment" (paragraph 4).

Brazil and India maintain that TRIMs are important for developing countries to increase their share in the higher-technology segment of international trade; counter excessive corporate power; foster regional development objectives; address environmental concerns as well as external financial weaknesses.

The communication proposes that "Article 4 of the TRIMs Agreement should be amended in order to incorporate specific provisions that will provide developing countries with the necessary flexibility to implement development policies. One possible solution is to extend the range of situations in which developing countries are allowed to deviate temporarily from the provisions of Article 2. Among the new provisions that should be included, the following should be considered."

"Developing countries should be allowed to use TRIMs in order to:

- (a) promote domestic manufacturing capabilities in high value-added sectors or technology-intensive sectors;

/...

Box I.1. Communication by Brazil and India on the need for an amendment of the TRIMs Agreement (concluded)

- (b) stimulate the transfer or indigenous development of technology;
- (c) promote domestic competition and/or correct restrictive business practices;
- (d) promote purchases from disadvantaged regions in order to reduce regional disparities within their territories;
- (e) stimulate environment-friendly methods or products and contribute to sustainable development;
- (f) increase export capacity in cases where structural current account deficits would cause or threaten to cause a major reduction in imports;
- (g) promote small and medium-sized enterprises as they contribute to employment generation."

Source: WTO Document G/C/W/428.

Some developed country governments maintain that further international regulation of performance requirements under the TRIMs Agreement is desirable. The United States, for example, has argued in favour of an expansion of the list of prohibited TRIMs to include exports, technology transfer and product mandating requirements.³⁰ An argument put forward in this context is that the banning of some mandatory requirements would be in the self-interest of developing countries, as many requirements would have a deterring effect on inward FDI. In particular, it has been proposed that the coverage of the prohibited performance requirements should include also joint venture and technology sharing requirements (Moran, 2002, p. 17).

Some scholars take the opposite view and caution against further international regulation on the grounds that host countries should be free to take the risk of losing the investments from foreign

³⁰ See the Communication from the United States (WT/GC/W/115).

firms for the sake of specific development objectives they wish to promote with the help of performance requirements (Balasubramanyam, 2002). Moreover, as noted above, the incidence of mandatory requirements has generally declined, even in the absence of multilateral rules restricting their use. This may suggest that developing countries are themselves best positioned to determine the usefulness of various requirements in light of their resource endowments and development objectives.

From an international perspective, a policy dilemma arises when the imposition of a performance requirement by one country could affect not only that country but also other host locations. Export performance requirements imposed by a relatively large country as a condition for domestic market access, for example, may lead to the diversion of export-oriented FDI from a competing location, which may not be in as strong a position to bargain with a potential investor. In such a situation, the use of a performance requirement could lead to adverse effects on other countries, especially smaller and weaker ones, while at the same time enhancing trade.

It may be difficult to show how the use of certain requirements would harm the interest of another country in such a fashion. In the absence of significant adverse impacts on third countries, the case for restricting the right of countries to impose performance requirements would be considerably weaker. As long as the main risks to consider are that a requirement may deter FDI inflows or affect the quality of the investments, each government would have to weigh these costs and risks against the expected development gains, and decide whether or not to apply the measure. The fact that mandatory performance requirements have become less common even in the absence of multilateral restrictions of their use suggests that many governments have become less inclined to rely on such policy measures. Empirical evidence of the usefulness of individual performance requirements is still relatively limited and the experience of different countries does diverge. The fact that many performance requirements analyzed in this publication seem to have

played a positive developmental role would speak against further restrictions of their use.

To conclude, many developing countries view performance requirements – whether linked to incentives or not – as important policy tools for their development. Moreover, that several countries have sought and been granted extensions as regards the use of local content requirements and export subsidies reconfirms that these countries continue to perceive them as valuable policy instruments. Further discussions on the future treatment of performance requirements in IIAs need to recognize the right of developing countries to regulate and allow sufficient policy space to allow them to pursue their development policies. In this context, performance requirements remain a policy instrument to affect the behaviour of foreign affiliates and their impact on the economies of developing countries.

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CHAPTER II

CHILE

A. Introduction

During the past twenty-five years, Chile has followed an orthodox policy towards foreign direct investment (FDI).³¹ The underlying philosophy has been to provide a stable legal system, clear and non-discriminatory laws, an open economy, relatively low customs duties and non-tariff barriers, and a transparent business environment. In line with this overall strategy, Chile has generally avoided selective government intervention. While this largely also applies to the area of performance requirements, there are a few exceptions. Some performance requirements have been linked to the approval of investments and others have been associated with the receipt of an incentive. Chile does not use tax incentives to attract new investments, but it does provide some inducements for investment in certain geographical areas of the country and in new industries (Poniachik, 2002).

Performance requirements have been (or are) related to export performance, local content in the automotive industry, incentives for investment in high technology industries, capital controls, and the protection of the environment. Some of these have recently been abolished while others remain in force. All current Chilean performance requirements are consistent with the country's multilateral and bilateral obligations signed in the last decade (see also annex A to this chapter).

This chapter is structured as follows. After the introduction, which gives a background to FDI and related policies in Chile as well as presents the key performance requirements that have been applied, sections B to F assess the impact of such requirements in the Chilean context. Section G makes some concluding observations.

³¹ This chapter is based on a paper prepared for UNCTAD by Castillo (2002).

1. FDI inflows and the regulatory framework for FDI

An assessment of the role of performance requirements has to be viewed in light of the broader legal framework governing FDI. In the Chilean context, there are two main legal instruments under which FDI can enter the country: the Foreign Investment Statute and Chapter XIV of the Chilean Central Bank Compendium of Foreign Exchange Regulations (CFER).

The *Foreign Investment Statute*, Decree Law 600 (DL 600), was promulgated in 1974. Under DL 600, an investor signs a legally binding contract with the State for the implementation of an individual project and, in return, receives a number of specific guarantees and rights in the areas of taxation and customs tariffs (Poniachik, 2002). The Law stipulates the principle of non-discrimination between domestic and foreign investors in terms of investment applications, unrestricted access to economic sectors or geographical regions and provides for unlimited repatriation of profits and capital as well as free access to the formal exchange market. The contract cannot be modified unilaterally by the State or by subsequent changes in the Law.

Chapter XIV of the CFER is a simpler mechanism, which only requires a foreign investor to comply with registration procedures. However, it does not carry all of the guarantees that are provided under DL 600 (Poniachik, 2002). It stipulates that foreigners are allowed to bring capital in the form of foreign currency into Chile, and that they are permitted to sell foreign currency freely through a commercial bank. It also states that registered foreign investors may transfer capital and profits abroad in accordance with the terms and conditions contained in the specific regulations of the Central Bank. Foreign capital can be remitted road

only after the passage of one year following completion of registration procedures.³²

Between 1985 and 1995, *Chapter XIX of the Central Bank's foreign-exchange regulations*, allowed foreign investors to purchase Chilean external debt titles that were then used as capital for investment. Chapter XIX authorized legal entities that were resident abroad to invest in certain economic areas in Chile using local currency derived from the negotiation of Chilean foreign debts. A minimum investment threshold was stated at \$5 million.

Table II.1. Evolution of FDI in Chile and the main mechanism of capital inflow
(Millions of dollars)

Period	DL 600	Chapter XIV	Chapter XIX	Total
1974-1984	2,316	284	-	2,600
1985-1989	2,794	61	3,160	6,015
1990-1994	7,551	906	440	8,897
1995-2001	35,861	4,512	-	40,373
Total	48,522	5,763	3,600	57,885

Source: Chilean Foreign Investment Committee.

Table II.1 shows the evolution of FDI under these three main legal frameworks during the past quarter century. Most foreign investment in Chile to date has taken place under DL 600 (see also annex A to this chapter).

2. *Performance requirements in Chile*

The role of performance requirements in Chile reflects an ongoing debate in the country with regard to the potential impact of FDI on economic development. As in most countries, the question is

³² The Central Bank has the right to restrict access to the formal exchange market if adverse macroeconomic conditions make this necessary. However, investors under the DL 600 are exempt from these restrictions (Poniachik, 2002).

related to the balance of benefits and costs associated with such investment and has been a matter of controversy. While some argue that FDI can bring substantial benefits to national development through sources of capital, exports, training and managerial skill, and technology transfer, others rather emphasize the risks, for example, of creating balance of payments problems, resulting from excessive capital flows in the short-term and also when investors begin repatriating profits in the medium-term. To a limited degree, regulations, incentives and performance requirements have all been used in Chile to encourage desired forms of FDI and to address international distortions in the supply of capital.

A distinction can be made between those performance requirements that are linked to the granting of some kind of advantage and those requirements that are mandatory in nature. In the first of these two categories, export requirements, local content requirements linked to the automotive industry, and requirements for investments in high-technology activities are particularly important. In the second category, this study will consider requirements for the control of capital movements and for environmental protection. In the following analysis, for each performance requirement, a brief description of the measures and their objectives as well as an assessment of their impact are provided.

B. Export performance requirements

1. Description and objectives

Since the 1980s, at least two export subsidy schemes – with associated performance requirements – have been implemented in Chile to encourage the diversification of exports. Among the most important subsidies are a “simplified” drawback scheme for non-traditional exporters and a scheme for facilitating the importation of capital goods.

The *simplified drawback scheme for non-traditional exporters programme*, set up in 1985, sought to promote export

diversification by encouraging the production and marketing of products that had not previously been exported into foreign markets. It allowed firms to obtain a cash subsidy of 3, 5 or 10 per cent of the f.o.b. value of their exports. To qualify for participation in this scheme, firms had to comply with a combination of export and local content requirements. A firm had to export a product, defined by its tariff item, with an imported content of not more than 50 per cent and of which the total exports of that product by all companies in the country in a given time period accounted for less than a specified export threshold (see table II.2). A key feature of this scheme was the automatic extinction of the subsidy once the exports of an item grew above the specified threshold.

Table II.2. Simplified drawback system
(Millions of dollars and percentage)

Total exports of a given product in the previous year must not exceed (\$ million)	Right to a refund (% of f.o.b. export value)
11.6	10
17.4	5
20.9	3

Source: Macario (2000).

The *scheme for importing capital goods*, based on a 1987 law, allowed companies under certain conditions to delay the payments of tariff duties for up to seven years on imported capital goods, provided they were used in the manufacture of products for export.

Chilean legislation recently has been adapted in order to comply with the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement), under which both schemes described

above are considered to be export subsidies and thus have had to be eliminated by 1 January 2003.³²

2. *Impact assessment*

Although careful econometric studies have not been undertaken on the impact of the simplified drawback scheme on the emergence of new exports, two independent studies have concluded that this policy has contributed to an increase in the number of exporting firms, particularly small and medium-sized enterprises (SMEs) (see Agosin, 1997 and Macario, 2000). Moreover, after the introduction of the scheme the number of exported manufacturing products and their export value grew rapidly (table II.3). According to various sources, more than 2,200 firms (37 per cent of total number of exporters) have used this scheme, with an average annual cost of \$120 million (Banco Central de Chile, 1997; Landerretche, 1997; Agosin, 1997; Macario, 2000). As of 1994, almost 70 per cent of all export products had benefited from this scheme (Ffrench-Davis and Saez, 1995). In addition, firms in the category of “other manufactures”, such as companies in the food and beverage, wood processing, printing, and chemical industries, were the main users of the arrangement. In all of them, Chile’s exports have expanded. The share of “other manufactures” rose from 5 per cent in the 1970s to almost 30 per cent in the 1990s (Agosin, 1997).

Table II.3. Evolution of export sector and simplified drawback in Chile

	1985	1995	1998
Export/GDP	0.3	0.3	0.34
Goods exported (\$)	3 804	15 680	14 754
Number of markets	120	167	172

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³² The SCM Agreements were absorbed into Chilean law in 1995 and, in 1997, Chile notified these two measures as constituting export subsidies to the WTO Secretariat (World Trade Organization, 1997; Lopeandia, 2001).

Table II.3. Evolution of export sector and simplified drawback in Chile (concluded)

	1985	1995	1998
Number of products	1 437	3 647	3 828
Number of exporters	2 100	5 815	5 900
Simplified drawback (\$ million)	89	117	163

Source: Ffrench-Davis and Saez, 1995; Banco Central, 1997; Landerretche, 1997; and Silva, 2001.

The scheme for importing capital goods also encouraged new investment for exporters by reducing the cost of imports. While no quantitative studies of the impact of the scheme for importing capital goods are available, it has been argued that this subsidy undoubtedly encouraged investment for exports (see Agosin, 1997, p. 32). In the 1990s, about \$30 million per year was spent on providing this incentive (Landerretche, 1997; Macario, 2000).

The public and private sector both agree that these schemes have had a positive impact on the non-traditional export sector. Private sector representatives have also expressed concerns about their elimination. Meanwhile, the Government of Chile is anxious to respect the WTO rules. In response to the need for efforts to encourage Chilean exports, the Government has therefore allocated additional resources in support of other ways to promote exports and technological innovation.

C. Local content requirements linked to the automotive industry

1. Description and objectives

Like many other Latin American countries, Chile has applied local content requirements (LCRs) in order to protect its domestic automotive industry. Such measures were first adopted in 1962, for

passenger cars, and in 1966 for commercial vehicles.³³ The special policy for the automotive industry was motivated on grounds related to infant industries, predatory dumping, technology transfer, labour absorption and foreign currency savings.

The stipulated local content levels have varied over time. The automotive industry policy adopted in 1985 exempted manufacturers from the payment of import tariffs on completely or partially unassembled units. A vehicle was considered assembled in Chile when 13 per cent or more of its final value was assembled in the country. For a component to be classified as “domestic”, the minimum requirement of 70 per cent value added was imposed when used for domestic sales and 50 per cent for export sales.³⁴

Fiscal credits were provided in cases where domestic components were used in the assembly of finished goods, whether destined for either export or domestic markets, in any finished goods industry.³⁵ Fiscal credits for domestic assembly were calculated by multiplying the value of the domestic assembly by a predetermined and decreasing percentage; 40 per cent between 1985 and 1995 then decreasing by 10 percentage points every year from 1996 until such credits disappeared in 1999.

Between 1985 and 1999, the principle arrangements contained in the Automotive Statute provided the following:

- a 50 per cent allocation of fiscal credits for domestic assembly;³⁶

³³ WTO document G/C/W/307/Add.1.

³⁴ Both General Motors and Automotora Franco Chilena have been oriented towards other Latin America markets. In the case of General Motors, 50% of its production is exported to Argentina, Bolivia, Colombia and Mexico, while Franco Chilena exports more than 80% of its production to Mexico and Colombia.

³⁵ The fiscal credit for the exportation of a domestically produced component was 15% of the f.o.b. value, with a maximum of 15% of the c.i.f. value of the imported parts required in the production of domestic vehicles.

³⁶ The fiscal credits decreased gradually from 1994 (50%) to 1999 (0%). See also footnote 37.

- fiscal credits for the exportation of domestically-produced components; and
- an exemption from tariffs on imported items in equivalent amounts to the exports from that sector.

Under the WTO TRIMs Agreement, the Automotive Statute was identified as an inconsistent national measure, and Chile was required to eliminate it within a period of five years. As of early 2003, the compensated exchange was still in force, however, a special law is in process that proposes to eliminate this last fiscal benefit. Between 1995 and 1999, Chile implemented a transition process in order to reduce and finally eliminate all related fiscal benefits at the end of 1999.³⁷

2. *Impact assessment*

Table II.4 shows the direct fiscal subsidies that the Chilean automotive industry received between 1986 and 1998, indicating that the fiscal cost of the Automotive Statute was at least \$224 million.

Table II.4. Chile: fiscal subsidies to the automotive industry, 1986-1998
(Millions of dollars)

Activity	Subsidy
Domestic assembly	148
Export	22
Exemption from tariffs*	54
Total	224

Source: Castillo, 2002, unofficial estimation from diverse sources.

* Estimation only over the period 1994 - 1998.

³⁷ In two communications to the WTO TRIMs Committee, Chile requested an extension of the transition period until 31 December 2000 (G/C/W/172 and G/C/W/172/Add.1).

Some studies claim that the Automotive Statute did not manage to meet the objectives set out and that the automotive industry lacked any particular characteristics that justified special treatment as compared to other industries (see, for example, ILADES/Georgetown University, 1990; and Agosin, 1997). While some financial support may have been justified as a means to promote technology transfers, the magnitude of these subsidies has been subject to question.

The Statute did not have a noticeable positive impact with regard to the absorption of labour. Rather, the Statute was subsidizing a relatively capital-intensive industry and the number of people employed therein was low – only 642 people in 1989, employed in two companies (Automotora Franco-Chilena and General Motors). Moreover, there is no evidence that this provision contributed to an increase in the local value added, neither directly by the automotive industry nor indirectly by the local suppliers. Production has not been significantly affected since the Statute started to be phased out in 1995 (see table II. 5). Thus, it appears as if the use of local content requirements in the automotive industry policy in Chile was relatively unsuccessful in actually contributing to the stated objectives.

Table II.5. Chile: average yearly production of vehicles, 1985-2001

(Number of vehicles)

Period of statute 1985 – 1994	Transition period 1995 - 1999	Period without statute 2000 - 2001
12,293	20,555	17,060

Source: Comision Automotriz.

D. Performance requirements linked to incentives for high-technology investments

1. Description and objectives

In order to promote the expansion of new and more sophisticated industrial activities in Chile, the Government has set up a scheme called the "High Technology Investment Programme", in which the granting of incentives is linked to a number of specified criteria that have to be met. The programme involves two components. The first component is related to investment promotion and the second component provides for new incentives for pre-investment studies, development of human resources and investments in capital assets associated with new technology-based projects. Benefits are awarded only to "high-technology" projects (by Chilean or foreign companies) that are focused on developing and using "targeted technologies" in information technology (IT), telecommunications, biotechnology and electronics. The objective is to facilitate the growth of such activities as the development and production of software, equipment and components for data processing and transmission; provision of services for individuals and companies through the full use of IT (call-centres as well as suppliers of application, logistical and similar services); and the production and distribution of multimedia content as well as biotechnological and pharmaceutical products.

For projects that meet the specified requirements, the following types of incentives are available:

- (a) In the *initial phase* of a project, funds can be provided to co-finance pre-investment studies such as pre-feasibility and feasibility. The studies may be carried out by external consultants or by the companies themselves. At this stage, additional funds can be made available to people or institutions who promote and successfully help to implement high-tech projects.

-
- (b) During the implementation *phase*, the Government may co-finance investments in fixed assets that provide support to buy property, install basic services, build infrastructure and buy technology equipment.
 - (c) During the *operating phase*, the Programme provides funds for on-the-job training.
 - (d) The Programme also offers funding for R&D projects expected to have strong commercial impact or that are likely to contribute to improvements in key local vendor firms and/or high-tech R&D-related organizations.
 - (e) Finally, incentives may be given for renting of property for long-term use.

To qualify, projects have to fall within the "targeted technology areas" indicated above and to have a minimum value of \$1 million. Moreover, companies are required to submit a detailed project proposal on the basis of which the quality of a project can be assessed. The assessment considers a number of factors related to the competitiveness, technology position, financial stability and growth performance of the parent company as well as key aspects of the specific project. In the end, four main criteria are applied in completing the appraisal: the applicant's strength based on its business line, financial standing, marketing strategy, and mastery of key competences; the project's expected profitability and risk; the economic potential in terms of job creation, technology transfer, new markets access, and development of certain regions; and the skills of the project's executive team.

While the Chilean Economic Development Agency (CORFO) is the institution responsible for assessing the relevance and quality of a project, the final decision is taken by a special Committee of High-Technology Investment Promotion, which is chaired by the Ministry of Economy and includes, among others, the Executive Vice-Presidents of CORFO and of the Foreign Investment Committee.

2. *Impact assessment*

Given that this Programme is a relatively recent addition to the arsenal of policy measures in Chile, it is as yet premature to evaluate its full impact. Table II.6 identifies 12 international firms that have made the decision and are operating new projects in seven high-technology areas. Although the total amount of investment to date is relatively low (less than \$120 million), it is believed that the Programme has helped to improve Chile's competitive position in international services. The new investments so far attracted have been made by internationally leading companies, most of them listed in the Fortune 500 or Global 500. Most of the projects are located in Santiago. The level of technology is very high and important linkages have been created with local companies and institutions (table II.7). Although a number of investments have been attracted under the High-Technology Investment Programme, it is not possible to say whether they would have come to Chile even in its absence. While all projects were promoted by CORFO, only 40 per cent of the companies listed in table II.6 actually received financial incentives under this Programme.

Table II.6. Information technology projects in operation in Chile

Potential High-Tech areas	Examples of foreign companies with recent projects
Regional Contact Centres	Delta Airlines (USA) Air France (France)
Regional Share Service Centre	BHP Billiton (Australia) AT&T LA (USA)
Regional Technical Support	Ericsson (Sweden)
Global Support Centre	General Electric (USA)
Regional Centre for Information Technology	Banco Santander (Spain)

/...

**Table II.6. Information technology projects in operation in Chile
(concluded)**

Potential High-Tech areas	Examples of foreign companies with recent projects
Software Development Centre	Citibank (USA)
	Enersis (Spain)
	Motorola (USA)
	Group SP (Spain)
Integration of Electronic Component	Packard Bell Computer (Japan)

Source: Castillo, 2002.

E. The Unremunerated Reserve Requirement

1. Description and objectives

Following a rapid growth of capital inflows during the years 1988 to 1990, the Central Bank of Chile decided to impose quantitative restrictions on capital movements. This took the form of an “unremunerated reserve requirement” on financial capital inflows during the period 1991-1998. The main objective of these restrictions was to offset international distortions in the supply of capital through domestic capital controls. The reserve requirement was applied to both short- and long-term capital flows.

Under this scheme firms were required to hold an unremunerated fixed-term reserve at the Central Bank, equivalent to a fraction of capital inflows. The requirement was initiated at a rate of 20 per cent in June 1991, was then raised to 30 per cent in May 1992 until June 1998, when it was reduced to 10 per cent and finally reduced to zero in September 1998. The Government, however, does not rule out the possibility of using similar measures in the future, if necessary. In negotiating the free trade agreement concluded with the

Table II.7. Chile: performance criteria in information technology projects and use of benefits

Project and companies	Quality of project				Benefits obtained		
	Quality of company	Market position	Regional location	Technology	Linkages	Investment services	Incentives
<i>Regional Contact Center</i> Delta Airlines (USA)	High	Medium	Low	High	Medium	Yes	Yes
<i>Regional Shared Services</i> BHP Billiton (Australia)	High	High	Low	High	Medium	Yes	No
<i>Regional Technical Support</i> Ericsson (Sweden)	High	High	Low	High	Medium	Yes	No
<i>Global Support Center</i> General Electric (USA)	High	High	Low	High	High	Yes	No
<i>Regional Center for Information Technology</i> Banco Santander (Spain)	High	High	Low	High	Medium	Yes	No
<i>Software Development Center</i> Motorola (USA)	High	High	High	High	High	Yes	Yes
<i>Integration of Electronic Component</i> Packard Bell Computer (Japan)	High	Medium	Low	Medium	High	Yes	No

Source: Castillo, 2002.

United States in 2002, for example, Chile refused American demands to prohibit the future use of such requirements.³⁸

2. *Impact assessment*

Chile's capital controls can be seen as part of a policy mix during the country's transition to full financial integration and a floating exchange-rate regime. The application of the unremunerated reserve requirement has been perceived as an efficient, temporary tool and the capital controls were highly responsive to the domestic and international financial environment (Gallego at al., 2002; Ffrench-Davis, 1999). However, some negative side-effects of the reserve requirement have also been noted. Since the unremunerated reserve requirement tended to raise short-term interest rates proportionately more than longer-term rates, it discriminated against projects that were more dependent on bank financing. It is also possible that any increase in domestic interest rates caused by this requirement had a general dampening effect on investment and long-term growth.

F. Requirements to submit environmental assessments of investment projects

1. *Description and objectives*

An area that has received increased attention over time as countries open up to foreign investment is the potential impact of FDI on the environment. Chile is also committed to sustainable development and environmental protection. New institutions and laws have been established over the last decade to achieve these objectives and they are now being expanded.

Since January 1997, the country's legislation states that all projects susceptible to having an impact on the environment must be subjected to an "Evaluation of the Environmental Impact System".

³⁸ *The Economist*, 4 January 2003, p. 43.

The National Commission on Environment and its Regional Environmental Commissions are responsible for determining whether or not the environmental impact of a project is in accordance with the current norms.

In this institutional framework an “environmental impact assessment” has been defined and serves as a tool in the Chilean environment management system, operating in accordance with the Environmental Framework Law enacted in 1994. This system comprises two different components for the evaluation of the environmental performance of a project: Environmental Impact Studies and Environmental Impact Statements.

The *Environmental Impact Statement* is a descriptive document, whose contents should allow the competent organization to evaluate whether a planned project is in accordance with stated environmental norms. An *Environmental Impact Study* is a more comprehensive document that describes in great detail the characteristics of a planned project. It must contain an identification, prediction and full assessment of the environmental impacts of the project, including potential risk situations and a plan for the mitigation of such risks.

Investors are obliged to submit an *Environmental Impact Study* if an investment may generate at least one of the following effects (Foreign Investment Committee of Chile, 2001):

- Risk for human health;
- Adverse effects on natural resources;
- The alteration of the way of life of the population;
- The location of a project in a protected area; and
- The alteration of the scenic landscape, or alteration to sites considered part of the country’s cultural heritage.

Even if a project is not expected to generate any of the above effects, investors should file an Environmental Impact Statement.

For a list of projects that must be assessed (see annex B to this chapter).

2. *Impact assessment*

Available evidence suggests that the environment impact assessment has been an important policy in Chile's efforts to protect the environment.³⁹ According to the National Commission on Environment, during the period in which Law 19,300 has been in force, more than 3,600 projects, involving a total of \$49 billion of investment, have been submitted for certification under the evaluations of the environmental impact system. Of these submissions, 3,419 projects to a value of \$47.6 billion have been approved while 185 projects worth \$1.1 billion have been rejected. Among the main areas of investment for which project proposals have been submitted are mining (\$17 billion), tourism (\$445 million) and forestry (\$275 million).

The obligation to submit an Environmental Impact Study does not seem to have deterred new investment, but the private sector has voiced concerns that the regulatory framework and its procedures have been too general and discretionary, and has therefore proposed some adjustments to improve its efficiency. More specifically, it has been argued that the Government should focus on the Environmental Impact Study exclusively and eliminate the less comprehensive Environment Impact Statement (Sociedad de Fomento Fabril, 2002).

G. *Concluding observations*

Since the 1980s, Chile has experienced strong growth in inward FDI, partly attracted by the country's high-quality natural resources, and partly as the result of an opening, welcoming legislation coupled with improved macroeconomic stability and

³⁹ Chile has made great strides in developing regulations to this end, allowing for the assessment of the impact on air, soil and water, and to make more rational use of natural resources (Chilean Foreign Investment Committee, 2001).

regional integration. Policies followed in the past two decades have been based on the principle of non-discrimination and the equal treatment of foreign and local companies in terms of their access to both goods and services markets. Chile has removed restrictions on the repatriation of capital. Chile was among the first countries in Latin America to promote FDI through such liberal policies.

Chile's FDI policies have included relatively few performance requirements – whether for the approval of new investments or for the granting of a particular advantage. Among the most significant mandatory requirements have been the Unremunerated Reserve Requirement (abolished in 1998) and the requirement of firms to submit environmental assessments of certain projects. In the second group of requirements, that is those that have to be fulfilled to receive an advantage, are export requirements (to be eliminated by 2003), local content requirements in the automotive industry (until 1999), and requirements stipulated for the receipt of high-technology incentives. The effectiveness of the various requirements has varied. Thus, after 2003, the only notable performance requirements in force will be those linked to incentives for high-technology investments and the mandatory requirement for environmental assessment.

The evidence suggests that the export performance requirements have played an important role in encouraging a greater number of firms to export. The instrument most often used by export firms was the simplified drawback scheme for non-traditional exporters. Some firms have also used the scheme for securing lower tariffs on capital goods. As required under the WTO SCM Agreement, the scheme will have to be eliminated in 2003. As a compensation, the Government has decided to allocate new resources in other programmes linked to export promotion and technological innovation.

The local content requirements imposed under the Automotive Statute (1985-1999) do not appear to have been effective in meeting the stipulated objectives. There is no evidence that they

contributed to raise local value added in the automotive industry. Moreover, since the scheme was abolished (in 2000), production does not appear to have been adversely affected.

Whether the requirements linked to incentives for investments in high-technology industries have been effective is difficult to assess. The scheme has only been in operation since 2000, and it is hard to judge how important the incentives and the attached requirements have been for the attraction of and the steering of those investments that have been undertaken. Whether foreign projects would have come to Chile even in their absence is unclear. Although Chile has improved its competitive position in international services through projects in new information technologies, the data tend to suggest that general “investment promotion activities” may have been more important than the incentives and their associated requirements per se.

The Unremunerated Reserve Requirement (1991-1998) was an efficient tool as part of a policy mix implemented during Chile's transition to full financial integration and within a floating exchange-rate regime. However, it appears to have had some negative effects in terms of allocation of resources, investment, and growth.

Finally, requirements that were introduced in 1997 to avoid adverse effects from investment on the environment have exerted an important role in encouraging a more rational use of Chile's natural resources without deterring new investment. During the period in which the new law has been in force, more than 3,400 projects have been approved and less than 200 have been rejected.

To conclude, performance requirements have not frequently been used in Chile. Nonetheless, inward FDI has contributed in different ways to Chile's economic development (see Annex A). Since 1987, FDI has constituted a considerable source of capital and has helped to boost exports and, after 1995, some evidence suggests an increased positive technological impact of FDI, particularly in the form of technology transfer and training (Castillo, 2002). To honour

its international commitments, Chile is changing its FDI policies. Under the new policy framework the emphasis is shifting increasingly towards horizontal policies aimed at ensuring the efficient functioning of markets rather than the provision of selective subsidies with specific performance requirements attached.

Annex A to Chapter II. Chile: the regulatory framework for FDI

During the past three decades, inward FDI to Chile has grown at an increasingly high rate, especially since the beginning of the 1990s (figure A.II.1). Although FDI occupies an important presence in the Chilean business environment,⁴⁰ its contribution to Chile's economic development varies between different issue areas. Recent research indicates that FDI has contributed both to physical capital formation and to the growth of exports, not least in the area of natural resources. While some studies suggest that foreign firms have been instrumental in improving Chile's competitiveness,⁴¹ others have concluded that the technology impact of FDI has been of limited significance.⁴²

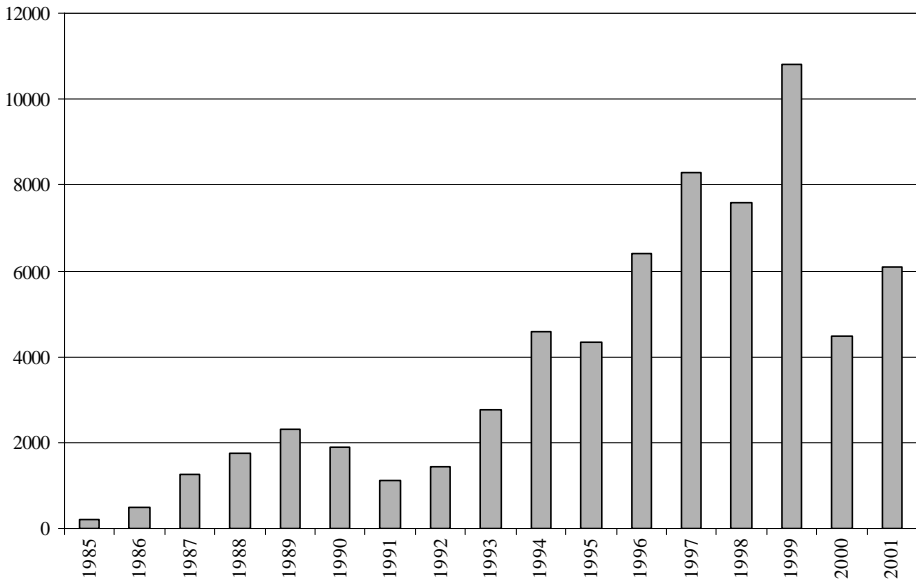
As indicated in table A.II.1 the pattern and performance of FDI in Chile can be explained as a function of three main factors: the country's comparative advantage in natural resources, low country risk, and the provision of special incentives. The growth in inward FDI has also been facilitated by the gradual liberalization of FDI policies, the positive regional integration outlook and changes in corporate strategies.

⁴⁰ Of the 20 largest Chilean firms, FDI represents majority stakes in nine of them (ECLAC, 2001). More than 4,300 companies from 64 countries have investments in Chile (www.chileinfo.com).

⁴¹ ECLAC, 2001.

⁴² See Riveros, Vatter and Agosin, 1995; and UNCTAD, 1999.

Figure A.II.1. Evolution of FDI in Chile: 1985-2001
(Millions of dollars)



Source: Chilean Foreign Investment.

Table A.II.1. The framework for FDI in Chile

Period	Trend of inward FDI	Main causes of the increase in FDI	Legal instruments and new sectors	Corporate strategies	FDI impact
1974-1984	Slow growth rate	Competitive advantages in natural resources Leadership in economic reform Liberalization of FDI policies	Mining Law Decree Law 600	Primary resource-seeking strategy	Capital: low Export: low Technology: low Employment: low

/...

Table A.II.1. The framework for FDI in Chile (continued)

Period	Trend of inward FDI	Main causes of the increase in FDI	Legal instruments and new sectors	Corporate strategies	FDI impact
1985-1989	Medium growth rate	Privatization	Extraction and processing of natural resources Decree Law 600	Primary resource-seeking strategy	Capital: medium Export: medium Employment: low
1990-1994	Medium to high rate growth	Economic and political stability Outlook for regional integration Mega projects in mining	Agribusiness, fisheries, pulp and paper, and financial services Decree Law 600 Chapter XIV	Primary resource-seeking strategy Market-seeking FDI in services	Capital: high Export: high Technology: low
1995-2001	High rate of growth	Exceptional acquisitions of energy companies Privatization in the water and sanitation sector	Telecommunications Decree Law 600 Chapter XIV	Primary resource-seeking strategy Market-seeking FDI in services	Employment: low Capital: high Export: high

/...

Table A.II.1. The framework for FDI in Chile (concluded)

Period	Trend of inward FDI	Main causes of the increase in FDI	Legal instruments and new sectors	Corporate strategies	FDI impact
		Springboard to Latin America in services	Electricity, water and sanitation	Purchase of existing assets in electricity sector and telecom	Technology: low to medium in services Employment: low

Source: Castillo, 2002 based on Riveros et al., 1995; ECLAC, 2001; and Chilean Foreign Investment Committee.

Regarding its development contributions, FDI has played different roles in different time periods. In the early years (1974-1984), FDI was an important source of market knowledge, which helped export diversification efforts, but investment inflows were limited. Since 1987, FDI has represented a considerable source of capital and has helped to boost exports. During the 1990s, not only natural resource-based FDI showed a very high rate of growth but also new projects in the service sector. Since 1995, however, some evidence suggests an increased positive technological impact of FDI, particularly in the form of technology transfer and training (Castillo, 2002).

Investment incentives and international agreements

Chile's legislation has conceded "investment incentives" through tax benefits and grants for certain activities and regions of the country. Among others,⁴³ the petroleum and radioactivity element

⁴³ Other sector-specific benefits in the Chilean tax system are related to construction and real estate and presumed income in any activity. Revenues earned from housing qualified legally as "low-income housing" are exempt from any income tax. Also, there are certain activities such as small-scale agriculture, transportation and mining, in which the income of taxpayers is calculated on a presumed basis.

industries have been subject to a special regime, through value-added tax and tariff reductions of 10 per cent to 100 per cent on certain items, taking into account special contractual circumstances. Only the Government of Chile can exploit these resources but, however, it may enter into operating agreements with private contractors.

Under the Foreign Investment Statute (DL 600), investors are exempt from value-added taxes on certain specified types of assets that are included in their capital contributions. Value-added tax is not imposed on capital goods that are part of an investment project, are not produced in the country and are included in the list referred to in the Decree Law 825 of 1974.

These tax benefits are available equally to both local and foreign investors and do not have any performance requirements linked to them. Foreign investors enjoy national treatment in matters concerning indirect taxes and customs duties.

In the area of investment promotion, the Chilean Economic Development Agency (CORFO) has developed two types of programmes. The first is oriented toward developing new private investment in underdeveloped regions and the other programme is focused on the promotion of high technology investments. Since 1994, the regional investment programme has covered the Provinces of Arica and Arauco, and the Regions of Aysen and Magallanes. Its main components are activities related to investment generation, facilitation, investment services, and special incentives in the form of co-financing of feasibility studies, investment promoters, financial guarantees, hire of new employees, and purchase of industrial infrastructure. Again, foreign investors have the same rights as domestic investors in matters concerning grants.

Chile honours its international commitments at multilateral and bilateral levels. As a member of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), Chile has respected the guidelines contained in investment-related WTO rules such as in the General Agreement on Trade in

Services (GATS) and the Agreement on Trade-Related Investment Measures (TRIMs).

Bilateral treaties have also been a source of new rules for the treatment of foreign investment. As of December 2001, Chile had signed 50 bilateral investment treaties, of which 32 were already in force. The free trade agreements that Chile signed with Canada in 1997 and with Mexico in 1999 contain exceptions with conditions related to human health and environmental impacts. Moreover, in the case of performance requirements associated with receiving an advantage, the bilateral treaties allow the use of performance requirements when they are linked to objectives such as investment location, investment in new facilities, hiring and training of workers and research and development. In 2002, Chile also concluded free trade agreements with the European Union, the United States and the Republic of Korea.

Annex B to Chapter II. Chile: Projects for which an environmental assessment must be undertaken

- Aqueducts, reservoirs, dams and siphon spillways;
- High voltage power transmission lines and their substations;
- Power stations generating in excess of 3 MW;
- Nuclear reactors and plants, and related facilities;
- Airports, bus and truck terminals, train stations, railroads, gas stations, highways and public thoroughfares likely to affect protected areas;
- Ports, navigation corridors, shipyards and maritime terminals;
- Urban or resort development projects in areas not included in the plans referred to in subparagraph (h) of Section 10 of the Environmental Law;
- Regional plans for urban development, inter-district plans, district zoning plans, sectional plans, industrial or real estate projects modifying same or carried out in areas deemed latent or saturated;
- Mining projects, including coal, oil and gas;
- Factories used for metallurgy, chemicals, textiles, construction materials, equipment, metal products and tanneries, of industrial dimensions;
- Agro-industries, slaughterhouses, facilities and stables for animal husbandry and cattle milking and fattening, of industrial dimensions;
- Forestry development projects on fragile soils, in native forest, cellulose, pulp and paper mills, chipping plants, lumber dressing facilities and sawmills, all of industrial dimensions; Projects for the intensive beneficial use, harvesting and processing of hydro-biological resources;

- The customary production, storage, transportation, disposal or reuse of toxic, explosive, radioactive, flammable, corrosive or reactive substance;
- Environmental sanitation projects;
- Performance of works, programmes or activities in national parks, national reserves, natural monuments, virgin wildlife reserves, sanctuaries of Nature, ocean parks, marine reserves or any area under official protection, in those cases authorized by the applicable legislation; and
- Massive application of chemicals in urban areas or rural zones in the vicinity of urban settlements, or in waterways or bodies of water likely to be affected.

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CHAPTER III

INDIA

A. Introduction

This chapter examines the incidence and effectiveness of selected performance requirements in India.⁴⁴ The analysis is confined to export requirements, joint venture or domestic equity requirements, technology transfer requirements, research and development requirements, and employment and training requirements.

Following this Introduction, the structure of the chapter is as follows: section B briefly reviews the policy framework for FDI in India and the place of performance requirements within that framework. Sections C to E describe selected types of performance requirements, their objectives and their incidence as well as their effectiveness in meeting stated development objectives. The main attention is given to export and domestic equity requirements. In section F, the mechanisms of enforcement and monitoring are reviewed. Section G identifies some overall trends in the use of performance requirements and section H contains some concluding observations.

B. The evolving policy of India towards FDI

This section briefly reviews the evolution of India's policy towards FDI over the past five decades to provide a background to the subsequent analysis. It then looks at the trends in FDI inflows in the light of policy changes.

⁴⁴ This chapter is based on a background paper prepared for UNCTAD by Kumar and Singh (2002).

1. Policy developments 1948-2002

India's policy towards FDI has evolved over time in tune with the requirements of the process of development in different phases.⁴⁵ Soon after independence, India embarked on a strategy of import-substituting industrialization in the framework of development planning with a focus on encouraging and improving the local capability in heavy industries including the machinery-manufacturing sector. As the domestic base of such "created" assets as technology, skills and entrepreneurship was quite limited, the attitude towards FDI was increasingly receptive. FDI was sought on mutually advantageous terms though majority local ownership was preferred. Foreign investors were assured of no restrictions on the remittances of profits (dividends) and fair compensation in the event of acquisition. The foreign exchange crisis of 1957-1958 led to further liberalization in the government attitude towards FDI.

The Government of India adopted a more restrictive attitude towards FDI in the late 1960s as the local base of machinery manufacturing capability and local entrepreneurship developed and as the remittances of dividends, royalties and technical fees, etc. abroad grew sharply on account of servicing of FDI and technology imports. Restrictions were put on proposals of FDI unaccompanied by technology transfer and those seeking more than 40 per cent foreign ownership. The Government listed industries in which FDI was not considered desirable in view of local capabilities. The permissible range of royalty payments and duration of technology transfer agreements with foreign collaborators were also specified for different items. The guidelines evolved for foreign collaborations required exclusive use of Indian consultancy services wherever available. The renewals of foreign technical collaboration agreements were restricted. From 1973 onwards the further activities of foreign companies (together with those of local large industrial houses) were restricted to a select group of core or high priority

⁴⁵ See Kumar (1998) for more details.

industries. In the same year a new Foreign Exchange Regulation Act (FERA) came into force which required all foreign companies operating in India to reduce the foreign equity to 40 per cent or below, and to register under the Indian corporate legislation. Exceptions were made only for companies operating in high priority or high technology sectors, tea plantations, or those producing predominantly for exports.

In the 1980s, as a part of the strategy of modernization of industry, the attitude towards FDI began to change with liberalized imports of capital goods and technology, exposing the Indian industry to foreign competition, and assigning a greater role to transnational corporations (TNCs) in the promotion of manufactured exports. The policy changes adopted in the 1980s covered liberalization of industrial licensing (approval) rules, a host of incentives and exemption from foreign equity restrictions under FERA to 100 per cent export-oriented units. Four more export processing zones (EPZs) were created to attract TNCs to set up export-oriented units.⁴⁶ A degree of flexibility was introduced in the policy concerning foreign ownership, and exceptions from the general ceiling of 40 per cent on foreign equity were allowed on the merits of individual investment proposals. Rules and procedures concerning payments of royalties and lump sum technical fees were relaxed and withholding taxes were reduced.

After having pursued a somewhat restrictive policy towards FDI over the four decades with a varying degree of selectivity, India changed tracks in the 1990s and embarked on a series of reforms designed to increase her integration with the global economy. The New Industrial Policy announced on 24 July 1991 marked this departure. This Policy and its subsequent amendments have liberalized the industrial policy regime in the country especially as it applies to FDI. The industrial licensing approval system in all

⁴⁶ Two EPZs already existed in Kandla (set up in 1965) and in Santacruz (set up in 1974).

industries has been abolished, except where it is required on strategic or environmental grounds. In order to bring greater transparency in the FDI approval system and expedite their clearance, a system of automatic clearance was put into practice for FDI proposals fulfilling the conditions laid down, such as the ownership levels of 50 per cent, 51 per cent, 74 per cent and 100 per cent foreign equity allowed in the sectors specified for each limit. The cases other than those following the listed norms are subject to normal approval procedures. A new package for enterprises in EPZs and 100 per cent export-oriented units was announced including automatic clearance for proposals fulfilling specified parameters on capital goods imports, location and value addition. The Foreign Exchange Regulation Act of 1973 was amended in 1993 when its previous restrictions on foreign companies were lifted.

New sectors such as mining, banking, insurance, telecommunications, construction and management of ports, harbours, roads and highways, airlines and defence equipment, have been thrown open to private, including foreign, companies. However, restrictions on the extent of foreign ownership are applied to some of these service sectors.⁴⁷ Foreign ownership up to 100 per cent is permitted in most manufacturing sectors – in some sectors even on an automatic basis – except for defence equipment where it is limited to 26 per cent and for items reserved for production by small-scale industries where it is limited to 24 per cent. However, FDI above 24 per cent is permitted in small-scale industries' reserved items subject

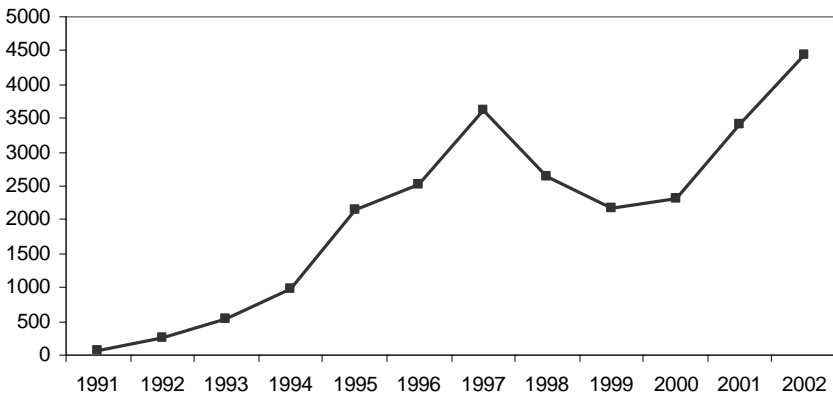
⁴⁷ For example, the foreign equity caps are 49% in banking, 26% in insurance, 51% in non-banking finance companies, 49% in telecommunications, 74% in internet service providers, 40% in airlines, 74% in shipping, 51% in export-oriented trading, 49% in broadcasting, 74% in advertising and 51% in health and education services. For more details as of May 2001, see table A.III.1 in annex A to this chapter. Minor changes have been made later, see the Ministry of Industry website <http://indmin.nic.in/policy/default.htm>. For the automobile sector foreign equity up to 51% has been allowed on an automatic basis since 1991; up to 100% of foreign equity has been allowed on a case-by case basis since early 2000, and under the automatic route as per the March 2002 Policy (Munjal and Pohit, 2002).

to a mandatory export obligation of 50 per cent of annual production; this export obligation also applies similarly to a large domestic enterprise. Dividend balancing and related export obligation conditions, which applied to 22 consumer goods industries, were withdrawn in 2000.⁴⁸

2. *FDI inflows since 1991*

FDI inflows received by India during the 1990s showed a marked increase till 1997 when they peaked at \$3.6 billion. However, in the subsequent period the inflows have stagnated at around \$2.5 billion despite progressive liberalization of the policy regime. In the year 2001, they rose again to a level of \$3.4 billion (figure III.1).⁴⁹

Figure III.1. FDI flows into India
(Millions of dollars)



Source: UNCTAD FDI/TNC database.

⁴⁸ Ministry of Commerce and Industry, Press Note No. 7 (2000 Series), 14 July 2000.

⁴⁹ FDI flows into India are expected to increase further in 2002, to reach \$4.5 billion.

The expansion of FDI inflows in the mid-1990s can be partly attributed to the liberalization of FDI policy in the form of the opening up of new sectors,⁵⁰ and partly to the expanded scale of global FDI inflows in the 1990s. Still, the magnitude of FDI flows into India is relatively small, especially if compared with those received by other countries in the region.⁵¹ The difference is particularly striking in terms of making FDI contribute to manufactured exports. While foreign-owned enterprises contribute about 44 per cent of manufactured exports and about 80 per cent of high-technology exports in China, this share in India's exports was a marginal 3 per cent in the early 1990s (UNCTAD, 2002, pp. 154 and 163).and is unlikely to exceed 10 per cent at present.⁵²

C. Export obligations

1. Description and objective

Export obligations have been imposed in the hope of prompting TNCs to undertake export-oriented production in India, and in that process benefit from transfer of more advanced/appropriate technology, greater efficiency, backward linkages and externalities besides earning foreign exchange. Global strategies of TNCs may lead them to restrict the export potential of individual foreign affiliates (see e.g. NCAER, 1994).

Before 1991, companies willing to accept an export-obligation could have a higher extent of foreign ownership than the general limit of 40 per cent. During the 1970s and 1980s, companies having foreign ownership of more than 40 per cent were general

⁵⁰ Services, e.g. have received the bulk of new contracted investments.

⁵¹ For example, FDI flows into China have averaged more than \$40 billion in recent years. However, the figures of India and China are not strictly comparable as Indian data do not cover the reinvested earnings. Moreover, FDI flows into China are affected by substantial round tripping of Chinese capital.

⁵² Interviews with government officials and academics in Delhi, November 2002.

allowed to expand only in a number of priority industries listed in Appendix 1 of the Industrial Policy Resolution 1973. However, if companies agreed to export a major portion of the additional output, they could also be given similar treatment in non-priority industries. Similarly they could expand their output beyond the sanctioned capacity in their existing lines of business if the additional output was exported.⁵³

After 1991, the incidence of export obligations relating to foreign collaboration approvals has been comparatively much smaller, except in the automobile sector and for items reserved for production in small-scale industries, and for special schemes for export-oriented production (see below). In these latter cases, export obligations are imposed only as a condition for the receipt of incentives and are applied uniformly to indigenous and foreign investors.

The entry of foreign enterprises with more than 24 per cent foreign equity or other large enterprises in areas reserved for exclusive manufacture by small-scale industries is allowed subject to accepting a mandatory export obligation of 50 per cent of output. The list of reserved items has been shrinking over time. The export obligation clause is automatically removed if at a later date the small-scale industries item is de-reserved.⁵⁴ The objective of this policy has been to facilitate development of a new breed of entrepreneurship by protecting small companies in their infancy from big industry and to generate employment. So neither domestic large enterprises nor TNCs are allowed to enter these industries. However, an exception is made for export-oriented production in order to earn

⁵³ These percentage export obligations in respect of non-priority products were reduced from 60% or abolished entirely during the 1980s in cases where manufacturers agreed to set up plants in identified industrially backward areas (Rao, 1994, p. 136 and footnote 91).

⁵⁴ See *Business Line*, April 28, 2001. A small-scale unit loses its small-scale industry status if more than 24% of its shares are held by an industrial enterprise – domestic or foreign.

valuable foreign exchange. Thus, FDI approvals in these industries are subject to accepting an export-obligation.

Under the Export Promotion Capital Goods scheme, operational since April 1990, firms are allowed to import capital goods at concessional duties (0-15 per cent) subject to an export obligation of 4 or 6 times the c.i.f. value of imports, in a period of five to eight years.⁵⁵ This scheme has been very popular among many large companies and the TNCs. Also there has been an advance licence scheme for the import of inputs without payment of basic customs duty, subject to the fulfilment of an export obligation to be met within 18 or 24 months of issue of the licence.⁵⁶

Units located in EPZs (or recently created special-economic zones, SEZs) have to export their output. These zones are duty-free enclaves under Customs supervision and provide infrastructure facilities, including land, power, and water, at low rates, and telecommunication facilities, as well as on-the-spot customs clearance for imports and exports. In addition, a wide range of incentives are provided.⁵⁷ With the creation of the SEZs in 2001, several EPZs have been converted into SEZs. Units set up in the *Electronic Hardware Technology Parks* and *Software Technology Parks* receive similar treatment to those in EPZs plus specialized infrastructure (such as data transfer facilities). The technology parks' and software technology parks' companies also have to export their

⁵⁵ In case of zero duty the companies receive a two-years calling period. After that within the 3rd and 4th year they have to meet 15% of the total export obligation, 35% in the 5th and 6th year and the remaining 50% in the 7th and 8th year; initially the export obligation was over a block of 5 or 7 years.

⁵⁶ See *Business Line*, Aug. 11, 2000; *Economic Times*, 5 March 1997.

⁵⁷ Such privileges include 100 per cent foreign ownership, exemption from payment of customs duty on imports of raw materials, capital goods, and consumables, exemption from payment of central excise tax on goods procured from indigenous sources, income tax deductions for new units for 10 years, reimbursement of central sales tax paid on goods procured locally, and permission to sell a share of their output in the domestic tariff area subject to the payment of duties. In 1999, tax holidays were increased from five to ten years.

output. The same applies to companies established under the *Export Oriented Unit (EOU) scheme*. The 100 per cent EOU scheme was introduced in 1981 and provides essentially the same facilities as for EPZs, but with a wider choice for location of the units. With the exception of infrastructure facilities, EOUs enjoy more or less the same incentives as EPZs and are duty-free enclaves.⁵⁸

In addition to direct export obligations imposed in return for incentives given to units covered under the various schemes referred to in the previous paragraph, enterprises in some industries have been required to generate export earnings in order to meet their foreign exchange requirements. These indirect export obligations were imposed in the early 1990s (and in earlier periods) prompted by the balance of payments difficulties faced by the country and have been gradually phased out as the economic situation improved.

According to the July 1991 Policy, the payment of dividends was to be monitored by the Reserve Bank of India to ensure that dividend remittances were balanced by export earnings over a period of 7 years from commencement of production. Dividend remittances were to be made out of the export earnings from export items listed in the foreign collaboration agreement or through export of other items, provided these were included in the list of industries eligible for automatic foreign investment approval. In a relaxation of the Policy, the dividend balancing requirement was limited in 1992 to 22 specified consumer goods industries.⁵⁹ The purpose of the Policy

⁵⁸ The units in the EPZs and under other such schemes include a range of industries, such as electronics, engineering items, chemicals and allied products, gems and jewellery, textiles and clothing, agriculture and forest products, plastics and rubber products. Minimum value addition norms apply on all of these ranging from 10% in jewellery to 60% in software

⁵⁹ These included manufacturing of food and food products (e.g. dairy products, grain mill products, bakery products, hydrogenated oil), beverages, tobacco and tobacco products; soft drinks and water; refining of sugar; production of common salt; processing of tea and coffee; distilling of spirits, wines and malt liquors; manufacture of wood and wood products; leather and fur products; manufacture of

was to push consumer goods' TNCs to explore the sourcing of some items from India and in the process to neutralize the outflow of foreign exchange on account of dividends paid by TNCs. The requirement was abolished in 2000 as the balance of payments situation improved.

Under the Automobile Policy applicable before the removal of quantitative restrictions on imports in April 2001, the automobile manufacturers were allowed to import completely knocked-down or semi-knocked-down kits on execution of a Memorandum of Understanding with the Directorate General of Foreign Trade, stipulating *inter alia* the following conditions:

- Establish actual production of cars and not merely the assembly of vehicles.
- Indigenize components up to a minimum of 50 per cent and 70 per cent by the third and the fifth year respectively from the date of clearance of the first consignment of imports. Thereafter the Memorandum of Understanding and import licensing will abate; that is, the venture will not be required to obtain further import licences from the Directorate General of Foreign Trade.
- Neutralize the foreign exchange outgo on imports (c.i.f.) of kits by exports of complete vehicles and automotive components (f.o.b.) over a 7-year period. This obligation to commence from the third year of the start of production. From the fourth year imports were to be regulated in relation to exports made in the previous year.

Therefore, automobile manufacturers were required to undertake an obligation to export automotive components or vehicles to neutralize the imports of kits or components. With the phasing out of quantitative restrictions on imports in April 2001, however, this provision of foreign exchange neutralization, became redundant. The

footwear, prophylactics; motor cars; entertainment electronics; and white goods (Press Note 12 (1992 Series), Ministry of Industry, Govt. of India).

export obligation was withdrawn even for the existing companies in August 2002.⁶⁰

2. *Impact assessment*

The effectiveness of export obligations imposed on enterprises approved under EPZ-type schemes in promoting their exports is obvious as these enterprises operate from customs bonded premises and have to export their output. Judging from the export share realized by the enterprises based in these zones in India's total exports, these schemes have not been particularly successful. However, there is some variation in the rates of success of these respective zones depending upon the quality of their infrastructure.⁶¹ In any case the Indian EPZs and other schemes have not had much success in attracting TNCs to set up export-oriented production. The majority of enterprises approved under these schemes are Indian-owned. Moreover, as noted earlier, the overall proportion of TNCs in India's manufactured exports is still very small.

The effectiveness of export-obligations imposed on foreign affiliates either directly or indirectly in the form of foreign exchange neutrality or dividend balancing can be evaluated in terms of trends in export performance of foreign affiliates vis-à-vis that of their local counterparts. However, a more direct effect of these requirements is provided by case studies.

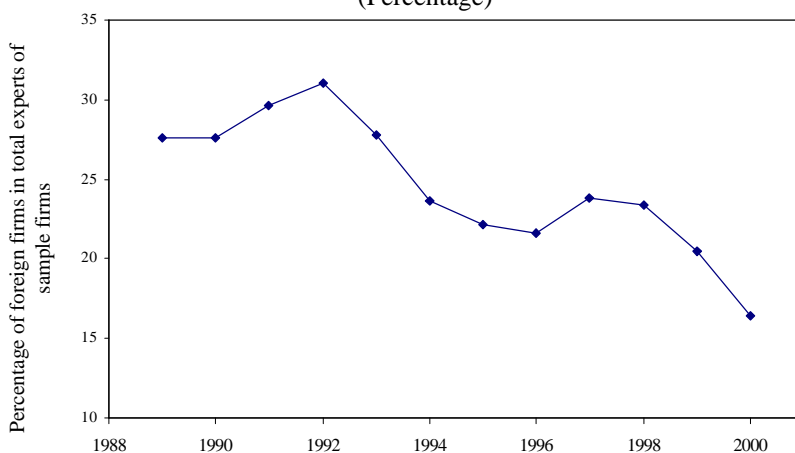
In a study of firm-level exports, foreign affiliates with a foreign equity share of more than 40 per cent reported a superior export performance to that of other companies their local counterparts in the 1980s (Kumar and Siddharthan, 1994). The authors interpreted this as an indication of a positive impact of the export obligations imposed on such foreign enterprises. Moreover, a simple comparison of average export performance of foreign and local enterprises in 30 Indian industries based on stock market listed

⁶⁰ See *Economic Times*, 22 August 2002.

⁶¹ See WTO (2002) for details.

companies over the 1989-2000 period (see annex A to this chapter, Table A.III.2) shows that FDI companies tend to outperform their local counterparts in a number of industries, especially in the consumer goods area.⁶² It would appear, therefore, that dividend-balancing or foreign exchange neutrality conditions imposed on consumer good industries have led to higher exports by foreign affiliates. The share of foreign companies in total exports of all companies in the sample fell from 28 per cent in 1989 to 16 per cent in 2000 (see figure III.2). This happened during a period when export requirements were gradually relaxed. It would tend to suggest that export-obligations did indeed lead some TNCs to export more than they would have done otherwise.

Figure III.2. Share of foreign affiliates in sample companies' exports
(Percentage)



Source: Kumar and Pradhan, 2002.

⁶² The industries are: food processing, other food products, tobacco products, beer and liquors, textiles, garments, plastic products, non-ferrous metals, non-electrical machinery, electronics, transport equipment and paper (see table A.III.2 in annex A to this chapter).

A more direct evidence on the positive role of export obligations in promoting exports is provided by case studies. For instance, as shown in box III.1, in order to meet the export obligation, Pepsi Foods set up a plant to process tomatoes and potatoes for exports. However, given the scarcity and poor quality of locally available raw materials, they developed improved planting materials and associated technologies in collaboration with an agricultural university located in Punjab State and started contract farming with extension services provided to farmers. Through this process the whole horticulture economy of the State of Punjab has been revolutionized. What started as a reluctant export activity, pushed by government imposed export obligations, has become a financially viable and promising business proposition for the company. Even though the export obligation period ended in 1996, the activity has continued and has been constantly growing. From the host country's point of view, the export requirement in this case not only generated exports but had other favourable effects in the form of access by farmers to new technology and improved earnings and levels of living for them through their participation in contract farming.

Box III.1. Export obligations and technology diffusion: Pepsi Foods and Contract farming in Punjab

Pepsi Foods Limited was established in the late 1980s as a joint venture between PepsiCo Inc., USA, Voltas (a Tata group company, India) and Punjab Agro Industries Corporation (PAIC). Apart from the joint venture requirement, the company was also required to meet an export obligation, as well as a dividend balancing requirement being a consumer goods producer. Subsequently it became a wholly owned subsidiary of PepsiCo. Pepsi Foods manufactures soft drinks and snack foods, apart from running a few fast food restaurant chains with an annual turnover of Rs 40 billion and exports around Rs 4 billion.

As per their FDI approval terms, there was an export commitment of Rs. 2 billion in 10 years besides other export obligations attached to capital goods imports. Being a company whose main business was bottling

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Box III.1. Export obligations and technology diffusion: Pepsi Foods and Contract farming in Punjab (concluded)

of soft drinks for the domestic market, using imported concentrate, meeting the export obligations was a formidable challenge.

Pepsi proposed to meet the export obligation by undertaking exports of tomato puree and other processed foods. In 1989 when Pepsi set up tomato and food processing plants in the Punjab, it faced problems of raw materials supply. For example, the Punjab produced only table varieties of tomatoes (not processing ones) available over a 25-28 days period, and in inadequate amounts. Pepsi needed a supply of tomatoes over a minimum 55 days time frame. To resolve these problems, Pepsi launched a system of contract farming of improved varieties that would meet the quality requirements. An R&D team – consisting of 3 scientists brought by Pepsi from its headquarters and scientists from Punjab Agricultural University was formed to develop a technology to improve productivity and decrease the cost of production of tomatoes. A Pepsi team under the direction of PAIC educated farmers about the benefits of contract farming. Contracted farmers were then provided with seeds and plantlets at the doorstep with written instructions in the local language. They were loaned some equipment and provided with regular crop inspection and advisory services on crop management and offered procurement of a certain quantum of output at a pre-agreed price. As a result, the annual tomato yield per hectare rose from 16 to 52 metric tons in Punjab over the period 1989-1999.

Contract farming by Pepsi Foods - with initial R&D inputs and regular fine-tuning later in experimental trials - has now extended to some other Indian crops (potatoes, basmati rice, chillies, peanuts, garlic, groundnuts etc.) and to several other States. The technology has also spread to non-Pepsi growers – buying from the company's nursery and other extension services without any buy-back arrangement – implying benefits to a broad-based spectrum of users. Thus, the export obligation imposed on Pepsi catalyzed a mutually rewarding partnership between the farmers, the university, PAIC and Pepsi and has fuelled a horticultural revolution in the Punjab, with significant improvement in yields and technology. The company's exports are still booming and have become a thrust area for Pepsi Foods.

Sources: Company interviews; a Pepsi Foods Ltd. Publication: *Partners in Progress*, June 2000; Press Reports: Economic Times, 1 May 1998; *Business India*, 19 February 1990; Financial Express, 19 July 1990.

Foreign affiliates of automotive TNCs have tended to fulfil export obligations in the form of sourcing some components from India by the parent companies for their global operations (box III.2). For example, Ford was hesitant regarding the import of components from India because of (unfounded) fears of poor quality. Export obligations helped in overcoming the information asymmetry regarding the host country capabilities and led to a fuller realization of the export potential through TNCs. In this case, export obligations generated a favourable externality in the form of establishing linkages between Indian component producers and global automotive majors that would be of long-term value.

Box III.2. Export obligations and global component sourcing strategies: Ford, General Motors and Daimler Chrysler in India

Export obligations imposed on automotive TNCs in the form of foreign exchange neutrality have prompted them to explore the potential of the country as a sourcing base for components for their worldwide operations.

Ford India initially started as a joint venture in 1996 with a local automobile group, Mahindra and Mahindra, to manufacture cars in India. The joint venture was subsequently taken over by Ford. As a part of the Indian automotive policy, it faced an export obligation to earn foreign exchange to pay for its imports of components and kits. To meet its commitments, Ford undertook a programme to source components from India (through its components subsidiary, Visteon). Ford has also used India as an export base for Ikon (a car developed for India based on the "Fiesta" platform), to South Asian, African and Latin American markets. Initially Ford was sceptical regarding the quality of components sourced from India. However, Ford UK, to which the Indian sample batches of components were exported, found their quality to be superior to that of their conventional sourcing bases.

Hence, following a visit in 2000 by a Ford team to components suppliers in India, a joint programme was launched with Automotive Component Manufacturers Association for sourcing components from the country for Ford. Ford set up two ventures to handle component sourcing:

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Box III.2. Export obligations and global component sourcing strategies: Ford, General Motors and Daimler Chrysler in India (concluded)

Visteon Automotive Systems India (95% holding by Visteon, and 5% by a company from the Republic of Korea), a supplier of automobile components and integrated systems; and Visteon Powertrain Control System Pvt. Ltd., an exporter of automotive components. There is also a growing export of Ikon completely knocked-down kits (without engine and transmission that are not manufactured in the country) to Mexico and South Africa. Thus while export obligations prompted Ford to discover an important sourcing base of quality components, from the host country point of view, they helped the country's automotive component manufacturers develop their linkages with one of the world's largest manufacturers of automobiles that could be of long-term interest.

The role of export obligations in prompting TNCs to explore the potential of India as a sourcing base for components is also corroborated by the case of General Motors (GM). GM India claims that it has recommended various companies to GM's overseas operation for sourcing of components and has helped GM source components from India. In the year 2000, GM India facilitated Sanden India – that developed the HVAC system for GM India's Corsa car model – to secure a major export order from GM Europe that also helped to meet GM India's export obligations. GM India is also pursuing partnerships with Indian component suppliers for worldwide sourcing of components for GM overseas units from India.

Daimler Chrysler India (formerly Mercedes-Benz India) also started as a joint venture in 1994 to manufacture and sell E-class Mercedes-Benz cars in India and subsequently became a wholly owned subsidiary in 2001 with the liberalization of equity ownership norms. In order to fulfil its export-obligation as per the automotive policy, DaimlerChrysler India has developed more than 20 joint ventures for manufacture and export of automotive components to the Daimler Chrysler plants in Germany. Daimler Chrysler's Indian suppliers are made to follow its stringent quality guidelines and quality standards. By early 2002, cumulative exports of DM 260 million had been achieved.

Sources: interviews with a Visteon UK executive, Company websites, McKinsey-FICCI (2002), SIAM (2002) and Press Reports: *Economic Times*, 16 April 2002; *Economic Times*, 9 Jan. 2000; *Business Line*, 20 April 2000; *Economic Times*, 11 April 2002, Chennai edition.

As well as the sourcing of components, some automobile manufacturers have fulfilled their export-obligations by exporting completely built-up units as Daimler Chrysler (exporting E-class units to neighbouring countries), or the Maruti-Suzuki joint venture that is exporting compact cars (Alto) to Europe for Suzuki following the phase out of production of those models by the parent firm.

A recent report corroborated that obligations imposed on the automotive industry in the form of export requirements and the Memorandum of Understanding followed by the Government until recently have been successful in meeting the policy objectives with regard to development of a local manufacturing base while preventing heavy drain of foreign exchange on imports. The export and import figures in the car industry in March 2002, for instance, were neutral at around Rs. 21 billion. Most manufacturers had also achieved high levels of localization of production. In March 2002, Ford had achieved an indigenization level of 74 per cent, General Motors had 70 per cent and 64 per cent for Astra and Corsa respectively, Mercedes and Toyota had close to 70 per cent and Honda had reached a level of around 78 per cent indigenization.⁶³

While export obligations have helped to generate new exports, technology transfer and diffusion, inter-firm linkages, and to improve the technology vintage and product quality, they might have adversely affected the overall volume of inward FDI to a limited extent.⁶⁴ In the post-1991 period, the incidence of export obligations has steadily diminished. Meanwhile, in the pre-1991 period, the bulk of the FDI was of a tariff-jumping type, seeking access to a sheltered domestic market. In most cases, TNCs seeking access to domestic market might have come in spite of the export obligations. The dividend-balancing requirement has been of marginal importance because most TNCs reinvest the bulk of their profits earned in the

⁶³ See 'MoU, export riders for auto cos. bear fruit', *Economic Times*, 2 September 2002.

⁶⁴ Interviews with Government officials.

early years (it was applicable only for seven years from commencement of production).

There is another reason to believe that export obligations may not have adversely affected the volume of FDI flows into India significantly. FDI entry to India in the automobile industry faced the maximum number of performance requirements: phased manufacturing programmes (like local content regulations); foreign exchange neutrality (until March 2001) under the automotive policy; and also dividend balancing (until July 2000). Nevertheless, during the 1990s the Indian automotive industry attracted 17 new ventures, 16 of which were for the manufacture of cars, representing nearly all of the major automobile makers in the United States, Europe, Japan and the Republic of Korea (SIAM, 2002). Apparently, the lure of the market seems to have been a more important factor than the performance requirements imposed by the host government. In host countries with smaller markets, however, the imposition of such conditions may produce different outcomes.

D. Joint venture and domestic equity requirements

1. Description and objective

As noted above, India has limited the extent of foreign ownership allowed in FDI approvals. In the late 1960s, the Government started to impose a general limit of 40 per cent on foreign ownership, an informal policy decision that culminated in the Foreign Exchange Regulation Act, 1973, which not only put a general ceiling of 40 per cent on foreign equity, but also required existing foreign-owned companies to dilute their foreign equity holding to 40 per cent. Predominantly export oriented companies or those involved in high technology industries were allowed to retain up to 51 or even 74 per cent of foreign equity. In July 1991, however, this policy was relaxed and has been progressively liberalized since then. Currently, 100 per cent foreign ownership is permitted in most areas of manufacturing. The extent of foreign

equity is capped at some specified limits in certain service sectors and in a few areas of manufacturing (see table A.III.1 in annex A to this chapter). Following the relaxation of policy on the extent of foreign ownership, a number of TNCs have increased their ownership in their affiliates in India and have delisted them from the stock exchanges. In a few cases, approvals of FDI have contained requirements of dilution of foreign equity holding.⁶⁵

The broad policy objective for imposing restrictions on foreign equity ownership was to encourage formation of joint ventures and to help in absorption of the knowledge brought in. Local partners in joint ventures may be able to learn valuable management practices from their foreign partners in joint ventures and to absorb the know-how brought in by the latter. The explicit objective behind the dilution of foreign equity ownership to 40 per cent under FERA, 1973, was to ‘conserve foreign exchange’ and ‘indigenization’ of companies. It was expected that the dilution would help in increasing the hold of local shareholders and thereby indigenize the management and reduce the remittances of dividends.

2. *Impact assessment*

The effectiveness of domestic equity requirements imposed at the time of approval and those implemented under the Foreign Exchange Regulation Act in the 1970s and 1980s need to be evaluated separately. The dilution policy under this Act generally failed to meet its objective (see, for example, Kumar 1994, chapter 2). Most of the companies effected the dilution of foreign equity by offering additional shares to resident shareholders through initial public offerings that were distributed to thousands of individual

⁶⁵ Sometimes foreign firms are initially allowed 100% foreign ownership on a temporary basis (considering the initial difficulty in finding a local partner), subject to the obligation to dilute 26% or 49% of the equity in favour of the Indian public in 3-5 years (depending on the sectoral caps of 74% or 51% foreign equity); E-commerce activities are an explicit policy example. In 1999, this dilution obligation was removed for companies using proprietary technology.

minority shareholders. Hence, foreign shareholders controlling a single share holding of 40 per cent of the total shares continued to exercise management control as before. The management control by foreign parents was further fortified through amended Articles of Association giving them special powers. Meanwhile, with the dilution of foreign ownership, companies were able to expand freely in any area like a domestic company. Therefore, most of them readily agreed to comply with the foreign exchange regulation directives. As the dilution affected only the proportion of foreign ownership and not the absolute magnitude of it and given the expansion of their business after dilution, even the remittances of dividends abroad did not decline.

The domestic equity requirements imposed at the time of entry have tended to encourage the formation of joint ventures. The rationale for such a policy is that joint ventures would behave differently from that of a wholly owned venture. For instance, foreign parents can be expected to instruct their affiliates to import a larger proportion of their raw materials and other inputs because of their greater familiarity with foreign suppliers and lack of information about the capabilities of local suppliers. The presence of a local partner may help to bridge the information gap regarding potential of local suppliers. It may also make the venture more prone to export and to undertake R&D to absorb and assimilate technology and thus have more beneficial externalities in terms of local learning and diffusion of knowledge. Furthermore, a local partner can bring knowledge of the local market, experience in handling government agencies and other resources to the joint venture. Therefore, joint ventures could be win-win situations for both parties. Indeed, a large proportion of new entrants in India in the 1990s have preferred to enter as joint ventures despite the fact that equity restrictions have been relaxed, making it possible to have up to 100 per cent foreign equity in most manufacturing industries. Examples include Mahindra-Ford, Tata-IBM, Tata-Mercedes-Benz, Godrej-GE, and Godrej-Procter and Gamble. Subsequent to their entry, once the foreign partner seems well versed in conducting business in India,

many of these joint ventures have been bought out by their foreign parents (Kumar, 2000).

A multivariate study of Indian pharmaceutical firms found that over the period 1978-1979 to 1991-1992, the increase in percentage of export-sales ratios was higher for minority foreign-owned firms compared to majority foreign-owned units. This finding was interpreted to mean that in a minority foreign-owned enterprise the local joint venture partner may view exports as integral to the success of the firm (Singh, 2001). It should be noted, however, that joint ventures that are formed voluntarily by TNCs to exploit the complementary assets of local enterprises and those that are forced by government policy may show different performance.

A more direct evidence on the effectiveness of domestic equity requirements or joint ventures is possible from case studies (box III.3). Two cases from the Indian two-wheeler industry suggest that joint ventures can facilitate the local learning and absorption of know-how brought in by the foreign partner. These joint ventures were set up in response to restrictions on foreign equity ownership. In both cases, not only were the local partners able to survive after the foreign partners pulled out of the joint venture, they were successfully able to bring to the market new products designed and developed by them and to target exports markets on their own.

Box III.3. Local learning in joint ventures: Two cases from the two-wheeler industry

Joint ventures between TNCs and local enterprises in developing countries could be instrumental in learning and technology absorption by the local partners and hence could contribute significantly to building of local technological capability.

TVS Motor Company Ltd. (formerly Ind-Suzuki Motorcycles Ltd.) started as a joint venture between Sundaram Clayton Group and Suzuki Motor Corporation in 1982 to produce motorcycles. In 2000/01 it produced 139,000 scooters, 358,000 motorcycles and 369,645 mopeds. During the past two decades, the local partners in the joint venture

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Box III.3. Local learning in joint ventures: Two cases from the two-wheeler industry (concluded)

absorbed technology and knowledge brought in by Suzuki and built capability to design and develop new models of two-wheelers. In 2001, Sundaram Clayton and Suzuki disengaged in an amicable manner and the company was renamed TVS Motor Company, run entirely by Sundaram Group. Subsequent to the departure of Suzuki, TVS has launched its own and indigenously developed the 110cc four-stroke motorcycle TVS-Victor. Victor was developed completely by the company's in-house R&D team comprising 300 people within 24 months with an investment of Rs 250 million. The new product has been described as a 'stunning success' by the business press, having captured a 16 per cent share of the market, giving the company new confidence in its ability to develop and market new products on its own. The company has decided to double its R&D spending in 2002 to 3.6 per cent of sales and has a number of new product launches in preparation and an ambitious expansion plan including establishing its presence in Asian markets such as Indonesia, Thailand and Vietnam.

Kinetic Motor Company Ltd. (formerly Kinetic Honda Ltd) also started as a joint venture between Kinetic group and Honda Motor of Japan in 1984 for manufacture of advanced scooters. In 1998 the Honda partnership was realigned as a technical collaboration as Honda pulled out from the joint venture to launch its own wholly owned subsidiary. On the basis of the learning and knowledge it absorbed during the partnership with Honda, Kinetic has launched several new products. These include recently launched Kinetic Nova, a four stroke 115 cc scooter with a breakthrough design and best in class performance. It competes directly with the erstwhile joint venture partners Honda's Activa, a 102cc auto-gear scooter. It is also launching a 65cc scooterette, Zing, custom designed for college students. Like TVS, Kinetic is planning a major export push with a 50 per cent export target growth in 2002.

These two cases do suggest that joint ventures provide opportunities for local partners to absorb knowledge brought in by the foreign partner after which they are able to stand on their own feet.

Sources: Authors based on SIAM (2002), *Business India*, 28 October 2001, 27 May 2002; *Businessworld*, 1 July 2002; *Economic Times*, 24 June 2002.

The favourable externalities resulting from joint ventures in terms of local learning and absorption of technology are not limited to the product line covered by the joint venture alone. Sometimes access to an industry leader as a partner in a joint venture may be useful for the local partners in other activities. A case in point is Mahindra and Mahindra's association with Ford (box III.2). Although the joint venture was limited to manufacture and selling of Ford models in India, it had favourable spillovers for another project of Mahindra and Mahindra that involved indigenous development of a multi-utility vehicle Scorpio. In 1999 when the product was under development, Ford, their joint venture partner in another venture, became interested in the Scorpio project. Ford posted four engineers at the Indian partner company and an R&D team to study the design and development effort of Mahindra and Mahindra. These engineers from Ford also helped in ironing out problems faced by Scorpio design teams by contacting design officers of Ford in the United States and getting their feedback to the team.⁶⁶ The indigenously designed Scorpio was successfully launched in July 2002. Therefore, the joint venture with Ford brought favourable externalities for both partners, beyond the production of Ford cars.

The restrictions on foreign ownership, may have affected the inflow of FDI adversely by deterring some potential investors and made foreign investors somewhat less enthusiastic.⁶⁷ Investors consider the long-term perspective and are guided by fundamentals. However, some TNCs may have entered the country to build a position in the domestic market, hoping that a higher foreign ownership norm would be allowed in due course. Indeed, over time, the caps have been removed, or at least raised, and the foreign ownership levels in existing companies have risen accordingly.

With regard to technology transfers, while foreign collaborators fear dissipation or diffusion of technology, through

⁶⁶ *Businessworld*, 1 July 2002: p. 34.

⁶⁷ Interviews with government officials.

labour mobility even in the case of wholly-owned subsidiaries, they may be more wary of transferring proprietary technology to a joint venture for reasons of secrecy. There is possibly a trade-off to consider here. While TNCs may be more willing to transfer the latest technology to a sole venture than in the case of a joint venture, the presence of a local partner may enhance the chances for local learning and diffusion of whatever knowledge that is transferred.

E. Other performance requirements

The Indian Government has very seldom imposed regulations on foreign direct investors, other than domestic equity requirements, phased manufacturing programmes (as in the automotive industry), export obligations or dividend or foreign exchange neutrality, as observed earlier. In this section, brief reference is made to technology transfer, R&D and employment and training requirements.

1. Technology transfer requirements

Technology transfer requirements have rarely been applied in India in an explicit form. In the pre-1991 period, FDI was seen as a channel of technology transfer and FDI unaccompanied by technological collaboration was not permitted. In accordance with the 1968 Industrial Policy, industries were classified into three groups: those industries where no foreign collaborations would be permitted, those where only technical collaboration was allowed, and those where financial collaboration might be allowed with technical collaboration. However, since July 1991 technology transfer is no longer a condition for FDI approval. Nonetheless, the involvement of ‘sophisticated technology’ is a major factor in allowing higher foreign equity than the sectoral caps for automatic approval, in case-by-case decisions by the Foreign Investment Promotion Board. It was also an important criterion for allowing more than 40 per cent foreign equity under the Foreign Exchange Regulations Act, 1973. The Government policy in the 1970s and 1980s also attempted to

promote quick absorption of technology by keeping the life of technological collaboration limited and by discouraging renewals.

The basic principles covering the acquisition of technology following the Technology Policy Statement of 1983 were to ensure transfer of basic knowledge (know-why) and to facilitate further technological advancement. In 1985, the Ministry of Industry required all Indian companies having foreign collaborations to state in their annual reports the efforts made on the absorption of technology, indicating also their R&D efforts. In 1986, the Ministry imposed the following conditions for cases involving technology payments during the period of collaboration exceeding Rs. 20 million, *inter alia*: the submission of a time-bound programme for technology absorption, adaptation and improvement within six months of approval; and to set up in-house R&D facilities or enter into long-term consultancy agreements with any relevant R&D institution in the country within 2 years of approval.⁶⁸ In addition, the approval letters in a few cases indicated that the relevant technology be transferred to ancillary units.

2. *Research and development requirements*

The Department of Scientific and Industrial Research under the Ministry of Science and Technology monitors R&D activities of the recognized R&D centres, including any related performance requirement imposed on foreign collaborations. R&D requirements may be imposed to ensure an adequate investment in R&D for absorption and adaptation of imported technology.⁶⁹ As mentioned, since 1986, cases involving an outflow of Rs. 20 million in

⁶⁸ See DSIR, *Foreign Collaboration Approvals*, 1988, for more details.

⁶⁹ The DSIR-recognized R&D Centres have been provided with some fiscal benefits, and easier and concessional (in terms of import duty) availability of required imports. For the drugs and pharmaceutical industry the 1979 Drug Price Control Order allowed somewhat higher profitability to firms undertaking R&D activity. However, these measures do not distinguish between the foreign-owned and locally owned firms.

technology fees have been required to set up in-house R&D facilities or enter into long-term consultancy agreements with any relevant R&D institution in the country, within 2 years of approval. Other than this general policy applicable to foreign and local companies alike, the R&D requirement has rarely been imposed in India.⁷⁰ It has been imposed in a few cases, such as those with high levels of foreign equity or those involving high technology payments.⁷¹ The requirements have been minimal, like setting up an R&D centre, or having an R&D intensity of 1 per cent. In any case there has been little subsequent monitoring of these requirements.⁷²

In a study of foreign collaboration approvals during 1984, it was found that of these firms only 40 per cent had some R&D during the period 1989-1990 to 1991-1992; 89 per cent of R&D firms reported the indigenization of production being an important R&D activity (National Council of Applied Economic Research, 1994). A recent analysis of corporate R&D activity in India shows that foreign affiliates reveal a lower R&D intensity than their local counterparts after taking account of extraneous factors. The R&D activity of foreign affiliates focused more on customization of their parent's technology for the local market or on exploiting the advantages of India as an R&D platform for their parents, while local firms' R&D was geared towards absorption of imported know-how and to provide a backup to their outward expansion.⁷³

⁷⁰ Interviews with government officials.

⁷¹ Monsanto's approval of 1995 for setting up a 100 per cent subsidiary under which it was expected to invest in R&D to adapt technology to local conditions, is a case in point. In 1984, in respect of six fresh foreign collaboration approvals Indian companies were asked to set up R&D Centres and to develop design capabilities (DSIR, *Foreign Collaboration Approvals*, 1984). In one such case, the Indian company was asked to invest 1% of its total turnover in R&D and the lump sum and royalty payments were linked to carrying out satisfactory R&D programmes. The collaboration-wise information explored by the authors indicates that all these six cases involved technical licensing agreements only without any FDI inflow.

⁷² Interviews with government officials.

⁷³ See Kumar and Agarwal (2000).

3. *Employment and training requirements*

The Indian policy on FDI has never imposed any performance requirements on employment of foreign nationals in top positions, or insistence on their occupancy by nationals. The conditions of employment in top positions such as directors are governed by the Companies Act. There has never been any training requirements imposed either. It was felt that whenever firms required any training of their employees, they would do this on their own initiative. Hence the need to impose any conditions with regard to training did not arise. In a small number of cases the training requirements or suggestions to that effect, were usually conveyed verbally in an informal way, but not imposed formally.⁷⁴

F. *Monitoring of performance requirements*

The fulfilment of export obligations has been monitored by the Directorate-General of Foreign Trade, acting on information received from the Foreign Investment Promotion Board on the export obligations imposed. Periodic reports are sent by companies every six months, and when the companies approach the Directorate-General for export-related import entitlements, their previous export obligations and actual exports are examined. There are relevant penalty provisions for defaults although these have rarely been imposed. When in early years, some companies had not fulfilled their export obligations, the Government sometimes resorted to the imposition of bank guarantees at the time of fixing the obligations.⁷⁵

Sometimes the Government has been requested to extend the period for complying with export obligations in cases involving non-fulfilment for reasons beyond the company's control, such as unfavourable export market conditions. Individual companies are consulted at the time of review of their export obligations and if there

⁷⁴ Interviews with government officials.

⁷⁵ See Gulati and Bansal (1980) for an early account.

is a default in one year, the firm is allowed to meet this obligation the following year. However, export obligations given in consideration of entry into small-scale industry reserved items (or in non-Appendix 1 industries etc.) have been more strictly enforced.

Interviews and various press reports suggest that monitoring of export obligations and adherence to these by companies has improved during the last decade. There also appears to be a greater degree of mutual trust and flexibility in terms of extensions allowed in cases of genuine difficulties in meeting the export obligations.

One bone of contention has been that many companies have been showing their export earnings as inclusive of the value of exports of items purchased from the market, unrelated to their manufacturing operations and not included in the initial list of exportables. In most cases the Government has accepted this behaviour.⁷⁶ However, in respect of the 1997 Automobile Policy under the Memorandum of Understanding, the Government has allowed both vehicles and automotive components to be considered for meeting the export obligations, but not any other products. Subsequent to the removal of quantitative restrictions on import of completely and semi-knocked-down kits and components with effect from 1 April 2001, the export obligations imposed for imports made up to March 2001 by existing automotive companies were abolished in August 2002. For such companies it is actually their export obligations against massive amounts of duty-free imports of capital goods under the EPCG scheme, which they have found difficult to fulfil in some cases.

The dilutions associated with the Foreign Exchange Regulation Act, 1973, were enforced by the Reserve Bank of India. In 1991, for many industries, up to 51 per cent foreign equity was

⁷⁶ The alcoholic beverages' companies have experienced difficulty in marketing molasses-based Indian whiskies overseas, and asked for a broadbasing of the items to be considered as alcohol exports (*Business Standard*, 30 March 1998, *Economic Times*, 30 July 1998).

allowed under an automatic route (of informing the Bank), while up to 100 per cent was allowed in case-by-case approvals by the Foreign Investment Promotion Board. The automatic route, without any bottlenecks, was applied to high priority industries (erstwhile Appendix-I industries), referred to now as Annexure-III industries. Foreign equity above the sectoral caps may be granted by the Board on the merits of the case depending on the capital requirement,⁷⁷ nature and quality of technology, marketing and management skill requirements and commitments for exports (SIA, 2000).

G. Overall trends in incidence of performance requirements

In order to examine the incidence of performance requirements and trends therein, the records of FDI approvals ("foreign financial collaborations" in official parlance) over the 1991-2000 period compiled by the Department of Scientific and Industrial Research under the National Register on Foreign Collaboration have been consulted (Kumar and Singh, 2002).⁷⁸ The bulk of performance requirements imposed by the Government are 100 per cent export obligations that are prescribed for enterprises under the various export-oriented schemes in return for several concessions and incentives. These are also imposed on domestic enterprises which avail of these incentives. These requirements are "voluntary" in nature and should be viewed differently from such mandatory export obligations as those imposed on enterprises manufacturing products reserved for small scale industries (SSIs) or to neutralize imports of components, etc.

Table III.1 summarizes the pattern of imposition of different types of performance requirements on FDI approvals of proposals (including by non-resident Indians); not all approvals are

⁷⁷ Even for existing JV enterprises planning a major expansion the foreign ownership may be allowed to be increased (even up to 100%) in case of inability of the local partner to contribute pro-rata to proposed enhanced equity. In the pre-1991 period foreign exchange requirements of the expansion project played a similar role.

⁷⁸ Information for 1994 was not available.

implemented. Figures in parenthesis are the percentage of FDI approvals during a certain year. The overall incidence of performance requirements on FDI approvals has declined sharply over the 1990s, from 33 per cent of FDI approvals in 1991 to just about 9 per cent by 2000. Secondly, the decline in incidence of performance requirements other than 100 per cent export obligations is even sharper. In 1991, 100 per cent export obligations accounted for 47 per cent of the performance requirements imposed, as compared to 81 per cent in 2000. As is apparent from figure III.3 (based on table III.1), the performance requirements other than those imposed on enterprises entering EPZs or other such schemes have gradually diminished.

Apart from 100 per cent export obligations and other requirements on export performance, some approvals have contained requirements stipulating that inflow of foreign equity would cover the import content of machinery and equipment. A few approvals also required the dilution of foreign equity ownership. Some approvals involving regulation of imports or local content include phased manufacturing programmes that were also imposed on automotive enterprises. Hardly any approvals have imposed conditions of skills or employment performance.

Another group of performance requirements has included requirements on foreign exchange neutrality or the capping of royalty payments to a certain percentage of turnover. The foreign-exchange neutrality condition has generally been imposed on companies in the automobile and beverages industries.

A further set of restrictions cover social or environmental obligations and small-scale industry promotion or restrict production of items reserved for small-scale industries. Some approvals relating to FDI in medical and diagnostic services have been made imposing obligations to provide free/concessional rates to poor patients, as a condition attached with allocation of land and other infrastructure at concessional rates (as also imposed on such domestic private enterprises). A few approvals belonging to biotechnology industry

have involved a condition not to bring into the country certain undesirable technologies (such as terminator technology).

Very few cases have required investment in R&D activity for product or technology adaptation (as required of Monsanto's 100 per cent subsidiary), or transfer of technology/designs to develop local capability (as Rothmans were required to undertake agronomic development for Indian farmers).

Table III.2, also based on DSIR data, summarizes the industry-wise distribution of incidence of performance requirements. Export obligations are largely concentrated in electrical and electronics, textiles and miscellaneous goods industries, and in consultancy and other services.⁷⁹ Since the mid-1990s, the consultancy and other services industry has attracted FDI with 100 per cent export obligations. These approvals cover the export-oriented software enterprises established in Software Technology Parks to take advantage of low-cost trained manpower in the country (Kumar, 2001).

H. Concluding observations

This chapter has reviewed the Indian experience of the imposition of performance requirements. The Government has employed some performance requirements to make FDI inflows conform to its development policy objectives. However, the incidence of these requirements has declined over the 1990s steadily as the balance of payments situation improved, the economy developed and hence the policy objectives changed. Some of the performance requirements had to be phased out to meet obligations under the WTO TRIMs Agreement.

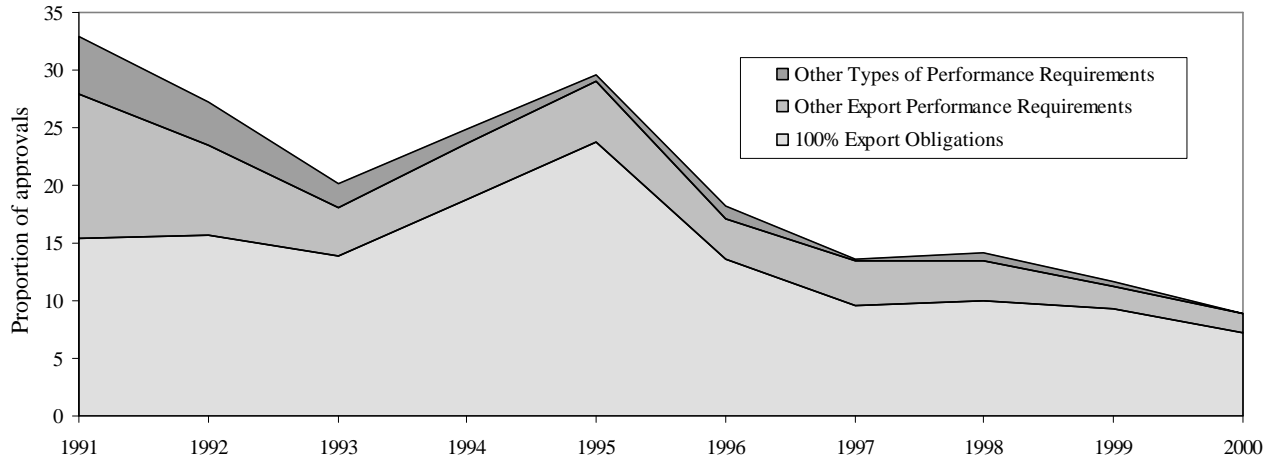
⁷⁹ The miscellaneous group contains certain consumer goods industries and horticulture (mushroom culture, floriculture) etc. which have attracted FDI under export-oriented schemes.

Table III.1. India: incidence of performance requirements on FDI approvals, 1991-2000

Year	Total Approvals	Cases with 100% Export Obligation	Approvals with other Export Performance Requirements	Other Performance Requirements related to						Total performance requirements other than 100% E.O.	Grand Total of Performance Requirements
				Equity	Imports/ Local Content	Skills/ Employment	Foreign Exchange-neutrality/Royalty	Social/SSI/ Environmental	R&D/Technology Transfer		
Col. 1	2	3	4	5	6	7	8	9	10	11=4 to 10	12=3+11
1991	298	46 (15.44)	37 (12.42)	0 (0)	4 (1.34)	0 (0)	9 (3.02)	0 (0)	2 (0.67)	52 (17.45)	98 (32.89)
1992	735	115 (15.65)	57 (7.76)	12 (1.63)	1 (0.14)	0 (0)	6 (0.82)	7 (0.95)	2 (0.27)	85 (11.56)	200 (27.21)
1993	762	106 (13.91)	32 (4.2)	4 (0.52)	0 (0)	0 (0)	3 (0.39)	7 (0.92)	1 (0.13)	47 (6.17)	153 (20.08)
1995	1355	321 (23.69)	72 (5.31)	0 (0)	1 (0.07)	3 (0.22)	1 (0.07)	0 (0)	3 (0.22)	80 (5.9)	401 (29.59)
1996	1555	211 (13.57)	54 (3.47)	6 (0.39)	7 (0.45)	2 (0.13)	0 (0)	1 (0.06)	1 (0.06)	71 (4.57)	282 (18.14)
1997	1690	162 (9.59)	66 (3.91)	2 (0.12)	0 (0)	0 (0)	1 (0.06)	0 (0)	0 (0)	69 (4.08)	231 (13.67)
1998	1187	119 (10.03)	41 (3.45)	1 (0.08)	4 (0.34)	0 (0)	2 (0.17)	0 (0)	1 (0.08)	49 (4.13)	168 (14.15)
1999	1708	160 (9.37)	33 (1.93)	0 (0)	2 (0.12)	0 (0)	0 (0)	3 (0.18)	0 (0)	38 (2.22)	198 (11.59)
2000	1612	117 (7.26)	27 (1.67)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	27 (1.67)	144 (8.93)

Source: Compiled by Kumar and Singh, 2002, based on DSIR data.

Figure III.3. India: Incidence of performance requirements in FDI approvals, 1991-2000
(Percentage)



Source: Computations by Kumar and Singh based on DSIR data.

The evidence presented suggests that performance requirements, effectively enforced, can affect the performance of foreign affiliates and help the host countries meet their objectives. The case study evidence presented shows that export requirements have brought a number of favourable externalities to the host economy in the form of diffusion of new technology through contract farming, or establishment of vertical linkages of the domestic automotive component producers with the world's major automobile producers that are going to be of long-term benefit. Similarly the domestic equity requirements have promoted formation of joint ventures. These joint ventures also appear to have favourable externalities in the form of substantial local learning and quick absorption of knowledge brought in by the foreign partner, although a difference in behaviour can be expected between joint ventures that are formed "voluntarily" and those that are set up in response to host country requirements. With regard to the scope for technology transfers and domestic equity requirements, there may be a trade-off to consider. While TNCs may be more willing to transfer the latest technology to a sole venture than in the case of a joint venture, the presence of a local partner may enhance the chances for local learning and diffusion of whatever knowledge is transferred.

Finally, it should be stressed that in a large economy like that of India, investors seeking access to the domestic market may still be attracted despite the performance requirements.

The evidence presented suggests that performance requirements, effectively enforced, can affect the performance of foreign affiliates and help the host countries meet their objectives. The case study evidence presented shows that export requirements have brought a number of favourable externalities to the host economy in the form of diffusion of new technology through contract farming, or establishment of vertical linkages of the domestic automotive component producers with the world's major automobile producers that are going to be of long-term benefit. Similarly the domestic equity requirements have promoted formation of joint

Table III.2. India: Industry-wise Incidence of Performance Requirements on FDI Approvals 1991 - 2000

Industry	1991		1992		1993		1995		1996		1997		1998		1999		2000	
	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO	100% EO	Other EO
Alternate Energy Sources	0	0	1	1	0	0	0	0	0	0	0	0	0	0	0	0	0	0
	(0.00)	(0.00)	(14.29)	(14.29)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Chemicals	1	6	2	3	8	1	18	8	7	7	7	3	3	2	3	4	5	6
	(2.08)	(12.50)	(2.50)	(3.75)	(9.52)	(1.19)	(18.00)	(8.00)	(4.43)	(4.43)	(4.67)	(2.00)	(2.88)	(1.92)	(2.97)	(3.96)	(4.67)	(5.61)
Electrical & Electronics	8	7	19	13	9	5	24	6	17	5	5	3	9	0	6	3	5	0
	(16.33)	(14.29)	(21.59)	(14.77)	(8.91)	(4.95)	(9.41)	(2.35)	(7.56)	(2.22)	(2.25)	(1.35)	(6.00)	(0.00)	(2.64)	(1.32)	(2.46)	(0.00)
Industrial Machinery	2	2	0	0	0	0	2	1	0	1	2	3	1	1	0	0	2	1
	(6.06)	(6.06)	(0.00)	(0.00)	(0.00)	(0.00)	(4.76)	(2.38)	(0.00)	(1.35)	(4.26)	(6.38)	(5.00)	(5.00)	(0.00)	(0.00)	(4.55)	(2.27)
Mechanical Engineering	2	5	1	1	5	2	8	3	11	2	5	4	4	0	3	4	3	2
	(6.90)	(17.24)	(1.85)	(1.85)	(9.80)	(3.92)	(8.42)	(3.23)	(11.34)	(2.06)	(4.42)	(3.54)	(5.00)	(0.00)	(3.66)	(4.88)	(3.85)	(2.56)
Machine Tools	0	1	1	0	0	0	0	1	1	0	2	1	0	1	0	0	0	0
	(0.00)	(25.00)	(16.67)	(0.00)	(0.00)	(0.00)	(0.00)	(16.67)	(6.25)	(0.00)	(10.00)	(5.00)	(0.00)	(6.25)	(0.00)	(0.00)	(0.00)	(0.00)
Metallurgy	1	1	7	2	5	1	9	2	11	0	4	0	3	2	4	0	2	0
	(14.29)	(14.29)	(26.92)	(7.69)	(13.51)	(2.70)	(25.71)	(5.71)	(19.64)	(0.00)	(9.52)	(0.00)	(8.82)	(5.88)	(12.90)	(0.00)	(11.11)	(0.00)
Textiles	4	0	5	1	5	2	12	2	18	7	12	3	5	3	5	0	3	4
	(57.14)	(0.00)	(31.25)	(6.25)	(33.33)	(13.33)	(52.17)	(8.70)	(34.62)	(13.46)	(27.91)	(6.98)	(21.74)	(13.04)	(16.13)	(0.00)	(13.04)	(17.39)
Transportation	0	1	1	0	1	1	1	2	2	2	3	5	1	0	1	0	1	2
	(0.00)	(20.00)	(5.56)	(0.00)	(3.57)	(3.57)	(4.55)	(9.09)	(2.99)	(2.99)	(3.00)	(5.00)	(1.35)	(0.00)	(1.01)	(0.00)	(1.92)	(3.84)
Consultancy & Other Services	7	2	17	6	9	3	46	5	51	6	48	9	65	0	117	0	80	3
	(14.29)	(4.08)	(10.82)	(3.82)	(5.92)	(1.97)	(13.07)	(1.42)	(11.14)	(1.31)	(8.33)	(1.56)	(14.61)	(0.00)	(16.30)	(0.00)	(9.96)	(0.37)
Miscellaneous	21	12	61	30	64	17	201	42	93	24	74	35	28	32	21	22	16	9
	(31.34)	(17.91)	(24.30)	(11.95)	(25.30)	(6.72)	(48.09)	(10.05)	(27.19)	(7.02)	(20.00)	(9.46)	(11.57)	(13.22)	(6.28)	(6.59)	(6.13)	(3.45)
Total	46	37	115	57	106	32	321	72	211	54	162	66	119	41	160	33	117	27
	(15.44)	(12.42)	(15.65)	(7.76)	(13.91)	(4.20)	(23.69)	(5.31)	(13.57)	(3.47)	(9.59)	(3.91)	(10.03)	(3.45)	(9.37)	(1.93)	(7.26)	(1.67)

Source: Authors' computations based on DSIR data.

Notes: These figures are based on approvals of proposals; not all approvals were implemented. 1994 figures are not available.

Figures in parentheses are percentages of the respective industry total FDI approvals. EO= export obligations.

ventures. These joint ventures also appear to have favourable externalities in the form of substantial local learning and quick absorption of knowledge brought in by the foreign partner, although a difference in behaviour can be expected between joint ventures that are formed "voluntarily" and those that are set up in response to host country requirements. With regard to the scope for technology transfers and domestic equity requirements, there may be a trade-off to consider. While TNCs may be more willing to transfer the latest technology to a sole venture than in the case of a joint venture, the presence of a local partner may enhance the chances for local learning and diffusion of whatever knowledge is transferred.

Finally, it should be stressed that in a large economy like that of India, investors seeking access to the domestic market may still be attracted despite the performance requirements.

Annex A to Chapter III. India: Additional tables**Table A.III.1. India: Foreign investment requirements as of May 2001**

Sector	Foreign equity	Approval process
Agriculture including planting	Not allowed	
Mining		
Coal/lignite mines together with power projects for captive consumption	100%	Automatic up to 50%; otherwise non-automatic
Exploration/mining of coal/lignite for captive consumption	74%	Automatic up to 50%; otherwise non-automatic
Coal processing plant	100%	Automatic up to 50%; otherwise non-automatic
Exploration and mining of diamonds and precious stones	74%	Automatic
Exploration and mining of gold/silver and other minerals, metallurgy and processing	100%	Automatic
Petroleum		
Exploration in small fields	100% through competitive bidding	Non-automatic
Exploration in medium-size fields	60% for unincorporated joint venture and 51% for incorporated joint venture	Non-automatic
Refining with domestic private company	100%	Automatic
Refining with public sector unit	26%	Non-automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Petroleum product and pipelines	51%	Non-automatic
Infrastructure related to marketing of petroleum products	74%	Non-automatic
Market study and formulation and investment/financing	100% through wholly owned subsidiaries	Non-automatic
Power		
Electricity generation, transmission, and distribution	100%	Automatic (as per Ministry of Commerce and Industry, Press Note No. 7 (2000 Series))
Atomic energy		
Mining and mineral separation, value addition and integrated projects	Up to 74%, and FDI beyond 74% is subject to clearance by the Atomic Energy Commission on case-by-case basis	Non-automatic
Others	Prohibited	n.a.
Manufacturing		
Small-scale industry sector	24% in a small-scale unit. FDI above 24% is subject to a mandatory export obligation of 50% of annual production, and loses small-scale status	Automatic up to 24%; otherwise non-automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Drugs/pharmaceuticals	100% for bulk drugs, their intermediates and formulations	Automatic except for activities requiring compulsory licensing: drugs produced with the use of recombinant DNA technology and specific cell/tissue targeted formulations; or FDI above 74% to manufacture bulk drugs from basic stages and their intermediates and bulk drugs produced with the use of recombinant DNA technology, and specific cell/tissue targeted formulations provided it involves manufacturing from basic stage
Telecommunication equipment manufacturing	100%	Automatic up to 49%; otherwise non-automatic
Pollution control equipment	100%	Automatic
Defence and strategic industries	Up to 26%	Non-automatic
Distillation and brewing of alcoholic drinks	100%	Non-automatic ^a

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Distillation and brewing of alcoholic drinks	100%	Non-automatic ^a
Cigars and cigarettes of tobacco and manufactured tobacco substitutes	100%	Non-automatic ^a
Electronic aerospace and defence equipment: all types	100%	Non-automatic ^a
Industrial explosives including detonating fuses, safety fuses, gun powder, nitrocellulose and matches	100%	Non-automatic ^a
Hazardous chemicals	100%	Non-automatic ^a
Arms and ammunition and allied items of defence equipment, defence aircraft and warships	26% subject to the guidelines and licensing of the Ministry of Defence	Non-automatic
Financial Services		
Banking	49% subject to Reserve Bank of India guidelines	Non-automatic (according to SIA Press Note No. 4 (2001) Series, FDI in this sector is through the automatic route)
Non-banking financial companies (NBFCs)	FDI up to 51% - \$0.5 million must be brought up front FDI above 51% and up to 75% - \$5 million must be brought up front FDI	Non-automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Insurance	above 75% and up to 100% - \$50 of which \$7.5 million must be brought up front and the balance in 24 months 26% subject to licencing issued by Insurance Regulatory and Development Authority	Non-automatic (according to SIA Press Note No.10 (2000 Series), 19 October 20001, FDI in this sector is automatic)
Telecommunications		
Basic, cellular, value added service and global mobile personnel, communications by satellite	49% subject to licensing by the Department of Telecommunications and Safety Requirements	Non-automatic
ISPs with gateways, radio-paging and end-to-end bandwidth	74%	Automatic up to 49%; otherwise non-automatic
ISPs not providing gateways (both for satellite and submarine cables), infrastructure providers providing dark fibre (IP Category 1), electronic mail and voice mail	100% subject to divestment of 26% equity to Indian public within 5 years, and to licensing by the Department of Telecommunications and Safety Requirements	Automatic up to 49%; otherwise non-automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Postal/courier services	100% in courier services excluding distribution of letters	Non-automatic
Transport & other services		
Airlines	Up to 40% with no direct/indirect equity participation by foreign airlines. 100% investment allowed for non-resident Indians /overseas corporate bodies (OCBs)	Non-automatic
Airports	100%	Automatic up to 74%; otherwise non-automatic
Shipping	74%	Automatic
Railways	Prohibited	n.a.
Construction and maintenance of ports and harbours, roads & highways	100%	Automatic provided that FDI does not exceed Rs 15 billion (SIA Press Note No. 1 (1999 Series), 4 January 1999)
Housing/real estate	FDI is not allowed except for development of integrated townships and settlements where 100% FDI is allowed. NRI/OCB are allowed to invest up to 100% in other housing and real estate activities	Non-automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (continued)**

Sector	Foreign equity	Approval process
Trading	Prohibited in retail business.	Automatic up to 51% for export activities; non-automatic in all other cases
	51% FDI is allowed in case of export-oriented activities	
	100% for some activities ^b	
Print media	26 per cent Up to 20% in broadcasting for distr. of multi-channel TV programmes	Non-automatic
Hotel & tourism, restaurants	100%	Automatic
Consultancy for pollution control and management	100%	Automatic
Advertising	74%	Automatic
Films	100% subject to specific conditions	Automatic
Professional services	51% except legal service, where FDI is not permitted	Automatic
Health and education services	51%	Automatic
E-commerce	100% (except for retail e-commerce where FDI is not permitted) subject to divestment of 26% equity to Indian public within 5 years.	Automatic up to 51%
Mass rapid metro transit system	100%	Automatic

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**Table A.III.1. India: Foreign investment requirements
as of May 2001 (concluded)**

Sector	Foreign equity	Approval process
Infrastructure	Allowed up to 49% subject to the condition that the management of the company is with Indian nationals	Non-automatic

n.a. Not available.

^a Industrial licence is compulsory.

^b These activities include exports; and Cash and carry wholesale trading.

Sources: WTO (2002) based on Secretariat for Industrial Assistance (2001), Manual on Industrial Policy and Procedures in India. May 2001; Department of Industrial Policy & Promotion (2001), Investing in India, 16 May 2001; Government of India (undated), Destination India, Secretariat for Industrial Assistance, New Delhi; Ministry of Finance (2001), Budget 2001-2002 [Online]. Available at: <http://indiabudget.nic.in/ub2001-02/bs/fi.htm> [6 July 2001]; Reserve Bank of India Notification No. FERA 215/2000, 22 March 2000 [Online]. Available at: <http://www.rbi.org.in/srch/rbi> [9 July 2001]; Reserve Bank of India Notification No. FEMA 20/2000, 3 May 2000 [Online]. Available at: <http://www.rbi.org.in/index.dll> [9 July 2001]; Ministry of Commerce and Industry, Press Note No. 7 (2000 Series), 14 July 2000, Online. Available at: http://indmin.nic.in/vsindmin/policy/chages/press7_00.htm [24 July 2001]; Ministry of Commerce and Industry, Press Note No. 4 (2001 Series), 21 May 2001 [Online]. Available at: http://indmin.nic.in/vsindmin/policy/chages/press4_01.htm [6 July 2001]; and Ministry of Commerce and Industry, Press Note No. 10 (2000 Series), 19 October 2001 [Online]. Available at: http://indmin.nic.in/vsindmin/policy/chages/press10_01.htm [6 July 2001]

Note: There is conflicting information from the Reserve Bank of India and the Ministry of Commerce and Industry regarding FDI in some sectors (e.g. housing and real estate, coal and lignite, drugs and pharmaceuticals, and hotels and tourism)

Table A.III.2. India: Industry-wise export intensity, 1989-2000
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Food Processing	All Firms	4.85	5.94	5.33	8.04	8.14	8.83	9.51	7.45	7.8	6.98	4.67	2.11
	Local Firms	1.24	6.34	1.43	4.4	6.02	9.81	9	5.43	4.65	4	3.5	2.69
	Foreign Firms	6.73	5.81	7.42	10.69	9.95	8.08	10.04	10.23	11.45	10.24	5.96	0.32
Sugar	All Firms	0.77	0.71	1.2	1.13	1.07	1.2	0.8	0.59	1.21	0.92	0.46	0.54
	Local Firms	0.8	0.71	1.23	1.16	1.09	1.22	0.81	0.61	1.23	0.94	0.47	0.54
	Foreign Firms	0		0	0	0	0	0	0	0	0	0	
Edible Oils	All Firms	4.84	9.04	6.34	10.01	11.86	15.65	10.78	11.91	12.19	13.28	9.38	11.66
	Local Firms	4.84	9.39	6.65	9.72	12.26	16.26	11.21	12.27	12.91	14.06	10.1	12.26
	Foreign Firms		0.83	2.3	13.29	6.88	5.43	2.12	4.19	0.11	0.34	0.34	0.29
Other Food Products	All Firms	9.29	14.99	29.89	46.84	59.01	54.31	49.62	54.53	50.69	41.19	54.15	52.71
	Local Firms	0.12	0.2	17.44	38.05	54.78	50.72	47.36	53.36	49.09	39.33	53.39	51.61
	Foreign Firms	82.36	71.49	81.82	82.94	84.9	82.48	81.12	80.34	77.73	78.52	72.5	76.22
Tobacco	All Firms	3.01	5.39	8.22	11.8	12.52	14.43	12.69	9.08	9.01	13.28	6.95	7.34
	Local Firms	0.97	1.49	5.06	5.08	9.32	7.74	2.99	2.54	3.22	2.86	0.28	3.06
	Foreign Firms	3.19	5.74	8.47	12.19	12.69	15.1	13.72	10.01	9.27	14.31	7.43	7.79

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (continued)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Beer & Liquors	All Firms	2.29	3.1	2.99	2.79	1.87	2.29	1.57	2	3.21	1.18	1.33	1.45
	Local Firms	1.89	2.29	1.58	2.42	1.77	2.04	1.22	1.67	2.75	0.68	0.97	1.32
	Foreign Firms	4.36	7.14	11.15	5.36	2.57	4.48	4.83	5.49	6.98	6.57	5.01	8.01
Textiles	All Firms	4.39	6.3	7.08	9.63	10.35	12.21	15.3	17	19.94	20.8	20.55	22.02
	Local Firms	3.71	5.83	6.62	8.85	9.29	11.09	14.19	15.97	19.01	20.02	20.24	21.69
	Foreign Firms	21.8	11.51	12.35	18.33	22.54	23.62	31.48	28.38	28.94	27.62	23.28	25.09
Garments	All Firms	53.66	53.26	58.24	54.26	46.38	51.91	52.87	52.22	46.85	55.93	54.57	48.68
	Local Firms	53.66	56.24	60.86	56.64	49.59	50.97	51.88	50.06	45.21	54.84	53.01	46.04
	Foreign Firms		0	0	0	0	60.82	60.42	70.39	60.47	67.3	74.44	86.12
Chemicals	All Firms	2.81	3.43	4.15	4.49	7.44	6.04	8.7	8.09	8.68	9.27	9.03	9.02
	Local Firms	2.57	2.45	3.11	3.88	5.47	5.57	8.65	7.94	8.63	9.82	8.85	9.25
	Foreign Firms	3.38	6.07	7.41	6.68	13.29	7.58	8.88	8.67	8.85	6.34	9.96	7.62
Fertilizers	All Firms	0.66	0.98	1.06	1.05	1.72	1.77	2.73	2.99	2.62	2.91	2.92	4.14
	Local Firms	0.69	0.94	1.06	0.96	1.77	1.83	2.76	3.01	2.56	2.82	2.7	4.35
	Foreign Firms	0.37	1.35	1.04	1.91	1.19	1.25	2.49	2.86	3.24	3.73	5.13	1.95

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (continued)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Paints	All Firms	9.9	10.46	9.7	9.18	12.18	12.58	12.46	13.84	15.36	16.44	16.34	15.02
	Local Firms	9.17	8.67	9.21	9.2	13.29	13.4	13.85	15.34	17.19	17.96	17.33	15.24
	Foreign Firms	11.86	14.54	10.85	9.08	9.66	10.44	7.45	8.13	9	11.31	13	14.32
Pharmaceuticals	All Firms	4.87	7.89	8.87	9.78	9.51	11.6	14.26	17.8	17.56	21.39	18.79	20.56
	Local Firms	5.1	7.12	8.47	9.69	10.64	12.25	15.17	17.96	17.67	20	19	23.34
	Foreign Firms	4.58	8.89	9.46	9.93	7.64	10.38	12.29	17.4	17.29	24	18.32	9.46
Personal Care	All Firms	7.07	10.5	7.91	9.02	6.84	6.33	6.87	10.04	8.13	4.34	5.85	5.69
	Local Firms	4.06	7.55	9.53	9.39	3.72	4.93	6.4	12.9	10.34	5.95	8.43	7.04
	Foreign Firms	8.32	13.77	6.42	8.66	9.04	7.51	7.32	7.14	5.68	2.1	1.9	1.19
Plastic Products	All Firms	2.51	3.32	4.35	3.98	4.28	5.5	7.13	7.36	8.57	8.74	7.7	9.29
	Local Firms	2.3	3.02	4.1	3.78	4.09	5.37	7.09	7.45	8.22	8.4	7.43	8.51
	Foreign Firms	10.49	14.11	12.34	11.27	10.95	9.79	8.24	4.9	14.36	14.33	13.05	28.16
Tyres	All Firms	4.61	7.23	6.93	6.47	10.76	10.15	8.17	9.18	7.74	9.18	8.31	8.79
	Local Firms	4.82	7.58	6.92	6.64	11.63	11.01	8.56	9.99	7.86	9.45	8.67	9.05
	Foreign Firms	3.71	5.9	6.96	5.73	7.1	5.74	3.88	3.52	6.98	5.53	4.73	2.26

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (continued)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Cement	All Firms	1.56	3.82	3.3	1.63	2.87	4.3	3.77	3.6	3.59	3.67	2.95	2.26
	Local Firms	1.63	3.96	3.4	1.67	2.71	3.9	3.71	3.62	3.57	3.63	3.01	2.26
	Foreign Firms	0	0	0.75	0.57	6.72	14.88	5.15	2.94	4.11	4.85	0.74	
Glass	All Firms	1.54	2.43	2.31	2.73	4.63	5.99	5.96	7.27	6.67	5.43	5.43	6.3
	Local Firms	0.88	2.19	2.22	2.74	4.63	5.78	5.83	6.35	6.5	5.43	5.84	6.55
	Foreign Firms	4.8	3.81	2.92	2.64	4.66	7.26	6.83	11.3	7.42	5.45	3.74	5.14
Gems	All Firms	62.98	69.53	96.5	99.52	89.68	92.05	72.79	76.67	59.47	66.28	88.93	67.32
	Local Firms	91.77	94.36	97.44	99.6	87.21	91.29	70.97	78.97	58.61	66.3	91.33	69.64
	Foreign Firms	0	0	93.39	99.21	99.33	98.27	99.36	50.1	69.32	66.09	64.7	52.54
Non-metallic Mineral Products	All Firms			28.34	27.63	23.64	63.1	62.01	60.11	59.3	54.18	54.6	52.97
	Local Firms			86.6	50.9	28.07	78.81	70.4	70.12	74.82	71.44	73.48	75.75
	Foreign Firms			0	0	0.05	2.72	23.61	21.17	14.53	11.35	13.92	14.39
Iron & Steel	All Firms	1.66	2.15	2.41	3.56	5.92	8.87	6.95	7.1	5.95	8.19	6.17	8.97
	Local Firms	1.69	2.23	2.5	3.65	6.01	9	6.92	6.8	5.57	7.84	6.14	8.15
	Foreign Firms	0	0.01	0.1	0.69	3.49	0.57	7.74	12.8	11.4	13.5	6.71	21.27

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (continued)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Ferro Alloys	All Firms	6.38	6.5	6.86	7.52	9.72	9.91	10.08	15.65	13.53	16.24	15.65	16.07
	Local Firms	6.47	6.92	7.35	7.93	10.11	9.91	9.48	15.83	13.9	16.71	16.01	16.67
	Foreign Firms	4.09	1.82	2.59	3.64	4.68	9.89	17.37	13.32	10.64	4.61	0	2.36
Metal Products	All Firms	4.59	5.63	5.34	6.94	8.45	11.69	11.17	17.76	18.34	19.18	20.25	20.25
	Local Firms	4.77	6.13	5.83	8.02	10	13.92	12.91	15.06	17.29	19.04	20.78	20.13
	Foreign Firms	2.69	2.56	2.68	2.29	2.28	4	4.03	29.42	22.95	19.67	18.7	22
Non-ferrous Metals	All Firms	9.05	11.09	7.04	7.72	9.75	9.26	8.83	9.31	14.21	10.8	9.48	14.87
	Local Firms	9.05	10.94	6.75	7.41	9.68	9.04	8.29	8.04	11.2	10.8	9.48	14.87
	Foreign Firms	9.61	20.33	22.58	23.1	14.87	21.24	27.98	47.27	87.15			
Non-electrical Machinery	All Firms	3.33	4.51	6.08	5.57	6.13	6.77	6.2	5.28	5.38	6.85	6.17	6.73
	Local Firms	1.99	2.48	4.68	4.19	5.04	5.81	5.29	4.52	4.4	5.26	4.69	4.93
	Foreign Firms	10.37	13.92	12.37	11.16	10.48	10.26	9.65	8.12	9.09	12.56	12	18.12

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (continued)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Electrical Machinery	All Firms	4.02	5.65	5.27	5.9	6.72	6.32	6.07	6.33	7.13	8.27	8.39	7.06
	Local Firms	3.24	4.82	4.39	4.81	4.29	4.65	5.07	5.63	6.17	8.69	8.61	7.64
	Foreign Firms	6.09	7.08	6.76	7.8	11.54	9.48	7.92	7.57	8.85	7.64	8.08	5.53
Electronics	All Firms	2.23	4.05	2.66	3.41	2.78	3.9	3.7	3.93	6.41	5.76	5.67	5.57
	Local Firms	2.02	4.18	2.57	3.61	2.75	3.95	3.62	3.58	5.42	4.39	4.57	4.23
	Foreign Firms	3.05	3.34	3.14	2.56	2.89	3.67	3.97	5.36	9.75	9.95	9.85	13.42
Transport Equipment	All Firms	2.6	3.33	3.55	5.51	5.95	6.32	6.53	6.16	5.74	5.85	5.88	4.33
	Local Firms	1.7	2.37	2.26	2.64	3.6	3.71	4.2	4.46	4.24	4.24	4.96	3.69
	Foreign Firms	3.93	4.47	4.84	8.35	8.5	9.03	8.61	7.43	6.79	7.08	6.62	4.83
Paper	All Firms	0.83	1.42	1.17	1.64	2.68	2.51	3.52	4.6	4.52	3.49	3.19	4.24
	Local Firms	0.72	1.36	1.1	1.54	2.55	2.39	3.4	4.45	4.41	3.35	2.77	3.91
	Foreign Firms	10.4	4.44	4.3	6.15	7.78	8.04	8.84	10.57	8.08	7.1	9.16	23.1

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Table A.III.2. India: Industry-wise export intensity, 1989-2000 (concluded)
(Percentage)

Industry	Firm Type	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Wood Products	All Firms	0.3	2.11	1.73	1.68	1.71	10.52	8.5	5.46	6.71	7.16	5.78	6.03
	Local Firms	0.3	2.11	1.73	1.68	1.71	10.52	8.5	5.46	6.71	7.16	5.78	6.03
	Foreign Firms												

Source: Kumar and Pradhan (2002).

Notes: Blanks : not available. Zero: no firms in the sample.

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CHAPTER IV

MALAYSIA

A. Introduction

Malaysia has made the transition from being an essentially primary commodity producing economy over the last three decades to one in which manufacturing contributes more than 30 per cent of annual GDP and the overwhelming majority of exports.⁸⁰ This transformation has been facilitated by an export-led investment strategy, in which FDI from more developed nations has played a key role.

To accelerate its economic transition, Malaysia has launched various policies and programmes with varying degrees of success. This chapter examines the use and impact of performance requirements in this process. Requirements linked to exports, employment, training, joint ventures, domestic equity levels and, finally, R&D are assessed. It should be noted that most of the requirements Malaysia has applied have been "voluntary" in nature in that they have been used as conditions for the receipt by the investor of an incentive or other advantage.

The chapter is structured as follows. The next section provides a brief introduction to how Malaysia's policies related to FDI have evolved during the past three decades. This is followed in sections C to H by descriptions of the various performance requirements and assessments of their impact in terms of meeting relevant development objectives. In the final section, some general lessons are drawn based on these preceding descriptions and assessments.

⁸⁰ This chapter is based on a background paper prepared for UNCTAD by Lim and Ong (2002).

B. Evolving policy framework

In order fully to understand the use and impact of performance requirements in the Malaysian context, it is important to place the analysis in the broader context of the country's evolving approach to economic development. Malaysia's policies have comprised a complex mix of restrictions, requirements and incentives.⁸¹

After independence in 1957, Malaysia passed through a stage in which the focus was on import-substitution. The Pioneer Industries Ordinance, introduced in 1958, provided incentives and tariff protection for the development of manufacturing industries, depending on the level of investment (Sivalingam, 1994). By the late 1960s, the need to shelter protected industries was overtaken by a need to expand exports. Towards this end, the Federal Industrial Development Authority was established in 1967 to promote inward investment.⁸² This was followed by the passing of the Investment Incentive Act in 1968 to encourage labour-intensive, export-oriented industrialization and employment generation. Several other related policies and programmes were also introduced, notably the Free Trade Zone Act (1971) for the attraction of export-oriented TNCs. This Act led to the establishment of 10 zones offering subsidized infrastructure, expedited customs formalities and freedom of import duties and export taxes. The 1975 Licensed Manufacturing Warehouse programme extended similar treatment to individual factories set up outside the free trade zones.

Industrial policies have also been used for reasons of redistribution. For example, to remedy inter-ethnic imbalances. In the second prong of the New Economic Policy, employment and domestic equity requirements were introduced as conditions for the

⁸¹ See annex A to this chapter for a chronology of key events, policies and regulations affecting industrialization in Malaysia.

⁸² This Authority was subsequently renamed the Malaysian Industrial Development Authority (MIDA).

receipt of incentives under the Investment Incentive Act as well as for the granting of the manufacturing licence as required under the Industrial Co-ordination Act introduced in 1975. This Act made the issuance of licences for industrial activity conditional upon compliance with the New Economic Policy guidelines stipulating 30 per cent Malay share of corporate ownership.⁸³

In the 1980s, a period of heavy industrialization was pursued to further economic diversification, increase local linkages, promote Bumiputera small and medium-sized enterprises (SMEs) and to upgrade the country's technological capacity.⁸⁴ The heavy industrialization programme took the form of new joint venture projects between state-owned enterprises and foreign (mostly Japanese and Korean) partners in automotives, motorcycle assembly, steel, cement, fertiliser, petrochemical and other industries (Felker and Jomo, 2002).

The economic downturn of the mid-1980s seriously affected Malaysia's development plans and led the Government to encourage more public-private cooperation. Various incentives for private sector participation were introduced to support other policy efforts in a more liberal direction. FDI was given more attention and new ventures were granted more generous treatment and flexibility with regard to foreign equity participation, especially in export-oriented industries. In 1985, the Industrial Master Plan identified three policy instruments for increasing technology capability: research manpower, institutional arrangements (such as industrial parks), and R&D incentives. Twelve priority sector development plans were announced as part of a comprehensive strategy.⁸⁵

⁸³ See annex B to this chapter for a specimen manufacturing licence.

⁸⁴ Bumiputera, meaning "sons of the soil", refers to indigenous Malaysians, as distinct from ethnic Chinese and Indian populations who have settled in Malaysia.

⁸⁵ Resource-based industries: rubber products, palm oil products, food processing, wood-based, chemical & petrochemical products, non-ferrous metal products, non-metallic mineral products; Non-resource-based industries: electrical and electronics, transport equipment, machinery & engineering products, iron & steel, and textiles/apparel.

Despite slow economic growth during the early years of the Master Plan period, most of the defined targets were achieved (MITI, 1986-1995). To give a further fillip to the Industrial Master Plan, the Promotion of Investment Act of 1986 was enacted to develop priority industries identified in the Plan. Under this Act, the Labour Utilisation Relief incentive was abolished and pioneer status incentives were delinked from capital investment criteria. In addition, tax incentives introduced for training, R&D and reinvestment complemented the Promotion of Investment Act. Other instruments to promote industrial development included exemption of import duty on raw materials, tariff protection for certain industries and financial and credit assistance.

The Second Industrial Master Plan, 1996-2005 extended the Plan's approach beyond export manufacturing operations towards more locally-integrated clusters. Emphasis was shifted to encourage supporting industries, including the services sector. This Second Plan also focused on integration of manufacturing operations along the value chain through investments in R&D and design capability, development of integrated supporting industries, packaging, distribution and marketing activities.

In 1991, a broad reform of Malaysia's investment policy regime was carried out by phasing out tax incentives for exports and reducing the scope of the pioneer status. However, full tax exemptions were granted to investments in specific higher-technology and strategic sectors. Incentives were increasingly tied to technological deepening, exports and domestic sourcing of inputs. Applications for pioneer status were to be more rigorously screened using four broad criteria: value added of 30-50 per cent, local content levels of 20-50 per cent, depth of technology and linkage effects (Felker and Jomo, 2002).

However, the East Asian financial crisis in 1997/98 spurred Malaysia to further liberalization. Restrictions on foreign equity in most new manufacturing investments were lifted regardless of export

orientation (National Economic Recovery Plan, 1998). Exemptions from import duties were granted to imports of machinery and equipment locally unavailable, as well as to all inputs used in export production while a "hands off" attitude towards existing foreign investors' compliance with the terms of their investment licences was explicitly declared (Felker and Jomo, 2002). Finally, to conform with the WTO TRIMs Agreement the local content requirement was removed in 2000.⁸⁶

The performance requirements (voluntary and mandatory) applied in Malaysia include export requirements, equity requirements, local content requirements, employment requirements, locational requirements, and R&D requirements. While most of these performance requirements were linked to incentives, some were also attached to the manufacturing licence itself. The following sections evaluate the impact of selected requirements on FDI flows to Malaysia.

C. Export performance requirements

1. Description and objectives

For more than three decades, export growth has been an integral part of the development strategy of Malaysia. Since the early 1970s, a combination of favourable tax incentives, special zones and various export requirements have been used to induce TNCs to use the country as an export platform. Although the types of export-oriented industries that qualified for incentives changed over the years (for example, from labour-intensive to high technology), the main goal has been the same: to industrialize via exports.

⁸⁶ The local materials content policy for the Malaysian automotive industry was given an extension by the WTO, subject to being phased out by 1 January 2004.

Export performance requirements were first introduced in 1968 under the Investment Incentives Act with tax exemptions given to export-oriented industrial investments. Export oriented manufacturing was given a further boost under the Second Malaysia Plan, 1971–75, with more generous and effective incentive schemes. In the early days the key incentive for labour-intensive and export-oriented investments was the establishment of free trade zones and, later, the granting of licensed manufacturing warehouse status. In the 1970s, ten free zones were established to attract FDI seeking to assemble and export electronics products as well as textiles. These initiatives also provided subsidized infrastructure and duty-free imports of raw materials, intermediate products as well as equipment for the purpose of manufacturing and exports of products.

With the Promotion of Investment Act, new incentives contingent upon export performance were introduced. In particular, the pioneer status tax holiday replaced the Investment Incentives Act and offered a five-year tax holiday, with an extension of five more years for selected productive activities, including export-oriented FDI. The link to export performance was abolished in the 1990s, partly in response to WTO obligations (UNCTAD, 2002, pp. 206-207).

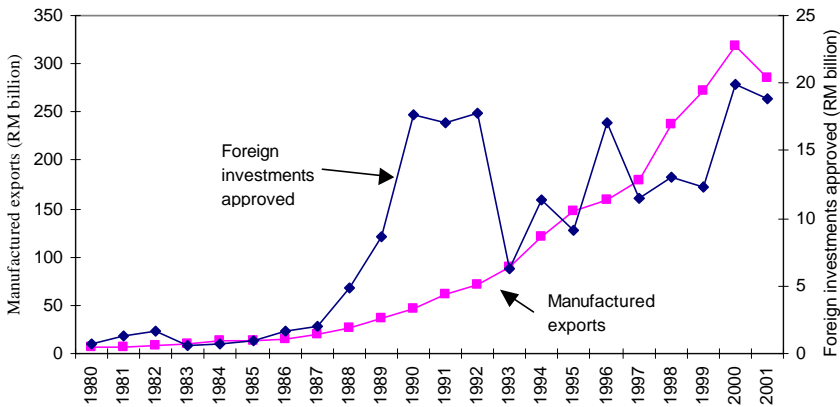
Export requirements were also linked to equity requirements. For instance, with some exceptions, investments that produced more than 80 per cent of products for export were allowed 100 per cent foreign ownership. This export requirement prevailed until 1998 (see section F).

2. *Impact assessment*

These policies appear to have contributed to a dramatic structural change in Malaysian exports, with the share of manufactures in total merchandise exports rising rapidly from 12 per cent in 1970 to 85 per cent in 2001. However, manufactured exports only displayed their rapid expansion after the mid-1980s. Furthermore, the exports of manufactures were heavily biased

towards the electrical and electronics industry, which started to dominate manufactured exports during the 1980s (see table IV.1). In 2001, that industry accounted for more than 70 per cent of manufactured exports. The increased exports, however, had a more limited positive impact on Malaysia's trade balance, as imports of capital and intermediate goods also expanded fast. It was only after 1997 that the trade balance improved significantly.

Figure IV.1. Malaysia: Manufactured exports and foreign investment approvals, 1980 – 2001



Source: Malaysia Industrial Development Authority (MIDA) and Bank Negara Malaysia.

The expansion of manufactured exports was closely correlated with a rapid increase in the volume of FDI approved (figure IV.1). Of the FDI flows into Malaysia, the electronics industry accounted for a major part. As a result, Malaysia's share of world electronic components exports increased from almost nothing in 1970 to about 10 per cent in 2000. Meanwhile, export-oriented FDI was also received in textiles and apparel, wood and wood products, chemical and chemical product and rubber products.

The creation of free trade zones and incentives contingent on exportation was important in this process but not the only determining factors. Foreign firms were also attracted by the availability of low-wage labour, reasonable infrastructure facilities and political stability. The export requirements and related incentives exerted their greatest influence on FDI in the electronics and textiles industries, which are not based on the presence of natural resources and are therefore more mobile. Over time, export manufacturing has moved beyond the free trade zones partly in response to incentives granted to encourage industrial dispersion.

At the same time, it is difficult to assess how important the export requirements were in encouraging inward FDI. Exports may well have increased even without such requirements since most of the FDI came mainly to take advantage of lower costs precisely for exports to markets in the United States, Japan and Europe. For such investments, Malaysia was an attractive and profitable production site. Even recent export-oriented foreign investors like the Dell computer company, which came to Malaysia in the mid-1990s, testify that they picked this country as its Asia-Pacific centre “because of proven infrastructure, proven management talent, supplier base and pioneer status incentives” (interview). Although they were obliged to export 90 per cent of their output to retain full ownership (see section F) that was never an obstacle, mainly because production at the outset was intended for regional and global markets, rather than for Malaysia.

D. Employment requirements

1. Description and objective

A key development objective of attracting FDI to Malaysia has been to create new employment. In 1970, the unemployment rate stood at 7.5 per cent and the labour force was growing at an annual rate of more than 3 per cent. Agriculture accounted for a half of total employment at that time while the greatest scope for expansion was perceived to lie in the industrial sector. Meanwhile, Malaysia was

rapidly urbanizing and there was a need to create employment in urban areas. Another development objective was to increase the employment of Malaysians, especially Bumiputeras. The manufacturing sector was expected to contribute in this regard too. In 1970, the share of Bumiputeras in manufacturing employment was only 29 per cent. In the second prong of the New Economic Policy, a target was set to increase this ratio to 50 per cent by 1990.⁸⁷

A shift towards the promotion of labour-intensive industries was initiated in the late 1960s and continued up to the early 1990s. Employment requirements were introduced in 1972 with the introduction of the Labour Utilisation Relief incentive. It provided increasingly generous tax exemptions for pioneer status industries the greater the number of full-time employees.⁸⁸

Under the Industrial Co-ordination Act, the manufacturing licence had ethnic composition requirements attached at all levels of employment to encourage firms as far as possible to recruit more Bumiputera workers at all levels.

The employment requirements continued into the 1990s. They were still applied as a condition for extension of (but not for new) pioneer status beyond the ordinary 5 years for companies performing certain promoted activities that had invested more than RM 25 million in fixed assets and employed 500 or more full-time Malaysian workers. In addition, companies that complied with the policy on employment after 1 January 1986 qualified for a tax abatement of 5 per cent of their adjusted income for five consecutive years. These requirements were subsequently removed in the mid-1990s as Malaysia started to face labour shortages arising from the massive increase in foreign as well as local investment.

⁸⁷ According to various Malaysia Plans, Bumiputeras accounted for 53% of the total population in 1970, 59% in 1980 and 62% in 1990.

⁸⁸ Firms with 51 to 100 employees were eligible for 2 years of income tax exemption; those with 101 to 200 employees were eligible for 3 years; those with 201 to 350 for 4 years, while those with 351 employees or more, could enjoy up to 5 years of income tax relief.

Manufacturing projects having a capital investment per employee of less than RM 55,000 were categorized as labour-intensive and would no longer qualify for manufacturing licences or tax incentives unless they met certain specified criteria.⁸⁹ Consequently, the Government also relaxed the restrictions on firms to hire foreign workers. Pre-existing conditions, however, continued to prevail.

2. *Impact assessment*

Manufacturing employment grew dramatically from 318,000 in 1970 to 2,126,000 in 2000, corresponding to a doubling of its share to 23 per cent of total employment. This contributed to a reduction of unemployment to below 4 per cent.⁹⁰ Since the economic downturn that began in 2000, however, a number of TNCs in electronics have decided to relocate some activities from Malaysia (notably to China), with a resulting increase in unemployment.

How important and effective have the employment requirements been in this process? Data on investments approved by the Malaysian Industrial Development Authority (MIDA) show that of the 7,385 approvals granted between 1972 and 1986, only 90 (just over 1 per cent) received the Labour Utilisation Relief incentive. Furthermore, these 90 projects generated a mere 16,749 job opportunities, as compared with the more than 730,000 jobs created from projects approved during the same period. This, however, does not necessarily mean that the Labour Utilisation Relief incentive was ineffective. Rather, since projects can only enjoy either the pioneer status or the Labour Utilisation Relief incentives, most projects were aimed at acquiring the more attractive pioneer status.⁹¹

⁸⁹ These criteria were: value added of more than 30%; 15% of the workforce in managerial, technical and supervisory positions; location in promoted areas; or projects undertaking promoted activities or manufacturing high-technology products (UNCTAD, 2002, p. 206).

⁹⁰ According to information from MIDA The unemployment rate was 3.6% in 2001 and is estimated to be 3.5% for 2002.

⁹¹ For a brief description of the pioneer status incentive, see annex C to this chapter.

Progress towards achieving the ethnic composition requirement was most noticeable during the 1970s, during which Bumiputera employment in manufacturing increased from 29 per cent to 41 per cent. By the mid-1990s, the goal of 50 per cent had been reached (see table IV. 2).

Table IV.2. Malaysia: Ethnic composition of manufacturing sector employment 1970–2000
(Percentage)

	1970	1980	1985	1990	1995	2000
Bumiputera (Malay)	29	41	46	46	50	49
Non-Bumiputera	71	59	54	54	50	51

Source: Government of Malaysia Plans, various years.

While it was relatively easy for firms to comply with requirements to increase overall Bumiputera participation, ensuring that Bumiputera were adequately represented at various levels of employment has been more challenging. Still, interviews with both foreign and local firms have shown that conscientious efforts were taken by many companies also to recruit Bumiputera employees, at the higher levels, but often with limited impact. In the absence of detailed national statistics, employment data for industries located in Penang can serve as an illustration. In Penang, Bumiputera employment is mainly concentrated in the lower hierarchies (table IV.3). Although significant improvements were registered in the supervisory category, Bumiputera representation at the managerial level remains low.

While the employment requirements may have incurred some cost concerns, interviews and other evidence do not indicate that they have deterred FDI in Malaysia. Firms need workers, and since the Bumiputera ethnic ratio is higher, it stands to reason that anyway they would generally hire more Bumiputera workers. The entry of Bumiputeras into the manufacturing labour force also helped to keep wages down during the expansion phase.

Table IV.3. Malaysia: Ethnic composition of the industrial workforce in Penang, by type of employment, 1988-1998
(Percentage)

		Non-			Total
		Bumiputera	Bumiputera	Foreigner ^a	
Total	1988	47.5	52.1	0.3	100
	1993	59.2	37.7	3.1	100
	1998	55.5	33.7	10.8	100
Managerial	1988	12.2	81.7	6.1	100
	1993	14.3	77.0	8.7	100
	1998	14.4	78.7	6.9	100
Supervisory	1988	26.0	73.4	0.6	100
	1993	36.2	63.4	0.4	100
	1998	43.3	56.0	0.6	100
Clerical	1988	22.8	77.1	-	100
	1993	31.7	68.2	0.1	100
	1998	39.2	60.3	0.6	100
General	1988	55.7	44.3	-	100
Workers	1993	64.0	33.4	2.6	100
	1998	46.2	27.7	26.1	100
	Production:	1988	49.1	50.9	0.1
Skilled	1993	65.5	30.3	4.3	100
	1998	66.3	22.9	10.9	100
	Production:	1988	61.3	38.7	-
Unskilled	1993	72.3	25.1	2.5	100
	1998	60.6	21.6	17.9	100

Source: Penang Development Corporation database.

^a Includes expatriate and foreign workers.

E. Training requirements

1. Description and objectives

To encourage the participation of the private sector in the skills upgrading of the workforce, Malaysia has imposed training requirements on firms stating that programmes should be drawn up for enabling employees to acquire the necessary skills and expertise to eventually replace expatriates. Such conditions have usually been attached to the manufacturing licences or the pioneer status certificates.

Training requirements were not very explicit until 1984/85, when additional incentives were introduced for “training and manpower”. Even so, these only amounted to tax exemptions related to buildings used for training (an initial allowance of 10 per cent and subsequent annual allowances of 2 per cent). In 1991, double deductions for training expenses were given for approved manpower training in the manufacturing sector. The purpose of this scheme was to encourage companies to participate in approved programmes designed to develop and upgrade skills need to raise productivity.

In 1993, the Government introduced the Human Resources Development Fund, an economy-wide payroll levy and training subsidy scheme. The purpose of this Fund was to encourage direct private-sector participation in skills development programmes. Manufacturing firms employing 50 or more Malaysian workers were required to contribute the equivalent of one per cent of their monthly wage bill to the Fund.⁹² In return, companies could then apply for reimbursement of between 75 and 95 per cent of allowable cost incurred for training in Malaysia and up to 50 per cent of the cost for training abroad, related to the amount they have contributed to the Fund (MIDA, 2001).⁹³ In 1995, another 100 per cent investment tax

⁹² In 1995, the Human Resources Development Fund was extended to companies with a minimum of RM2.5 million paid-up capital and more than 10 employees.

⁹³ A similar approach was later also implemented in South Africa, see chapter 5.

allowance for 10 years was introduced for training expenses. Double deductions were also automatically given if training was received from approved institutions. By the year 2000, additional incentives were developed, such as special capital allowances for computers and single deductions for pre-operation training expenses.⁹⁴

2. *Impact assessment*

The training requirements were imposed to enhance the skills and other productive capabilities of the Malaysian workforce in order to facilitate transfers of technology as well as to enable an upgrading of the Malaysian economy. In practice, however, their impact appears to have been relatively limited. Despite the double deduction incentive aimed at encouraging training, overall private sector participation in training was still inadequate to meet the demand for skilled labour (Sixth Malaysia Plan). Feedback from firms suggests that this incentive was not as well conceived, nor as effectively implemented, as other investment incentives. The reasons cited for the lack of enthusiasm include rigid procedures, excessive red tape and unnecessarily burdensome queries by the Government agencies involved. The double deduction incentive's "spend first and claim later" approach was also viewed as risky since the expenditure incurred could later be deemed non-deductible for tax purposes. In addition, it should be noted that the incentive was no inducement to firms awarded pioneer status since in any case they would not pay income tax (DCT, 1999).

In comparison, the Fund has brought better results. By 2000, approved financial assistance had risen to almost RM 114 million and the number of trainees numbered more than 300,000 (HRDC Annual Report 2000: Table X). Training in quality and productivity-related skills accounted for more than a quarter of the training places, facilitating progress into higher quality and higher value-added products. However, use of the Fund had significantly increased

⁹⁴ Special capital allowance: computer and IT assets, initial allowance of 20% and annual allowance of 40%.

training by medium-scale and large firms but not by small firms. Among purely domestic firms, the Fund had only been effective in increasing the training of firms with more than 250 employees (Felker and Jomo, 2002). The Human Resources Development Fund has contributed to continuous human resource development improvements mainly because, as the costs of training can be reimbursed, workers are trained by approved training centres/institutes.

F. Joint venture and domestic equity requirements

1. Description and objectives

Domestic equity requirements were introduced under the Industrial Co-ordination Act in 1975. With this, manufacturing companies with shareholder funds of more than RM 250,000 or employing at least 25 full-time staff, had to obtain a manufacturing licence. In this context, equity conditions could be imposed, for example, to encourage Bumiputera ownership. As stated in the Mid-term Reviews of the Second Malaysia Plan:

the “Malay share of total paid-up capital in pioneer companies was only 6% [...] To ensure that significant progress is made [...] the Government has now stipulated that at least 30% of the equity of all approved companies, except those that are export oriented will be reserved for Malays and other indigenous people.”

The manufacturing licences carried the following condition:

“At least 30% of the shares of the company shall be subscribed and held by Malaysian citizens and to be reserved and the company shall consult the Ministry of Trade and Industry before the allotment of its reserved shares.”

The equity requirements have changed over time. In the 1970s and 1980s, foreign equity participation in manufacturing projects was linked to export performance, as depicted in table IV.4.

In mining and other extractive industries, the percentage of foreign ownership allowed depended on the level of investment, technology and risks involved, the availability of Malaysian expertise, the degree of integration and the level of value added.

Table IV.4. Malaysia: Equity requirements linked to export performance

Export performance	Equity requirements
Export more than 80% (except for mining and extraction industries)	No restrictions
Export between 51% to 79%	Up to 79% foreign ownership
Export between 20% to 50%	Between 30% and 51% foreign ownership
Export less than 20%	Up to 30% foreign ownership; up to 50% foreign ownership for high-technology projects

Source: MIDA, 2001.

Although this requirement prevailed up to the end of 1991, there was a period during the late 1980s when it was relaxed in response to a slowdown of FDI inflows. The new regulation stated that 100 per cent foreign equity was allowed for all investment projects resulting in an export ratio to sales of more than 50 per cent, employing at least 350 Malaysian people and if the project did not compete with local producers. In 1989, other exceptions were allowed for manufacturing and agriculture where it was difficult to raise local equity. The exception for manufacturing and agriculture was conditional on exporting at least 20 per cent of the output. Negotiations with MITI were required if no local partner could be found, with agreement from the relevant state government of land ownership arrangements. Hotel and tourism projects also benefited from an exemption. All exceptions were limited to five years, after which foreign ownership had to be reduced to 49 per cent or less in the 6th year, with at least a 30 per cent resulting equity stake for Bumiputeras.

The equity requirement was relaxed again in connection with the East Asian financial crisis. As a result, new foreign investors can now hold 100 per cent equity, irrespective of the level of exports. This applies to applications received between 31 July 1998 and 31 December 2003,⁹⁵ and to the expansion of companies that had been licensed before 31 July 1998. It also applies to companies previously exempted from having a manufacturing licence, but that now have funds of RM 2.5 million or have engaged more than 75 full-time employees. The relaxation does not, however, apply to specific activities where Malaysian SMEs have capabilities and expertise.⁹⁶

2. *Impact assessment*

It is difficult to assess the impact of the various equity requirements on FDI in Malaysia. As most investments in the 1970s and 1980s were attracted by low production costs for export activities, most TNCs could easily fulfil the 80 per cent export requirement to avoid the domestic equity requirement. Thus, for many investors, the 30 per cent domestic equity requirement was not a deterrent. For TNCs coming later, self-selection may have occurred, as Malaysia makes its equity conditions explicit in its investment promotion.

Import-substituting FDI has had to comply with the requirements and has often experienced difficulties finding domestic (Bumiputera) investors in such instances, foreign companies have had to rely on government institutions like the state economic development corporations to take up the Bumiputera equity.⁹⁷

⁹⁵ According to MIDA, it is still not clear whether the requirements will be re-imposed in 2004.

⁹⁶ Examples of such activities are paper packaging, plastic packaging, plastic injection, moulded components, metal stamping, metal fabrication, wire harness, printing and steel service centres.

⁹⁷ Difficulties in identifying Bumiputera partners led the Government to set up the National Corporation, which can step in as "neutral" investment partners and enable investors to observe the ethnic equity requirements. There are also a number of Bumiputera investment trust companies that can take up Bumiputera equity. These were not established solely because of difficulties in identifying Bumiputera partners, however.

According to an international textile group that entered Malaysia during the mid-1970s, for example, the Ministry of International Trade and Industry provided information on potential domestic investors among organizations and firms. However, despite protracted negotiations, there were very few interested Bumiputera investors. The main reason for this lack of interest was the availability of other, more attractive investment opportunities, promising faster and greater returns. Many of the foreign investment projects were relatively capital intensive, with uncertain returns (interview).

Domestic investors were less enamoured with the Bumiputera equity requirement. In 1977, the Associated Chinese Chamber of Commerce and Industry in Malaysia openly denounced the Industrial Co-ordination Act and called on the Government for its repeal. Furthermore, declining investments in the manufacturing sector, and increased capital flight in the late 1970s and early 1980s have been linked to private sector concerns with the Industrial Co-ordination Act (World Bank, 1999).

Notwithstanding the obstacles and challenges encountered, in 1997, Malaysian equity in companies in production was estimated at 54 per cent, with Bumiputera equity at an estimated 23 per cent.⁹⁸

G. R&D requirements

1. Description and objectives

Performance requirements related to R&D have been applied in Malaysia only as a condition for the receipt of certain incentives. Anxious to upgrade the technological capabilities of domestic firms and to remove obstacles faced in acquiring technology, it introduced various targeted tax incentives and matching grants to attract and encourage investment by new and existing firms in R&D infrastructure and projects. In addition, several schemes were

⁹⁸ Data from MIDA. The figures refer to manufacturing only and exclude public corporations.

introduced to encourage local firms, especially SMIs, to acquire and upgrade technology. The Government has not applied any policies and incentive schemes directly tied to technology transfer requirements.⁹⁹ Rather the approach has been to encourage such transfers indirectly through incentives for investments.

The push for R&D was not very explicit before the mid-1980s, when “additional incentives” were provided for “R&D”. Initially, the amount was a one and one-third deduction of expenditures, and tax exemption for R&D buildings. The precursor to this was the provision of increased capital allowances for those without pioneer status benefits, in the form of building and plant expenditure for modernizing production techniques or setting up a modernized factory. These incentives were periodically revised and improved, and by the 1990s, expenditures on R&D were eligible for double deduction.

The Promotion of Investments Act 1986 defined R&D as follows:

"Research and development means any systematic or intensive study carried out in the field of science or technology with the object of using the results of the study for the production or improvement of materials, devices, products, produce or processes but does not include:

- quality control of products or routine testing of materials, devices, products or produce;
- research in the social sciences or humanities;
- routine data collection;
- efficiency surveys or management studies;
- market research or sales promotion."

⁹⁹ Some technical agreements signed with foreign companies have been vetted by MITI to ensure that the local party is not subjected to unfair treatment by the foreign technology supplier. After a recent Government decision, however, companies are no longer required to obtain prior approval of MITI to enter into technical agreements (Communication from MIDA).

Other incentives for R&D include tax exemption of five years for R&D institutions; plant and machinery eligible for a capital allowance; a building allowance; accumulated losses to be carried forward; double deduction for contributors to R&D institutions; double deduction for other companies procuring such R&D services; and tax exemption for five years to new technology-based firms. Further developments, including granting pioneer status, were also allowed for R&D activities. Alternatively, qualifying projects can enjoy investment tax allowances of 100 per cent for 10 years, or be set off (up to 70 per cent) against statutory incomes in the year of assessment.

The criteria applied for R&D incentives include the following (MITI, 1999):

- research undertaken should accord with the needs of the country and benefit its economy;
- at least 70 per cent of the company's income should be derived from R&D activities;
- for manufacturing-based R&D, at least 50 per cent of the company's workforce must be appropriately qualified personnel performing research and technical functions; and
- for agriculture-based R&D, at least 5 per cent of the company's workforce must be appropriately qualified personnel performing research and technical functions.

Another well-known special initiative by the Government to attract some high technology industries is the Multimedia Super Corridor that was established in 1996 and approved a very generous and attractive investment package.¹⁰⁰ Firms that meet certain

¹⁰⁰ The Multimedia Super Corridor is a dedicated and determined IT initiative to support Malaysia's development thrust. Under this initiative, a 15 km x 50 km area stretching from Kuala Lumpur to Sepang, was identified for the development of an enabling working and living environment for progress towards a knowledge-based economy.

specified requirements for attaining appropriate status under this initiative enjoy various privileges and incentives under the Bill of Guarantee, including freedom of ownership and unrestricted employment of foreign knowledge workers. In addition, they also enjoyed tax exemption incentives for up to 10 years or a 100 per cent investment tax allowance for five years.

To be eligible for these privileges, a firm should:

- be a provider or a heavy user of multimedia products and services;
- employ a substantial number of knowledge workers;
- provide technology transfer and/or contribute to the development of the MSC or support Malaysia's knowledge-economy initiatives;
- establish a separate legal entity for Multimedia Super-Corridor qualifying multimedia business and activities;
- locate in a Corridor-designated cybercity; and
- comply with the environmental guidelines.

2. *Impact assessment*

Although the R&D requirements have not been mandatory in nature, but rather a positive inducement to stimulate further investments in R&D, the response from the private sector has not been encouraging. The use of the R&D incentives on offer has been relatively low (Tan, 1999). In 2001, 582 applications approved for double deduction for R&D were valued at only RM 57 million (MITI, 2002). The 1998 National Survey of Research and Development reported that only 43 foreign-owned and 30 foreign controlled companies were engaged in R&D that year, accounting for not more than RM 309 million, or 38 per cent of total private R&D expenditure (MASTIC, 1998).

The predominant complaint from the private sector has been that the conditions for approval are too rigid and too vague. Companies are hesitant to apply for R&D incentives because they are

not confident of being successful in carrying through their research projects. Furthermore, companies are often reluctant to reveal confidential R&D information. Other constraining factors that have been cited include inadequate infrastructure and a lack of skilled R&D personnel (DCT, 1999).¹⁰¹

Meanwhile, some TNCs that came to Malaysia in the 1970s started to invest in local R&D well before Malaysia introduced R&D incentives (Best, 1999; Ngoh, 1994). For example, Motorola Penang's R&D centre was established as early as 1976. The R&D Centre, which started with four engineers, has nearly 120 employees today. Motorola Penang enjoys design leadership in Asia for the CT2 cordless telephone and the Centre is responsible for new product design, product-process interfacing and advanced manufacturing processing (Best, 1999). During the past 28 years, Motorola Penang has enjoyed double deduction for R&D in addition to enjoying 5 to 10 years of pioneer status for three different projects.¹⁰² Similarly, Intel Penang, started to carry out R&D activities to support its manufacturing operations as a precursor for establishing its design centre in 1992.¹⁰³

¹⁰¹ Evidence from the 1997 World Bank Inter-Firm Linkages and Technology Development (ILTD) Survey found that only 11 per cent of the firms surveyed were engaged in R&D. Familiarity with and use of R&D incentives and programmes was particularly low among locally-owned firms. Again, the main impediment cited was "lack of skilled personnel".

¹⁰² The three projects are related to high-tech and national strategic industries and reinvestment allowance for expansion and modernization (author interviews).

¹⁰³ The design activities of the centre progressed through three stages (Best, 1999, p. 13): "First, they engaged in the design and redesign of mature products, for example the Intel 286 microprocessor, to improve optimization, yield rates, and robustness. At the same time, they developed the capability to design chips which led, in 1992-4 to the second stage: product proliferation. During this period the first patent was awarded. Stage three has involved the Penang design centre in original design for commodity or embedded applications and for PC central processing units (CPU) and chip sets. A second patent was awarded for intellectual property from their work in a new 8 bit CPU for embedded microprocessor applications, four other patents are pending."

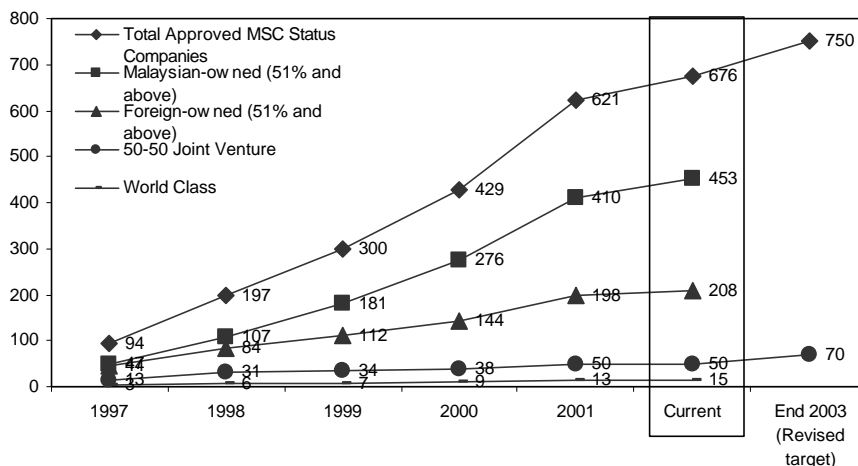
Some R&D incentives may have been offered “in vain”. Discussions with foreign industrialists for this study confirmed that while incentives contributed towards the “bottom line”, they were only one aspect among many affecting the decisions to undertake R&D activities. The availability of R&D skills was probably more important.¹⁰⁴ Neither have local firms that have ventured into R&D been entirely dependent on incentives. For example, BCM, a Bumiputera firm that makes telecommunication equipment, did not receive any incentives as they “fell in the ‘twilight zone’” (interviews). Nevertheless, BCM conducts R&D activities to keep abreast of developments and to stay competitive. On the other hand, other firms, like VMS, have been successful in getting R&D grants, and while “this was an invaluable boost to the company” (*The Edge*, 8-14 July 2002), it claims that it would have proceeded with its R&D investment even without the grants.

The more recent Multimedia Super Corridor initiatives to attract technology investors appear to have been relatively successful. According to the Multimedia Development Corporation, as of 15 July 2002,¹⁰⁵ 676 Multimedia Super Corridor status companies had been approved, of which more than 200 were foreign-owned and some 50 companies considered “world-class” (figure IV.2.). The two largest activities among Multimedia Super Corridor companies were focused on related software development (figure IV.3).

¹⁰⁴ Somewhat ironically, the economic slowdown of the 1980s enabled Motorola Penang successfully to expand its R&D center as it could “keep” its design engineers who might otherwise have been “poached” by other firms during a boom.

¹⁰⁵ The Multimedia Development Corporation was established in 1996 to act as a one-stop agency to promote and spearhead the initiative.

Figure IV.2. Approved multimedia super corridor status companies
(Number of companies)



Source: <http://www.mcd.com.my/> on July 15, 2002.

Despite the relatively low uptake of R&D incentives, inward FDI in Malaysia has resulted in important technology transfers. This has been most visible in the electronics cluster in Penang, in which leading local supporting industries have managed to absorb and adapt to the high quality practices and standards applied by TNCs and the rapid technical innovation in the global electronics industry (for example, Rasiah, 1995; 1999). As a result, the most successful local supporting industries today fully comply with international standards and produce components, machinery and equipment for TNCs, not only in Malaysia but also elsewhere.¹⁰⁶ Other studies report encouraging signs of technology taking root and of diffusion of expertise, more so in the Penang region than in the Klang Valley.¹⁰⁷ (Lai et al., 1994; Narayanan et al., 1997).¹⁰⁸

¹⁰⁶ See UNCTAD, 2001, pp. 129-30, for the example of ENGTEK.

¹⁰⁷ In Penang, TNCs and supporting firms were established earlier and the local personnel have accumulated the necessary technical skill to absorb new technology (Narayanan et al., 1997). Penang also has a larger concentration of electronic TNCs and the exposure to intense international competition has put more pressure on them to upgrade their operations. Finally, the geographical proximity of the electronic

Malaysians working in foreign affiliates have been sent for internships at the parent company, and TNCs have located expatriate engineers in Malaysia, thereby providing training to Malaysian workers. Another important form of technology transfer has been the installation of new generation equipment and machinery and the introduction of state-of-the-art technology in the activities of foreign affiliates as well as their local vendors. In many instances, training provided in this context is not solely for the TNCs' own workers, but also for local suppliers. Supplier linkages and development efforts play an important role in this regard (UNCTAD, 2001).

Interviews conducted for this study uncovered some instances when significant R&D had been conducted by foreign investors. Indeed, in some regards it was generally believed that electronics manufacturing capability in Malaysia has at times been ahead even of that in the United States. The strongest element in Malaysia's R&D activities has been related to process, rather than product technology.

H. Overall assessment of impact of performance requirements

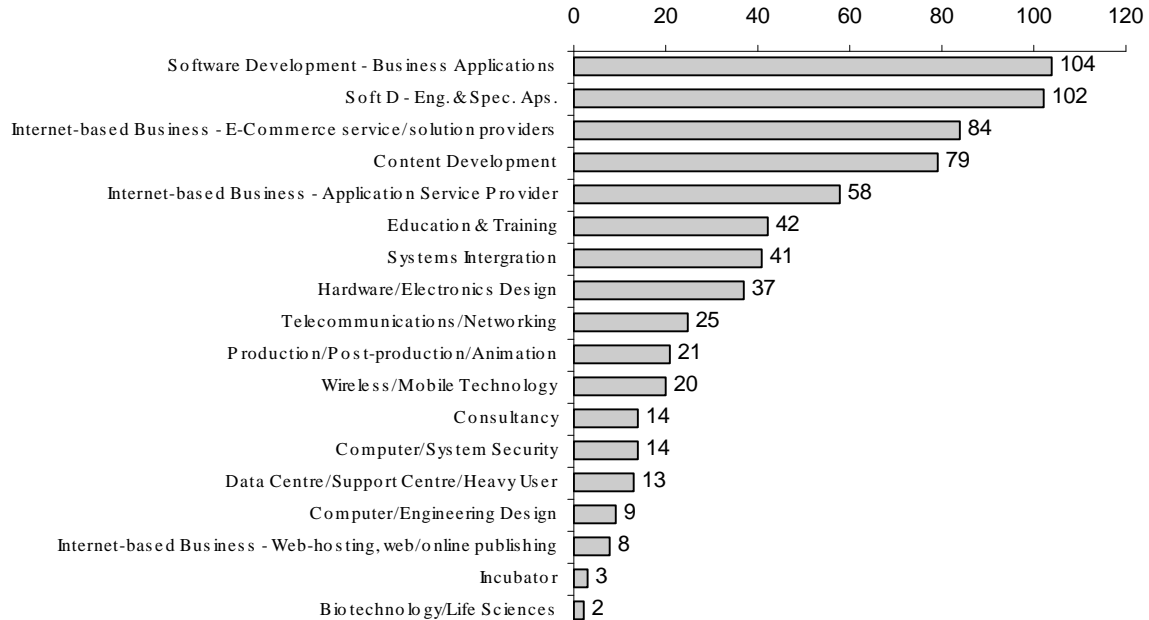
Malaysia has utilized performance requirements to fulfil various development objectives (see table IV.5) and, at least at first glance, their overall impact seems to have been positive. At the aggregate

TNCs and supporting industries in Penang may have facilitated closer interaction (Lai et al., 1994).

¹⁰⁸ In Penang, TNCs and supporting firms were established earlier and the local personnel have accumulated the necessary technical skill to absorb new technology (Narayanan et al., 1997). Penang also has a larger concentration of electronic TNCs and the exposure to intense international competition has put more pressure on them to upgrade their operations. Finally, the geographical proximity of the electronic TNCs and supporting industries in Penang may have facilitated closer interaction (Lai et al., 1994).

Figure IV.3. Multimedia super corridor status companies, by activity, 2002

(Number of companies)



Source: <http://www.mdc.com.my/> on July 15, 2002.

level, the Malaysian policy has fostered rapid economic growth based on an expansion of manufactured exports. This has been paralleled by achievements in the social area, including a reduction of poverty, a more ethnically balanced industrial labour force and distribution of income.

Table IV.5. Summary of performance requirements and their development objectives

Performance requirement	Development objectives
Export performance	Economic restructuring from primary producing to manufacturing Development of export industries Promotion preferred industries Improving the balance of trade GDP growth
Employment and training	Create jobs Increase Bumiputera participation (in line with the New Economic Policy) Increase productivity
Joint venture/domestic equity	Equity restructuring Increase Bumiputera participation (in line with the New Economic Policy)
R&D	Development of local R&D Development of IT industries
Local content	Development of local industries Development of local resources Reducing imports and improving balance of trade

Source: UNCTAD based on Lim and Ong, 2002.

It is difficult to assess how important the various types of performance requirements have been in practice. They do not appear to have generally deterred FDI inflows, even if the peaks in inward FDI seem to have coincided with a relaxation of equity requirements (figure IV.4). Studies carried out for the Second Industrial Master Plan reported that FDI in the electronics industry was concerned mainly with "bottom line" issues (such as production costs), but also

access to market, and centres of excellence. In another study of what factors had affected investors' decisions to locate in Malaysia, political stability of the environment in which profits could be made received the highest score, followed closely by the availability of labour. Infrastructure quality and exemptions from export and import duties were also considered very important (DCT, 1999). Meanwhile, incentives did not appear at the top of the list. By the mid-1990s, most Asian developing countries competing with Malaysia for export-oriented FDI offered relatively similar incentives, which may have been taken more or less for granted.

Interviews with firms indicate that they have generally been sympathetic to the overall goals of the various requirements. Moreover, few companies have perceived them as major hurdles, which is not surprising given that most of them are voluntary in nature. While the performance requirements linked to incentives were meant to help ensure that investments continue to support and enhance Malaysia's overall development objectives, investors were often routinely able to meet the stipulated criteria. For example, all major foreign investors were granted pioneer status, and most were able to renew this after the initial five-year period by claiming an upgrading of their product mix. For the first generation of FDI, the equity requirements linked to various export levels were a non-issue since they came mainly to take advantage of relatively low-wage labour for export production.

The monitoring of various requirements appears to have become increasingly relaxed over time.¹⁰⁹ During the 1970s and up to the early 1980s, when the New Economic Policy was first being implemented, Ministry officials diligently monitored and enforced policies such as the 1975 Industrial Co-ordination Act. According to

¹⁰⁹ The main responsibility lies with the Ministry of International Trade and Industry and its agencies, i.e. the Malaysian Industrial Development Authority, Malaysia External Trade Development Corporation, National Productivity Corporation, Small and Medium Industries Corporation, Malaysian Technology Development Corporation, and the Malaysian Industrial Development Finance Bhd.

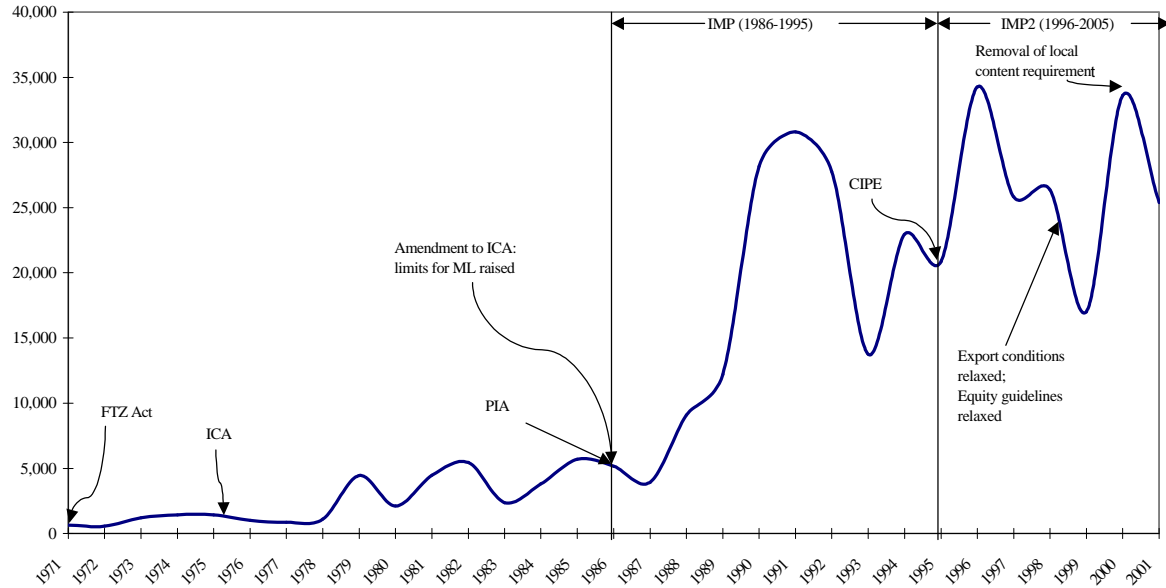
several companies interviewed for this study, regular monitoring of requirements was carried out up to the mid-1980s. In addition to annual performance reports that firms had to submit to the Ministry of International Trade and Industry, various Government agencies sent teams to carry out field checks. Since the 1990s, such monitoring has almost ceased. Checks are now carried out only to ascertain compliance when investors apply for the extension of existing incentives (for example, accompanying pioneer status) or submit new applications. The Inland Revenue Board also monitors all tax exemptions and deductions that need its approval.¹¹⁰

Moreover, incentives have seldom been taken away from companies that could not comply with the associated requirements. Rather, investors have normally been granted more time to meet the conditions. For example, a 30 per cent local content policy set in 1990 for the electronics sector was only loosely monitored and rarely, if ever, enforced after it was found that domestic value added in electronics products averaged only 7 per cent of export value (Felker and Jomo, 2002). After the 1997-1998 East Asian financial in electronics products averaged only 7 per cent of export value (Felker and Jomo, 2002). After the 1997-1998 East Asian financial crisis, the Government further “relaxed” some conditions to encourage high technology and strategic industries to come to, or to stay in, Malaysia (interviews).

Like other countries, Malaysia faces fierce competition from other potential locations. The country may have avoided strict enforcement of performance requirements for fear of affecting its attractiveness as a host country. Indeed, the mild enforcement and monitoring of various requirements have, probably contributed to Malaysia’s success in attracting FDI.

¹¹⁰ Some foreign investors that commenced operations in the 1990s reported that they still submit reports to the Ministry of International Trade and Industry every 6 to 12 months.

**Figure IV.4. Malaysia: Total foreign investment approved
(RM million)**



Source: MIDA

It has been recognized that MIDA does not have sufficient staff or expertise to monitor or enforce investor performance and compliance with incentive provisions. This has become a more important issue as the policy regime has shifted from general to more targeted promotion of high-technology industries and industrial clusters (Felker and Jomo, 2002; McKendrick et al., 2000).

The Malaysian Government has shown that it is highly responsive to the needs and opinions of the private sector. For example, it has institutionalized a mechanism involving annual consultations (or policy dialogues) between the Minister of International Trade and Industry and the private sector. At these events, the Minister invites interested parties to present their problems, concerns and suggestions. In 1991, for instance, the business community complained about discriminatory relief being available only to those manufacturing companies 70 per cent owned by Malaysians and located in the principal customs area. The decision was then reversed by the Government and the allowance given to all companies regardless of ownership and location of projects. The private sector is also involved in the annual budget dialogue organized by the Ministry of Finance on tax and expenditure issues, and other dialogues are arranged on an ad hoc basis in response to specific economic problems.

It should be noted that performance requirements were not imposed on all FDI enjoying incentives. Moreover, 24 per cent of all approved FDI projects since 1980, *did not enjoy any incentives at all* (table IV.6). Interviews with foreign affiliates confirmed that the pioneer status has been the most important financial incentive. During the past 20 years, almost half (45 per cent) of the value of all FDI was linked to pioneer status. The pioneer status incentive seems to have been biased towards large, capital-intensive investments, mainly by foreign-owned companies (UNIDO, 2000).

It is quite possible that the performance requirements in Malaysia have not made a major difference to FDI inflows. For example, even without export requirements, most FDI coming into

Malaysia would have set up export-oriented activities. The share of Bumiputeras in the manufacturing workforce may have risen, regardless of the employment requirement, as the TNCs needed to recruit more staff. While the Bumiputera ethnic share targets have been largely met at the lower levels of decision-making in companies, they remain under-represented at higher levels. Performance requirements to promote R&D have not had much visible impact. Rather, it may well be that related incentives may have subsidized activities that would have occurred anyway. Equity 'sharing' requirements have been flexibly enforced, especially during times of economic difficulty in response to declining FDI inflows. In some cases, there has been little reason for firms to apply for additional tax incentives linked, for example, to training programmes, since pioneer status has already ensured zero income taxes. However, the mandatory training requirement to contribute 1 per cent of the wage bill to the Human Resources Development Fund has been useful in that it has created a pool of resources and an incentive for firms to invest in continuous upgrading of human resources and skills. Moreover, some mandatory equity requirements attached to the manufacturing licence may have contributed to greater Bumiputera participation in the labour force.

Table IV.6. Source of approved capital investment, by incentive, 1980-2001
(RM million)

	Foreign Investment					Domestic Investment				
	Total	Pioneer Status	Without Tax Incentives	ITA	Other Incentives	Total	Pioneer Status	Without Tax Incentives	ITA	Other Incentives
1980	730	436	173	116	6	1,373	454	658	244	18
1981	1,309	389	418	336	166	3,139	473	1,351	893	422
1982	1,627	540	116	409	561	3,808	458	642	1,255	1,453
1983	629	299	184	110	36	1,729	412	789	397	131
1984	718	144	229	326	18	3,083	474	925	1,017	667
1985	959	199	209	539	12	4,728	397	1,251	3,002	78
1986	1,688	285	1,280	123	-	3,475	849	2,169	457	1

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Table IV.6. Source of approved capital investment, by incentive, 1980-2001 (concluded)
(RM millions)

	Foreign Investment					Domestic Investment				
	<i>Total</i>	Pioneer Status	Without Tax Incentives	ITA	Other Incentives	<i>Total</i>	Pioneer Status	Without Tax Incentives	ITA	Other Incentives
1987	2,060	1,603	164	293	-	1,874	919	375	579	-
1988	4,878	3,344	454	1,080	-	4,216	3,089	434	692	-
1989	8,653	4,800	903	2,950	-	3,563	1,770	843	950	-
1990	17,629	14,097	1,049	2,484	-	10,539	8,310	1,482	747	-
1991	17,055	10,645	2,884	3,527	-	13,763	6,183	5,630	1,951	-
1992	17,772	3,050	7,884	6,838	-	10,003	871	8,047	1,085	-
1993	6,287	910	1,952	3,424	-	7,466	810	4,575	2,081	-
1994	11,339	5,579	3,617	2,143	-	11,612	1,940	5,902	3,768	2
1995	9,144	3,337	2,936	2,871	-	11,726	1,931	6,164	3,631	-
1996	17,056	7,734	2,831	6,491	-	17,201	2,026	11,640	3,535	-
1997	11,473	3,159	2,105	6,209	-	14,348	3,112	5,704	5,531	-
1998	13,063	2,496	3,201	7,366	-	13,289	1,439	5,903	5,947	-
1999	12,274	5,331	2,416	4,527	-	4,747	763	2,277	1,707	-
2000	19,848	11,376	5,380	3,092	-	13,762	2,021	10,221	1,520	-
2001	18,821	8,022	5,942	4,855	1	6,572	983	3,455	2,131	2
<i>Growth Rate/year</i>	26.60%	18.90%	35.60%	43.50%		4.80%	2.20%	5.30%	8.90%	
<i>Total (1980-2001)</i>	195,013	87,775	46,329	60,108	800	166,015	39,683	80,436	43,121	2,774
	100%	45%	24%	31%	0%	100%	24%	48%	26%	2%

Source: MIDA.

I. Concluding observations

What lessons can be learned from the Malaysian experience? The main attraction of Malaysia, 30 years ago as well as today, has been its political and macroeconomic stability combined with an attractive set of policies and a conducive environment with respect to FDI. Labour costs have been held down, infrastructure and logistics are well developed and continually upgraded, and the cost of utilities and services are reasonably priced, if not low in comparison with

other countries at the same level of development. Thus, while applying a set of performance requirements, most of which have been linked to incentives, Malaysia has managed to provide an attractive investment environment.

Malaysia has attracted export-oriented FDI since the early 1970s, but the real impact of such FDI has only been significant since the mid-1980s after greater steps towards liberalization were adopted. Malaysia's small domestic market has limited the potential for import-substituting FDI and export conditions linked to equity requirements have sometimes plagued domestic market-seeking investors.

The Malaysian experience of using employment requirements illustrates the importance of ensuring that labour skills keep pace with the needs of industry. While the early investors largely demanded relatively unskilled workers – which could easily be found in the existing urban labour force – the FDI that came into Malaysia from the mid-1980s until the mid-1990s increasingly sought technical and skilled people. This required investments in human resources, and the Government responded to this by establishing skills-upgrading programmes and training institutions. The need for continuous upgrading of skills and domestic production capabilities has been further underlined by the intense competition in labour-intensive production, not least from China. It appears in this context that the incentives introduced to encourage training and R&D activities have not been sufficiently attractive to have any positive impact. Although several incentive packages were offered to encourage foreign company participation, results did not become significant before the introduction of the Human Resources Development Fund and the 1 per cent training levy. Even then, the beneficiaries appear to be mainly large firms, while small and medium-size Malaysian firms tend to be reluctant to send their workers for training unless coerced. This situation has affected the ability of many local firms to increase their productivity and could cause them to lose out to lower cost centres in the region in the longer term.

The Malaysian case shows that FDI can play an important role in the process of economic and social development, and that government policies and institution-building efforts have a prominent function in this process. As a small economy, its desire to enforce strict requirements on investors entering the country had to be balanced against the risk of negatively affecting the attractiveness of the location. This has been a delicate balancing act. In Malaysia, the Government has been more than willing to be proactive. Beyond the desire to fulfil the country's development ambitions, it has been responsive to the needs and views of the private sector.

In conclusion, although the direct efficiency of performance requirements may have been limited, the principle of linking such requirements to incentives has been important in Malaysia. In some ways, they have contributed towards the industrialization and growth of the economy and in helping to realize the social restructuring objectives considered necessary for social and political stability. The requirements that have shown the least impact appear to be those linked to R&D and training. Still, in some parts of the Malaysian economy, the inflow of FDI has resulted in transfers of technology and the establishment of innovative activity. The export-oriented industrialization involving a continuous inflow of FDI and the generation of employment has been instrumental in transforming the economic structure of Malaysia into what it is today.

Annex A to Chapter IV. Malaysia: industrialization, chronology of major events

Year	Event/Policy/Regulation	Comments
1958	Pioneer Industries Ordinance (PIO)	To promote import-substituting manufacturing sector
1965	Establishment of Federal Industrial Development Authority - FIDA (later renamed MIDA)	Launched in 1967
1968	Investment Incentives Act (IIA)	To attract more export-oriented and labour intensive industries, with tax exemptions, etc.
1971	Free Trade Zone - FTZ Act	To allow duty-free import of equipment and raw materials for export-oriented firms located in FTZs
1971	Amendments to IIA, 1968 to extend maximum tax relief to 10 years (valid until 1973)	To promote export-oriented industries (e.g. electronics), which meet local content, location (in development areas') and priority product requirements
1971	Abolition of payroll tax	To promote labour-intensive industries
1971	Labour Utilisation Relief (LUR)	Tax exemptions for employment to attract labour-intensive industries
1973	Introduction of Licensed Manufacturing Warehouse Programme	To promote export-oriented industries and dispersal of such industries outside the FTZs
1974	Locational incentives (amendments to IIA, 1968)	To encourage dispersal of industries to rural areas to achieve rural industrialization
1974	Foreign Investment Committee (FIC) Guidelines	Regulations regarding assets acquisition, mergers or takeovers; used to restructure ownership and control of the corporate sector in line with the New Economic Policy objectives

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**Annex A to Chapter IV. Malaysia: industrialization, chronology
of major events (continued)**

Year	Event/Policy/Regulation	Comments
1975	Industrial Co-ordination Act (ICA)	Manufacturing companies with shareholder funds of more than RM 0.25 million, or engaging 25 or more full-time employees, must apply for a manufacturing licence and comply with equity, employment, distribution and export requirements
1980	Tax incentives for (i) equity restructuring and (ii) employment and/or marketing restructuring	For companies not enjoying other incentives 5% reduction of company income tax Exemption from 5% development tax
1983	Malaysia Incorporated Policy Announced	To encourage civil servants to be more private sector friendly
1983	Amendment to Income Tax Act 1967	Tax incentives to companies which undertake R&D
1986	Industrial Master Plan - IMP (1986– 95)	Programme of sectoral intervention to accelerate manufacturing growth
1986	Amendments to ICA	Thresholds for Manufacturing Licence raised to RM 2.5 million shareholder funds or 75 workers
1986	Promotion of Investment Act (PIA)	Replaced IIA 1968; LUR abolished; PS delinked from capital investment; Promotion of targeted industries, local content, exports, Malaysian equity and employment
1986	Liberalization of policy on foreign equity participation	Relaxation of equity requirements for new foreign investments that do not compete against local industries

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**Annex A to Chapter IV. Malaysia: industrialization, chronology
of major events (concluded)**

Year	Event/Policy/Regulation	Comments
1988	MIDA designated as coordinating agency for manufacturing investments	To reduce bureaucratic red tape
1990	Free Zone Act 1990	Replaced FTZ Act 1971
1991	National Development Policy & National Vision Policy	1991-2000 in line with Vision 2020 emphasising growth and modernization
1991	Review of investment incentives - "Ordinary" PS exemption reduced to 70%; 100% exemption under PS tied to strategic and high technology investments	To encourage higher value-added and capital intensive industries, strengthen industrial linkages, enhance export competitiveness
1995	Capital Investment Per Employee (CIPE) ratio introduced	To discourage labour-intensive industries
1996	IMP2 (1996 – 2005)	Manufacturing clusters approach
1998	Export conditions relaxed	To enhance industrial linkages and domestic sales; valid until 31 December 2003
1998	Equity policy guidelines relaxed	To encourage new manufacturing investments after the 1997/98 crisis, investors can hold 100% equity irrespective of level of exports; applies to all applications received until 31 December 2003, with some exceptions.
2000	Removal of local content requirement under PIA	In line with WTO trade liberalization requirements

Source: Lim and Ong, 2002.

Annex B to Chapter IV. Specimen Manufacturing Licence ¹¹¹

Site: -

Subject to the approval of the State Authority/ Authorities concerned.

- (a) At least 30% of the shares of the company shall be subscribed and held by Malaysian citizens and to be reserved and the company shall consult the Ministry of Trade and Industry before the allotment of its reserved shares.
- (b) In the event that the company is permitted to invite the public to subscribe to its share, its capital structure, the revaluation of its share of its assets, goodwill and the subsequent capitalization of profits/reserves, the manner the principles on which the shares are to be issued and allocated shall be approved by the appropriate government authorities/ (Ministry of Trade and Industry).
- (c) The original shares held by the non-Malaysian shareholders shall not be disposed off without the prior written approval of the Ministry of Trade and Industry.
- (d) The composition of the Board of Directors shall broadly reflect the equity structure of the company and the Ministry of Trade and Industry shall be informed of the appointment of and any changes to the Board.
- (e) The company shall as far as possible employ and train Malaysian citizens to reflect, at the earliest possible opportunity, the multiracial composition of the country's population in all grades of appointments up to managerial level.

¹¹¹ The performance requirements vary from firm to firm. This is only a specimen of the conditions imposed on one firm. Many of the licence conditions indicated here have subsequently been abolished, except for the conditions on location, equity, training of Malaysians and implementation of the project as approved in accordance with the laws and regulations of Malaysia.

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- (f) The company shall as far as possible install suitable and modern machinery in accordance with up-to-date and efficient layout. In the event that the company intends to use used machinery, prior written approval of the Ministry of Trade and Industry shall be obtained and for which there shall be a valuation certified by an independent valuer acceptable to the Ministry of Trade and Industry shall also be obtained before any proposed modification, addition or reduction in the machinery for which there is substantial implication on employment and/or output.
 - (g) The company shall, as far as possible, use local raw materials, components and parts to an extent no less than that indicated in its project proposal as approved.
 - (h) The company shall as far as possible use services provided by Malaysian-owned companies and enterprises in the spirit of the New Economic Policy.
 - (i) The company shall not enter into any agreement particularly for starting-up operations, technical know-how and assistance services (including employment of expatriate personnel) management, purchasing, marketing, payment of royalty, patent and trade-marks, without the prior written approval of the Ministry of Trade and Industry.
 - (j) The above conditions shall not apply in respect of purchases of machinery requiring the services of technical personnel from the machine manufacturers to oversee the installation or starting-up operation of the machine concerned.
 - (k) The products of the company shall be up to standards as specified by the Ministry of Trade and Industry where such standards are available.
 - (l) The company shall as far as possible appoint Malaysian-owned companies to distribute its products for the domestic market and shall also appoint *Bumiputera* distributors to

distribute at least 30% of its sales in the domestic market. The selection and appointment of the *Bumiputera* distributors shall be made in consultation with the Ministry of Trade and Industry. Appointment of non-Malaysian companies as distributors shall be made only after obtaining prior approval of the Ministry of Trade and Industry.

- (m) The company shall implement its project as approved subject to the above conditions and in accordance with other laws and regulations in force in Malaysia.

Annex C to Chapter IV. Incentives for investments¹¹²

A. Incentives for the manufacturing sector

1.1 Main incentives for manufacturing companies

The major tax incentives for companies investing in the manufacturing sector are the Pioneer Status or Investment Tax Allowance. Eligibility for Pioneer Status or Investment Tax Allowance is based on certain priorities, including the levels of value-added, technology used and industrial linkages. Such eligible projects are termed as “promoted activities” or “promoted products”.

(i) Pioneer Status

A company granted Pioneer Status enjoys a 5-year partial exemption from the payment of income tax. It will only have to pay tax on 30 per cent of its statutory income¹¹³, with the exemption period commencing from its production day (defined as the day its production level reaches 30 per cent of its capacity). As an additional incentive, companies located in the States of Sabah and Sarawak and the designated “Eastern Corridor”¹¹⁴ of Peninsular Malaysia, will only have to pay tax on 15 per cent of their statutory income during the 5-year exemption period. All project applications received until 31 December 2005 are eligible for this additional incentive. Applications for Pioneer Status should be submitted to the Malaysian Industrial Development Authority (MIDA).

(ii) Investment Tax Allowance (ITA)

As an alternative to Pioneer Status, a company may apply for Investment Tax Allowance (ITA). A company granted ITA gets an

¹¹² This compilation is extracted from www.mida.gov.my on 24 April 2002. For recent amendments, see the website of MIDA.

¹¹³ Statutory income is derived after deducting revenue expenditure and capital allowances from the gross income.

¹¹⁴ The “Eastern Corridor” of Peninsular Malaysia covers the States of Kelantan, Terengganu and Pahang, and the district of Mersing in the State of Johor.

allowance of 60 per cent of qualifying capital expenditure (such as factory, plant, machinery or other equipment used for the approved project) incurred within five years from the date on which the first qualifying capital expenditure is incurred. Companies can offset this allowance against 70 per cent of their statutory income in the year of assessment. Any unutilized allowance can be carried forward to subsequent years until fully utilized. The remaining 30 per cent of statutory income will be taxed at the prevailing company tax rate. As in the case of Pioneer Status companies, an additional incentive is enjoyed by companies located in the States of Sabah and Sarawak, and the designated “Eastern Corridor” of Peninsular Malaysia. These companies can obtain an allowance of 80 per cent of the qualifying capital expenditure incurred. The allowance can be utilised to offset 85 per cent of their statutory income in the year of assessment. All applications received until 31 December 2005 are eligible for this additional incentive. Applications for ITA should be submitted to MIDA.

1.2 Incentives for high technology companies

High technology companies are those engaged in promoted activities or in the production of promoted products in areas of new and emerging technologies, (please refer to the list in Appendix II). High technology companies qualify for:

- Pioneer Status with tax exemption of 100 per cent of statutory income for a period of five years; or
- Investment Tax Allowance of 60 per cent of qualifying capital expenditure incurred within five years from the date the first capital expenditure was incurred. Any unutilized allowance can be carried forward to subsequent years until the whole amount has been fully utilized. The allowance can be utilized to offset against 100 per cent of its statutory income for each year of assessment.

The high technology company must fulfil the following criteria:

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- The percentage of local R & D expenditure to gross sales should be at least 1 per cent on an annual basis. Companies have three years from their date of operation or commencement of business to comply with this requirement.
 - Scientific and technical staff with degrees/diplomas and a minimum of five years' experience in related fields should comprise at least 7 per cent of the company's total workforce.

Applications should be submitted to MIDA.

1.3 Incentives for strategic projects

Strategic projects involve products or activities of national importance. They generally involve heavy capital investments with long gestation periods, have high levels of technology and are integrated, generate extensive linkages, and have significant impact on the economy. Such projects qualify for:

- Pioneer Status with tax exemption of 100 per cent of statutory income for a period of 10 years; or
- Investment Tax Allowance of 100 per cent on qualifying capital expenditure incurred within a period of five years, which the company can offset against 100 per cent of its statutory income for each year of assessment.

Applications should be submitted to MIDA.

1.4 Incentives for Small-Scale Companies

Small-scale manufacturing companies incorporated in Malaysia with shareholders' funds not exceeding RM 500,000 and having Malaysian equity of at least 70 per cent can obtain Pioneer Status incentive under the Promotion of Investments Act 1986. A sole proprietorship or partnership is eligible to apply for this incentive provided a new private limited/limited company is formed to take over existing production/activities. The applicant company

must not be a subsidiary of another company with shareholders fund of more than RM 500,000.

To qualify for the incentive, the small-scale company has to comply with any one of the following criteria:

- the company’s finished products should be used as raw materials or components by manufacturing industries;
- the company’s products shall substitute imports and the local material content is more than 50 per cent in terms of value;
- the company exports at least 50 per cent of its output; or
- the project contributes towards the socio-economic development of the rural population.

The company shall carry out the manufacturing of products or participate in activities listed as promoted products/activities for small-scale companies (please refer to the list in Appendix III).

Applications should be submitted to MIDA.

1.5 Incentives to strengthen industrial linkages

To encourage large companies to participate in an Industrial Linkages Programme (ILP), expenditure incurred in the training of employees, product development and testing, and factory auditing to ensure the quality of vendors’ products, will be allowed as a deduction in the computation of income tax. Vendors, including small and medium-scale Industries (SMIs) which propose to manufacture promoted products or participate in promoted activities in an ILP are eligible for the following incentives:

- Pioneer Status with tax exemption of 100 per cent of its statutory income for a period of five years; or
- Investment Tax Allowance of 60 per cent on qualifying capital expenditure incurred within a period of five years, which the company can offset against 100 per cent of its statutory income for each year of assessment.

To encourage vendors to manufacture promoted products or participate in activities for the international market, vendors in an approved ILP who are capable of achieving world-class standards in terms of price, quality and capacity, will be eligible for the following incentives:

- Pioneer Status with tax exemption of 100 per cent of its statutory income for a period of 10 years; or
- Investment Tax Allowance of 100 per cent of qualifying capital expenditure incurred within a period of five years which the company can offset against 100 per cent of its statutory income for each year of assessment.

Applications should be submitted to MIDA.

1.6 Incentives for the Manufacture of Machinery and Equipment

Companies undertaking activities in the production of specific machinery and equipment, namely, machine tools, plastic injection machines, material handling equipment, robotics and factory automation equipment, and parts and components of the specified machinery and equipment are eligible for:

- Pioneer Status with tax exemption of 100 per cent of statutory income for a period of 10 years; or
- Investment Tax Allowance of 100 per cent on qualifying capital expenditure incurred within a period of five years, which the company can offset against 100 per cent of its statutory income for each year of assessment.

Applications should be submitted to MIDA.

1.7 Additional incentives for the manufacturing sector

Companies investing in Malaysia's manufacturing sector are also eligible for the following incentives:

- (i) Reinvestment Allowance (RA);
- (ii) Accelerated Capital Allowance (ACA);
- (iii) Tax Exemption on the Value of Increased Exports.

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CHAPTER V

SOUTH AFRICA

A. Introduction

South Africa's emergence from isolation in the 1990s has faced its democratic government with an enormous challenge in creating the structures; policies and processes to attract investors back to what was previously a pariah state.¹¹⁵ This chapter addresses the role played by performance requirements in this process and what influence they have had in optimizing the impact of FDI.

As a starting point, the next section B provides a brief introduction to the current FDI patterns in South Africa. In the following sections C-G, this chapter then examines performance requirements linked to exports; technology transfers; research and development (R&D); employment and training; and domestic equity levels.

Exports, technology transfer and R&D requirements are all "voluntary" in nature, in that they are only applied as a condition for the attainment of some form of advantage. Meanwhile, the employment and training requirements as well as the domestic equity requirements used in South Africa are mandatory in character. Keeping the distinction between mandatory and voluntary requirements in mind, section H then examines the impact of performance requirements on the nature and volume of FDI. In each of the above instances the success of various performance requirements is assessed against the sought after developmental objectives. In the concluding section I, some overall lessons from the analysis are drawn with regard to how performance requirements can be used to optimize the impact of FDI.

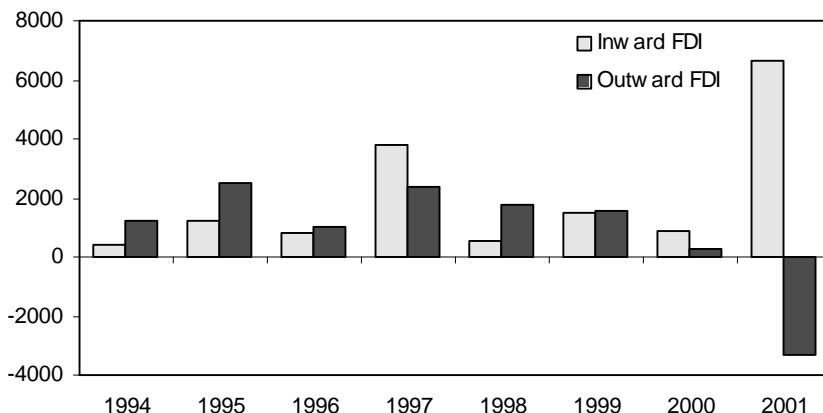
¹¹⁵ Based on a background paper prepared for UNCTAD by Gostner (2002).

B. FDI in South Africa

Since 1994, both domestic and foreign investment have remained at relatively low levels in South Africa. For example, in its *Integrated Manufacturing Strategy*, the Department of Trade and Industry noted that “Investment rates have been generally low in manufacturing. Moreover they have shown a tendency to decline and manufacturing investment has grown more slowly than for most other sectors” (DTI, 2002 a, p. 16).

Disregarding a few discrete business transactions, FDI has remained fairly static between 1994 and 2001 (figure V.1). In 1997 and 1999, inflows were boosted by the privatization of state assets, namely, Telkom and South African Airways (Business Map Foundation, 2001a; TISA 2001), while the dramatic upswing in 2001 was related to a restructuring of the corporate relationship between Anglo American Corporation and the De Beers mining company (SARB 2002a: 31-2; UNCTAD, 2002). If these deals are discounted,

Figure V.1. South Africa: Inflows and outflows of FDI 1994-2001
(Millions of dollars)



Source: UNCTAD FDI/TNC database.

the level of inward FDI has been more or less flat. Moreover, in general, South Africa has received very little ‘greenfield’ FDI with the majority of non-privatization FDI being driven by merger and acquisition (Business Map Foundation, 2001a).

It is in the context of not only low FDI but also fairly static domestic investment trends that the Government of South Africa has formulated its approach to investment policy in general and FDI in particular. The fact that South Africa’s supply-side policy environment is still very much in the process of being created, with most schemes having been operational for no more than three or four years, should be kept in mind when reviewing the performance requirements to which companies are required to adhere.

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In implementing its FDI policies the South African Government has followed the basic principle of national treatment. Thus, all performance requirements, whether mandatory or arising out of the accessing of an advantage, apply equally to domestic and foreign investors, with one exception – the Foreign Investment Grant – which will be discussed below. Foreign and domestic investors have access to identical services and incentives from the State and have to fulfil equal obligations in adhering to national legislation and policy.¹¹⁶ Despite this principle of national treatment, existing performance requirements have implications for both the levels of FDI received and its developmental impact.

¹¹⁶ For example, in the creation of Industrial Development Zones, the Government has insisted that all existing legislation will apply equally to these zones.

C. Export performance requirements

1. Description and objectives

Increasing exports is a central objective of the Government's approach to industrial development. The country does not impose any mandatory export requirements on investors, but some incentive schemes have export-related criteria attached to them. In particular, certain rebate and duty credit schemes that focus on selected industries require that investors perform in a defined manner in order to access the advantage. The DTI has introduced two schemes – the Duty Credit Certificate scheme for exporters of textiles and clothing and the Motor Industry Development Programme – aimed at assisting companies in the clothing and textile sector and the motor industry respectively. Both schemes were designed to enable these sectors to increase exports and retain jobs. Export performance requirements are an integral part of these schemes as the advantage gained is only accessible as a proportion of the value exported.

The DC Certificate scheme, introduced in 1993, offers duty credit certificates to qualifying exporters. The relief afforded to the exporter takes the form of a customs duty rebate that can be used to import an equivalent product for domestic market sales at a reduced rate of duty. Duty credits are offered at the following different percentages of proven export sales of clothing and clothing accessories (30 per cent); household textiles (20 per cent); fabric and other textiles (15 per cent); and yarn (10 per cent). In 2000, the scheme was extended to March 2005.¹¹⁷

The Motor Industry Development Programme was initially implemented in September 1995.¹¹⁸ Originally it was intended to

¹¹⁷ See www.mbendi.co.za/export/sa/export_incentives.htm.

¹¹⁸ The Programme constituted a major shift from the preceding approach to developing the automotive industry. The old strategy had been based on the imposition of local content requirements and a high level of tariff protection against import competition. While this strategy helped to develop a domestic assembly industry, few producers were internationally competitive; the protected environment

operate only for a seven-year period, but in light of its success, it has been extended through to 2012.¹¹⁹ It goes further than the primary objectives of job retention and export growth, incorporating three additional objectives, to improve:

- the international competitiveness of original equipment manufacturers (OEMs) and automotive component firms;
- vehicle affordability in real terms; and
- the industry's trade balance.

The Motor Industry Development Programme has been described in the following manner (Black, 2002, p.3):

“The MIDP is a trade facilitating measure with very particular industry policy objectives. As a result of protection, the industry structure has historically been very fragmented and the resultant failure to achieve economies of scale has not only made the assembly industry inefficient, but has imposed major negative externalities on the component sector. So the MIDP seeks to increase the volume and scale of production through a greater level of specialisation in terms of both vehicle models and components. Higher vehicle volumes allow for the attainment of economies of scale for component producers moving them further down their respective cost curves and enabling a higher level of localisation on an economic basis. In turn this would bring down assembly costs further”.

The Programme incentivizes the attainment of these objectives through three instruments.

resulted in relatively low volume production at relatively high costs. The Programme was launched to make the automotive industry internationally competitive (see e.g. Barnes and Kaplinsky, 2000; Black, 2002).

¹¹⁹ Deloitte and Touche newsletter, *Exclusive*, 11 December 2002.

- An import-export complementation scheme that allows both original equipment manufacturing and component manufacturers to earn duty credits from exporting. These duty credits can then be used to offset import duties on cars, components or materials. They can also be sold on the open market;
- A duty-free allowance for domestic original equipment manufacturers of 27 per cent of the wholesale value of the vehicles they manufacture; and
- A small vehicle incentive, which operates as a subsidy for the manufacture of more affordable vehicles. It operates via a duty drawback mechanism with the value of the drawback being contingent upon the ex-factory value of the motor vehicle.¹²⁰

In essence, the Motor Industry Development Programme allows manufacturers to import a Completely Built Unit – that is, a finished motor vehicle – or component to the same value of South African value or raw material that is contained in an exported unit or component. The value that is derived from export activity is recorded in income rebate credit certificates that are transferable once, giving them a cash value on the open market.

2. *Impact assessment*

While it not possible to draw a direct correlation between programme objectives and macroeconomic data, such a comparison may still be indicative of the extent to which objectives set out in the Programme are being met. Government officials have hailed the Programme as a success. By almost every measure the motor vehicle and automotive components sectors appear to be growing in accordance with the objectives of the Programme.

¹²⁰ The calculation for this subsidy is 0.003% multiplied by the amount by which the wholesale price of the vehicle is below R40,000 multiplied by the wholesale price.

- Motor vehicle exports grew by 29.4 per cent between the 3rd quarter of 1995, when the Programme was introduced, and the 3rd quarter of 2001. In the same period manufacturing exports as a whole increased by 7 per cent (DTI 2002c);¹²¹
- The strong export growth of the sector has helped to strengthen South Africa's balance of trade in this sector reducing the trade deficit from R4.6 billion in 1995 to approximately R3.6 billion in 2001 (in 2000 constant prices) (figure V.1);
- The values of sales have increased from R12,200,000 in mid-1995 to R14,650,000 in mid-2001 (constant 2000 prices);
- Export volumes of automotive components have increased considerably (table V.1) laying the foundation for increased firm level competitiveness; and
- A general improvement of the firm-level competitiveness in the automotive components industry has also been documented (table V.2).

The increased competitiveness is partly related to original equipment manufacturers replacing low volume models by imports. The number of base models has dropped from 42 at the start of the Motor Industry Development Programme to 27 as of 2002. Increased exports have provided duty credits that producers have used to lower the final selling price of imported vehicles. Since the introduction of the Programme, the sector has seen a considerable increase in the number of vehicles both imported and exported. Interestingly, original equipment manufacturers now import considerably more vehicles than independent importers. This is a complete reversal from the situation prevailing in the mid-1990s when the Programme was launched, when independent producers imported approximately 80 per cent more vehicles than original equipment manufacturers (Black 2002).

¹²¹ The most successful export ranges are the BMW-3-series, Mercedes C-Class, Volkswagen Golf and Jetta. Recently, Toyota started to export its new Corolla range (Deloitte and Touche's newsletter *Exclusive*, 11 December 2002).

Table V.1. South Africa: export volumes in the automotive components sector

Component category	1996	1997	1998	1999	2000	2001	% of total (2001)
Catalytic converters	485	835	1,520	2,569	4,683	8,989	48.4
Stitched leather	1,259	1,408	1,854	1,888	1,926	2,391	12.9
Tyres	296	342	498	639	682	781	4.2
Silencers/exhaust pipes	170	151	493	598	337	282	1.5
Road wheels and parts	227	325	446	518	551	725	3.9
Engine parts	127	285	390	383	409	520	2.8
Wiring harnesses	92	138	207	304	319	391	2.1
Automotive tooling	279	309	256	264	362	441	2.4
Glass	71	105	112	147	171	241	1.3
Radiators	107	93	108	11	72	70	0.4
Other components	928	1,126	2,011	2,253	3,088	3,795	

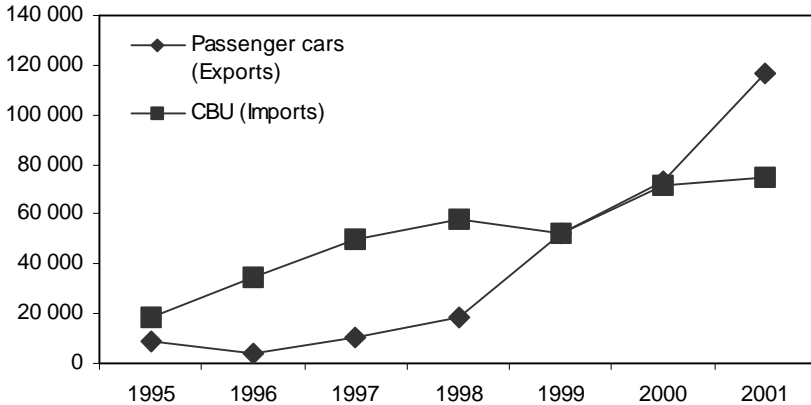
Source: Black, 2002.

Table V.2. South Africa: competitiveness performance in the automotive components sector

Performance measures	1995	1999	Change (percentage)
Raw material stock holding (days)	33.1	28.0	15.4
Work in Progress stock holding (days)	11.2	10.2	8.9
Finished goods stock holding (days)	17.9	23.1	29.1
Customer return rate (parts per million)	6,148.0	3,585.0	41.7
Labour turnover rate (%)	8.5	3.7	56.5

Source: Barnes, 1999, p.3.

Figure V.2. South Africa: imports and exports of passenger vehicles following introduction of the Motor Industry Development Programme
(Unit sales)



Source: NAAMSA, various reports.

Note: The 2001 import figures are projections.

Recent firm level decisions confirm the trends observed at the industry level. In April 2002, Ford announced that they had invested R1 billion in their Eastern Cape engine plant which would become the sole global supplier of a 1.3 litre RoCam engine. In July the same year, Toyota revealed its plans to double the annual production in South Africa to 150,000 units over the next 5 years. Of these 75,000 units were to be exported, while 25,000 units would be imported. In October 2002, Volvo also announced its intention to explore the manufacturing in and exporting from South Africa. Moreover, in a news article, the president of the Southern African-German Chamber of Commerce and Industry, Mr Klaus Doring, attributed investments by Daimler Chrysler, BMW and Volkswagen directly to the Programme (*Business Day*, 9 September 2002).

Many factors have contributed to the motor industry's improved performance. The abandonment of import substitution allowed foreign investors fully to capture economies of scale under

100 per cent foreign ownership. Liberalization led automobile manufacturers to change their strategies and move from domestic-market to export-oriented production. In this process, the duty credit scheme under the Motor Industry Development Programme has been important in helping producers to source competitively. Whereas many of the domestic suppliers have been unable to compete successfully under these new conditions, foreign investors have made considerable efforts to improve the competitiveness of existing plants by upgrading technology and training the workforce, and exports have risen fast.¹²²

By contrast, the DC Certificate scheme has not been as successful. Although exports have grown, most other indicators suggest that the clothing and textile industry has been experiencing decline, as summarized in table V.3. Despite the poor aggregate performance, participants in the scheme consider that it has contributed positively to their business. In one study, 87 per cent of the firms surveyed stated that the Certificate scheme had had a positive impact on their profitability and 73 per cent that it had enabled them to improve their product costing (Reid, 1999).¹²³

Table V.3. South Africa: performance indicators 3rd quarter 1995 - 3rd quarter 2001, by sector
(Percentage change)

Sector	Production volume	Employment	Exports
Textiles	-3.24	-4.92	5.28
Wearing apparel	-5.51	-0.47	14.83

Source: DTI, 2002c.

¹²² See, e.g. "A Quest to Promote the Quality of Cars Made in South Africa", *New York Times*, 24 November 2001.

¹²³ In an interview in July 2002, Jack Kipling, the Chairman of the Export Council for the Clothing Industry, stated that the Duty Credit Certificate Scheme had facilitated stronger export performance among South African producers (<http://www.bharattextile.com/newsitems/1978035>).

In both the Motor Industry Development Programme and the DC Certificate scheme, the good and poor performances of the industries are not directly attributable to the advantages themselves, rather the attached export requirements have most likely contributed to the reorientation of both industries. The original equipment manufacturers and automotive manufacturing industries would undoubtedly have increased their export orientation as a result of the liberalization following the Uruguay Round. However, the Programme enabled manufacturers to do it more effectively without the economies of scale that they were able to attain from the rationalization facilitated by the Programme. Similarly, in a context of general decline, the clothing and textile sector has responded to the incentives attached to export requirements and increased their export value. Thus, on balance, the incentives and requirements established by the Department of Trade and Industry seem to have contributed to increased export performance.

D. Technology transfer requirements

1. Description and objectives

In South Africa, technology transfer requirements have been applied only as a condition for receiving a form of advantage. Commonly recognized as one of the central benefits of FDI, the Government has sought to maximize technology transfers by providing incentives to foreign investors to bring in new machinery and equipment used for local production. The Foreign Investment Grant,¹²⁴ which was established in September 2000, covers the associated costs (freight, travelling, installations etc.), up to a maximum of R3 million, of bringing such assets to South Africa. The Grant may also subsidize travel costs for key personnel associated with the introduction of the new technology and to facilitate the installation of new machinery. While the Grant is not focused on a

¹²⁴ Confidentiality agreements between recipients of the Grant and the Department of Trade and Industry prevent the disclosure of names of the companies concerned.

specific industry or technology the Government reserves the right to reject applications in areas where strong domestic capabilities already exist or where the market is saturated.

The payment of the Grant is subject to two conditions:

- The equipment must be inspected by consulting engineers to certify that it is new and will add to the productive base of South African manufacture; and
- The company must prove that they have earned at least 25 per cent of their projected revenue before the grant is paid.

These two provisos have been introduced to ensure that the developmental objective of technology transfer is attained, by verifying that the technology brought into the country is not redundant and would add value to South Africa's manufacturing base, and that companies actually start to manufacture in the country.

2. *Impact assessment*

In the 18 months following the inception of the Grant, 44 companies have used the facility. Together these companies accounted for a total investment of nearly R700 million. Interviews with Department of Trade and industry officials revealed that the grant system has so far failed to attract the levels of technology transfers that had been hoped for. It is also difficult to assess how important the Grant has been for the companies' investment decisions and whether the investments may have occurred even in its absence.

According to interviews with government officials, the nature of technology attracted by the scheme has been mixed. Some companies have brought in technology that has added to the capital stock of the manufacturing sector but the technology has not in all instances been "state of the art". Thus the grant system has partially achieved its objective of attracting both FDI as well as the transfer of new machinery and equipment to South Africa.

A further examination of the Grant investment statistics indicates that the Grant may also have had an unintended

consequence, encouraging FDI from non-traditional investors. The top three countries of establishment of the TNCs using the FIG are China (31 per cent), Japan (16 per cent) and Greece (12 per cent). At the same time, China has taken a place, for the first time, among the top 10 investors during 2001.

E. R&D requirements

1. Description and objectives

Some incentives offered by the South African Government require companies to adhere to certain R&D requirements. The Technology for Human Resources in Industry Programme, initially established in 1989, incentivizes companies to undertake R&D in collaboration with tertiary education institutions leading to innovation. Since 1994, the Programme has also been used as a policy tool to increase the number of black and female students choosing technological or engineering careers. Between 1991 and 1998, the proportion of black university graduates of the overall number of graduates constituted only 9 per cent in medicine and engineering and 12 per cent in the natural sciences.

The objectives of this Programme are to:

- contribute to an increase in the number and quality of people with appropriate technological skills for industry;
- promote increased interaction among, and financial support of researchers and technology managers in industry, higher education and science, education and technology institutes, with the aim of developing skills for the commercialization of science and technology; and
- stimulate industry to increase its investment in research, technology development and innovation promotion.

The Programme requires that at least one higher education institution and one industrial partner is involved; and that at least one registered South African student is involved in, and trained through, the research per R 150,000 of Programme investment.

2. *Impact assessment*

The number of students benefiting from the Technology for Human Resources in Industry Programme has increased from 1,053 in 1996 to 2,541 in 2000. In addition, the number of female and black students as a proportion of the total number of students involved in the Programme has consistently increased since 1996. In 1997 there were 553 black and 466 female students being trained through its provisions and by 2001 this had increased to 887 black students and 713 female students. This has occurred in a context of declining overall student registrations in the tertiary sector in general and in the Programme's focus areas in particular (CHET, 2000).

The Programme has been less successful in encouraging high levels of foreign firm involvement. In 2000, of the 431 companies that received support, only 30 were foreign companies. These firms were drawn largely from the pharmaceutical and automotive sectors.¹²⁵

F. *Employment and training requirements*

1. *Description and objectives*

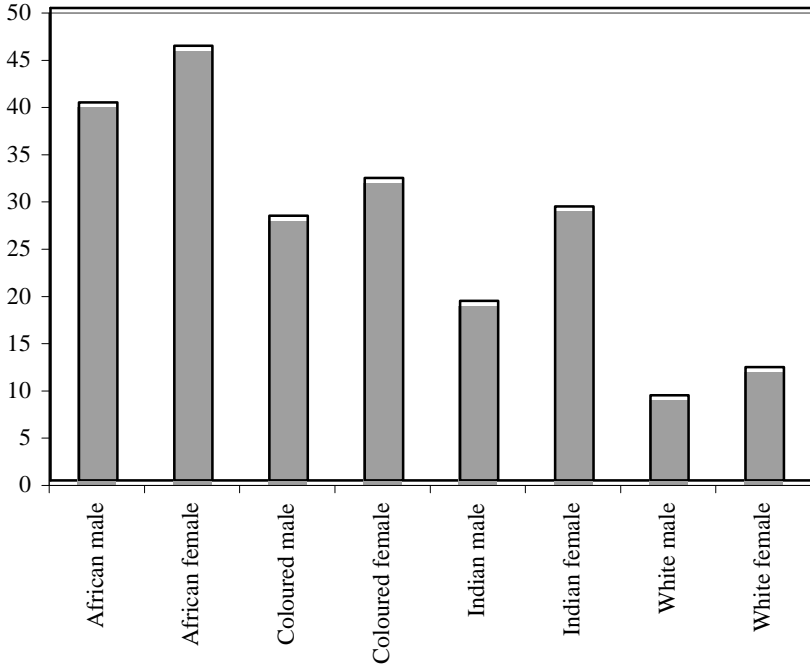
A key development objective for the Government of South Africa after the end of apartheid has been to remedy serious racial and gender inequalities in the labour market. As shown in figure V.3, African, Coloured and Indian people generally show disproportionately high levels of unemployment. The picture is particularly skewed in the professional and managerial strata of the labour market as indicated by the data contained in submitted employment equity plans (figure V.4).

In order to reform the labour market, the Government substantially altered existing labour market legislation and created both a broad foundation of legislative changes as well as mandatory employment and training requirements for most companies in the

¹²⁵ Information from a government official dealing with the Programme.

areas of labour relations rights, skills development and employment equity.¹²⁶ For purposes of this study, the most important legal documents are the Skills Development Act and the Employment Equity Act, both of which were introduced in 1998.

Figure V.3. South Africa: unemployment by gender and race
(Percentage)



Source: DTI, 2002b.

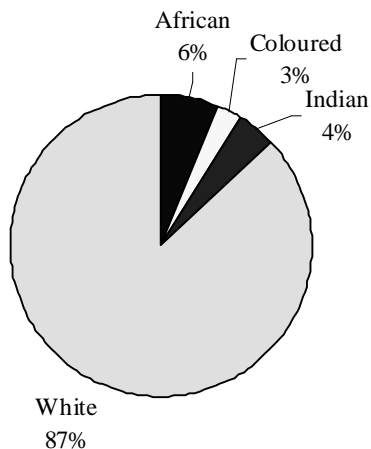
Note: The South African population is 76.7% African; 8.9% Coloured; 2.6% Indian and 10% White.

One of apartheid's most enduring legacies was an enormously under-skilled labour force, adversely affecting the

¹²⁶ Most Acts of labour legislation make some allowances for small and medium-size enterprises. For example, companies employing less than 50 people do not have to submit employment equity plans as required by the Employment Equity Act.

investment climate. In a study conducted by the World Bank in the Johannesburg metropolitan area, for example, 85 per cent of the firms surveyed reported difficulties in finding skilled employees for managerial and professional positions (Chandra et al, 2001a and 2001b). Another survey found that investors view the lack of skills as one of the prime constraints to growth (Business Map Foundation, 2001b). It was this situation that the Skills Development Act was designed to address. It requires all companies with an annual payroll in excess of R 200,000, to pay a Skills Development Levy.¹²⁷ Companies that do provide training are able to claim back 70 per cent of the levy to offset the training costs. Twenty per cent of the levy is channelled into the National Skills Development Fund, which finances training in areas that are of strategic importance, while the remaining 10 per cent pays for the administration of the National Skills System. The levy system came into operation in 1999.

Figure V.4. South Africa: Top management profile derived from employment equity plans



Source CEE 2001, p. 17.

¹²⁷ The Skills Development Levy is calculated as 1% of the total payroll.

Under the auspices of the Skills Development Act, the Department of Labour designed a National Skills Development Strategy, which states as targets that 85 per cent of the beneficiaries of learning programmes should be black, 54 per cent should be women and 4 per cent should be people with disabilities.

The levy system is administered by South African Revenue Services, which ensures efficient collection. For reimbursement, a company has to submit both plans and evidence of training.¹²⁸ Thus the system ensures relatively high levels of formal compliance. However, it is currently weakly designed with respect to its ability to assess the quality and utility of the training provided. The current weaknesses result from the lack of linkages between various institutions in the new training and development landscape. A variety of institutions, including the South African Qualifications Authority and Standards Generating Bodies for each industrial sector, are mandated to develop qualifications and standards against which both training providers and learners can be assessed. However, for many occupations formal benchmarks still have to be established, which makes it difficult for the Department of Labour to regulate the quality of the training.¹²⁹

The Employment Equity Act, 1998 has sought to address racial and gender imbalances by requiring companies employing more than 50 individuals to submit employment equity plans to the Minister of Labour with details on their current workforce composition by race, gender and disability, and their plans to promote representation of disadvantaged individuals within their companies.

Compliance with the Employment Equity Act is monitored by provincial inspectors. To date, the Department of Labour has

¹²⁸ Training can be either in-company or provided by external trainers.

¹²⁹ In addition to the levy and skills plan system, the Skills Development Act introduced so-called "learnerships", which intend to facilitate the development of skills and to provide unemployed people with experience and links into the labour market.

relied more on positive encouragement of employers to submit employment equity plans, rather than on a punitive approach. Nevertheless, the Directorate of Employment Equity has announced that it will “hold an employment equity blitz focusing on high profile companies that have not reported (on their employment equity plans)” (Department of Labour, 2002).

2. *Impact assessment*

The implementation of the Skills Development Act has met with some problems. Only 21 per cent of the total number of employers paying the levy have actually complied with the requirements of the Act (Department of Labour, 2002). Accordingly, a substantial amount of the R1.983 billion that has been collected through the levy system remains unused. Nonetheless, the skills development system is starting to yield results and since the launch of the system 350,000 workers have received training. Of these 64 per cent were black, 37 per cent were female and 0.12 per cent were disabled which implies a step towards the objectives of the National Skills Development Strategy.

The performance requirements implemented through the Skills Development Act thus appear to have yielded a substantial pool of capital for investment into skills development, led to the adoption of skills plans and skills development strategies by a substantial proportion of companies, and contributed towards redressing the racial and gender imbalance in access to skills and skills training opportunities.

The performance requirements stipulated in the Employment Equity Act have also contributed to this end. Previously disadvantaged groups are now beginning to enjoy a level of promotion more commensurate with their representation in the labour force.¹³⁰ It is equally clear, however, that men, and especially white men, continue to be overrepresented in promotions. For

¹³⁰ Promotion refers to the movement of an individual from a position in a company to a more senior position within the same company.

example, promotional trends within the managerial ranks during 2000-2001 show that while 35 per cent of all promotions (across all management levels) went to Black managers, the corresponding figures were only 9 per cent in the case of promotions to top management, 8 per cent to senior management, and 11 per cent to the professionally qualified and mid-management level (CEE 2001).

G. Domestic equity requirements

1. Description and objectives

Like many other countries, South Africa has imposed various equity requirements or restrictions linked to investments in certain activities. In the South African case, such requirements are imposed notably in two situations:

- In the state procurement process; and
- In the awarding of licences in deregulated industries.

The state procurement process seeks to advance the objective of Black Economic Empowerment by favouring domestic black-owned companies.¹³¹ The procurement system operates on the basis of points being awarded to companies tendering for state business. Of the available points, 20 per cent are allocated to the category of black-owned companies. Thus, such firms can secure an advantage over firms that are tendering for the same work. Consequently, this provides investors wishing to secure state business with the incentives to allow black individuals to acquire an equity stake in their businesses.¹³²

The other areas in which domestic ownership requirements are imposed include some deregulated industries such as the mining industry, where the Minerals and Petroleum Resources Development

¹³¹ Black-owned companies are understood to be those companies in which black individuals control 51 per cent or more of the firm's equity.

¹³² Similar conditions have been applied in the creation of public-private partnerships that operate part of the state's service delivery.

Bill (June 2002) created a series of opportunities for black entrepreneurs to gain access to mining licences; and the telecommunications industry, where 19 per cent of the licences for the second fixed-line network operator was reserved for black equity investors.¹³³

The broadcasting industry is the clearest-cut case in which strong restrictions were placed on the level of foreign equity. Until the mid-1990s, this industry was almost exclusively state-owned and operated. The Independent Broadcasting Authority Act of 1996 created for the first time a private broadcasting sector by requiring the state-owned broadcaster to privatize some of its radio assets and by issuing a free-to-air television licence and 8 private sound broadcaster licences. In each of these instances, the level of foreign ownership was restricted to 20 per cent of the total equity in an individual broadcaster.

2. *Impact assessment*

A comprehensive review of black economic empowerment strategies pursued by the Government concluded that the preferential procurement strategy had a significant effect on the formation of companies by previously disadvantaged individuals. Since August 1996, 47.3 per cent of government tenders were awarded to companies with previously disadvantaged individual shareholders. This compares with fewer than 5 per cent before 1994 (Beecom, 2001).

Similarly the deregulation of certain sectors coupled to the thoroughgoing emphasis on black economic empowerment also appears to have ensured new opportunities for black-owned business. In the telecommunications sector, black-owned companies now own 40 per cent of the third mobile network operator; 3 per cent of the national fixed line operator; 10 per cent of the first mobile operator; and 37 per cent of the second mobile operator (Business Map

¹³³ Domestic ownership is understood as those instances in which South African nationals control 51 per cent or more of the firm's equity.

Foundation, 2002b). During 2001, 61 per cent (R2.5 bn) of all deals involving black-owned companies occurred in the mining sector – an increase of almost 150 per cent over 2000, when the state had not yet made its intentions clear with respect to black economic empowerment in the sector.

The granting of new broadcast licences with an emphasis on black economic empowerment, precipitated the emergence of a number of black-owned media companies, four of whom are listed on the Johannesburg Stock Exchange. Moreover, of the eight new radio broadcasting licences that have been issued, four are exclusively owned by domestic investors. The free-to-air television licence is also exclusively owned by a domestic investor. However, this dramatic growth in domestic media interests has been partly offset in recent years by a loss in market capitalization of these companies and by the bankruptcy of one of the four listed companies.

Thus, in the areas defined above, the policy objectives contained in the performance requirements are being advanced. Even so, these requirements have not been without their critics. Influential commentators, representing the interest of domestic black-owned capital, (BeeCom 2001) have criticized these performance requirements for not being far-reaching or monitored sufficiently. While simultaneously representatives of white or foreign-owned business tendering for state or parastatal business have complained that the system implies an equity tax in practice. Finally, some unexpected criticism has been voiced. The black media owners (the beneficiaries of domestic equity performance requirements) have criticized the Broadcasting Authority Act's provisions that the regulator must approve any sale of equity that may reduce the level of black ownership in a broadcaster since this tends to reduce the liquidity and the value of their shares.

H. Performance requirements and FDI

The above review has shown that the performance requirements implemented by the Government are contributing to the attainment of various development objectives. This section looks at the likely impact of the different requirements on the type and level of FDI that South Africa receives.

1. Voluntary performance requirements

Sections C to E above considered a number of "voluntary" performance requirements, which are linked to the receipt of some advantage. Despite the apparent success of those policy measures within their own parameters, that is, the attached incentives are contributing to the attainment of their objectives, their overall impact on levels of investment activity (foreign and domestic) is likely to have been quite limited. To start with, the awareness of such government measures is generally very low (Business Map Foundation, 2000). In a recent study of medium-sized firms, for example, only 12 per cent had accessed any type of government programme (ibid), which is a finding that has been confirmed in other surveys (Chandra 2001a and 2001b).

The main exceptions are programmes that have a direct impact on the final selling price of manufactured goods, notably the Motor Industry Development Programme and tax exemptions of value added tax and customs duties (including the DC Certificate scheme). Figure V.5 shows that in 1999, the Motor Industry Development Programme was used by 31 per cent of the firms surveyed. More than half of the firms were aware of the Programme.¹³⁴ Among Johannesburg-based SMEs, the awareness of various programmes ranged between 7 and 34 per cent and usage was even lower, often in the range of one per cent or less. Black-

¹³⁴ The Chandra survey was a cross-industry study. This makes it likely that an even higher percentage of firms in the automotive sector would have been aware of and used the Programme.

owned and post-apartheid SMEs were more likely to have heard of government programmes (Chandra 2001b, pp. 39-40).

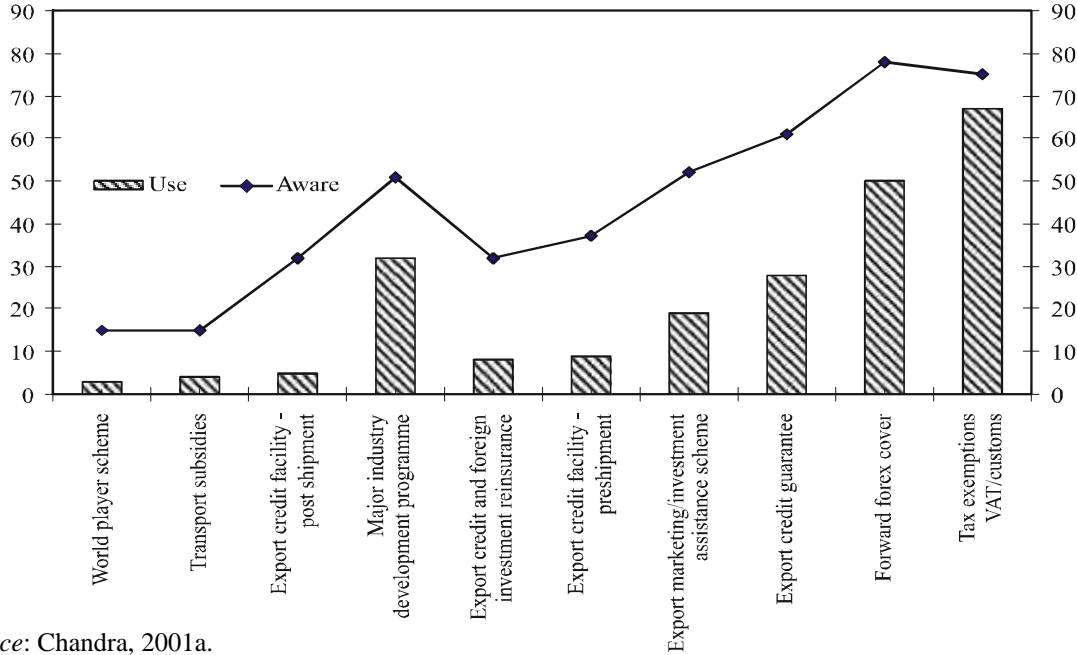
In addition to these low levels of awareness, foreign and domestic investors have expressed some reluctance to apply for incentives linked to certain requirements if the policy measures are perceived as being overly bureaucratic and difficult to use (Business Map Foundation, 2000). Moreover, the incentives offered are sometimes not generous enough to compensate for the costs invoked by the requirements. In interviews conducted for this study, company representatives commented that the advantages obtained from adhering to the performance requirements were typically "nice to have" considerations, but that they did not substantially influence investment decisions.¹³⁵

The generally low levels of awareness of the advantages and the attendant performance requirements complicate an assessment of their impact on FDI. Still, it is possible to identify three categories of programmes.

First, when the performance requirements are poorly defined, the impact on types of investment and development objectives is difficult to discern. For example, government officials working with the Foreign Investment Grant scheme emphasized in interviews that one of the Grant's objectives was to encourage skills transfers. This aim is not officially recorded, however, nor is it monitored. It is consequently difficult to establish its developmental impact in this regard.

¹³⁵ In specific cases, South Africa has lost FDI projects because of less generous incentives than other competing locations offered. In 2000, for example, a Malaysian textile and fabric manufacturer, Ramatex, opted to invest in Namibia after initially considering South Africa. The decision was partly motivated by more competitive incentives although company sources also indicated that the Namibian bureaucrats were more investor-responsive (Business Map Foundation, 2001b).

Figure V.5. South Africa: Awareness and use of Government measures for export, 1999
(Percentage of firms)



Source: Chandra, 2001a.

Second, there are instances where the assistance may be relatively insignificant to foreign investors but the developmental objectives are clearly articulated. The THRIP is a good example, where very few (less than 10 per cent) of those using the scheme were foreign investors, but the impact on human resource development among historically disadvantaged individuals was significant and clearly discernible. Similarly, while the Foreign Investment Grant may not have led to transfers of leading-edge technology, the incentive part has contributed to increased FDI in manufacturing.

The third category relates to instances in which both the developmental outcome and the targeted beneficiaries of a scheme are clearly defined. For example, the high level of awareness and use of the Motor Industry Development Programme can be attributed to the integration of the domestic automotive industry into global supply chains; an ability of South Africa-based manufacturers to successfully reduce the final selling price of their products by using the flexibility of their global supply chain and obtaining economies of scale; and the development of close working relationships between government agencies and investors.

The motor industry has been a significant recipient of FDI. In 2001/2002, this industry accounted for the largest share of investments facilitated by South Africa's investment promotion agency. This reflects international companies buying larger stakes in their existing South African operations as well as the expansion of the existing operations as they tool-up for export. Accordingly these figures point to the strategic significance of these operations within a global value chain – something which is in part attributable to the restructuring supported by the Motor Industry Development Programme. Conversely, the textile and clothing industry has not been a substantial recipient of FDI despite the existence of the DC Certificate scheme.

To conclude, a high level of specificity associated with the desired development outcome appears to be important when using

voluntary performance requirements to optimize the levels and impacts of inward FDI.

2. *Mandatory performance requirements*

Employment and training requirements

With regard to mandatory requirements in the area of employment and training, the effect of the new labour market legislation on levels of both foreign and domestic investment has been as a source of substantial debate and controversy. Private sector representatives have argued that requirements of labour market legislation have had a dampening effect on investment levels. In a large survey conducted in 2000, 70 per cent of the respondents reported labour market legislation to be a hindrance (Business Map Foundation, 2000). Similarly, in interviews conducted for the current study as well as World Bank studies on SMEs and large firms operating in the Greater Johannesburg Metropolitan area have also found labour legislation to be a factor limiting investment (Chandra 2001a and 2001b).

At the same time, none of these studies have identified any specific piece of labour legislation as impeding investment and few investors have singled out either the Skills Development Act or the Employment Equity Act as being major constraints on investment. Indeed the same studies also show that the shortage of skills remains another key obstacle to growth and investment in South Africa. Increased education and training has been rated as one of the most important steps for the Government to take in order to improve the investment climate (Chandra 2001b, p. 22).

The limitations on companies in their efforts to bring in foreign skills of which there are shortages in the South African economy, have been noted to be having a dampening effect on investment and business confidence. In a recent survey of British investors in the country, "easy access to foreign skills" was rated as

their second most pressing concern (British Chamber of Business in South Africa, 2000).¹³⁶

The performance requirements in the area of employment and training are starting to have positive effects on the South African labour market with increased levels of training as well as professional mobility of previously disenfranchised groups. This is anticipated to increase the human resource base of the economy as well as the stability of the broader socio-political environment. Thus, while perceptions of foreign (and domestic) investors remain negative in the short term, the medium or long-term impact of the requirements may be increased FDI if they enhance the availability of skilled labour. However, in the interim period a less stringent application of restrictions related to inflows of foreign skills could accommodate the restructuring of the labour market.¹³⁷

Domestic equity requirements

As discussed in section G, domestic equity requirements in the South African environment have taken two forms: straight limitations on foreign investment in specified sectors; and advantages given to firms that are black-owned or have black equity.

Limitations on foreign investment into certain key sectors have effectively reduced FDI in those arenas. In the broadcasting sector, the limitations on FDI have meant that there are no large

¹³⁶ Mr Rafiq Bagus, the then CEO of Investment South Africa (which later became Trade and Investment South Africa) estimated that R300 million of FDI was suspended because companies awaited work permit approvals for foreign nationals.

¹³⁷ New regulations governing the employment of foreigners have been published and are due to take effect in March 2003. In terms of the rules, 2 per cent of a foreigner's taxable remuneration will have to be paid quarterly by companies to the Home Affairs Department to be used for skills development. Foreigners who intend establishing businesses in South Africa must comply with several requirements before a business permit will be issued. The investment must be of at least R 2.5 million. The investment must have a good business track record, have a wide geographical spread of economic activity and employ 5 South Africans. The investment must also have export potential.

global investors in the sector. In the private radio-broadcasting sector, foreign investors own equity in only four enterprises, including Classic FM essentially a radio franchise operation, of the 13 licensed operations. Similarly, while Warner Brothers initially took an equity stake in South Africa's first free-to-air licence they later withdrew. While the emergence of domestic media companies, which was the main purpose of the legislation, can be seen as a positive outcome, the restrictions may have placed a cap on the industry's growth. Some interviewees have pointed to this cap being, at least partly, responsible for the substantial decline in market capitalization of the media sector.

In general, foreign investors tend to understand the need to redress social and economic imbalances in South Africa and are broadly supportive of black economic equity performance requirements (Business Map Foundation, 2000). However, investors are cautious of how this is done. The requirements associated with the three cellular licences did not prevent substantial investment into the sector. In the most recent licence issuance (2000), Saudi Oger invested \$391 million in establishing the third mobile network operator. However, the existing requirement that bidders for the second fixed line network operator partner will have to enter into "a forced marriage" with a black-owned consortia that will own 19 per cent of the licence has been met with skepticism by investors. Some interviewees indicated that the such equity performance requirements were likely to limit investment.

As discussed above, the other sector that has faced the emergence of equity performance requirements is the mining sector. This sector has, however, seen continued investment in 1999 and 2000 as investors have positioned themselves to exploit platinum reserves and a depreciating rand vis-à-vis the United States dollar. Existing investors have also continued to expand their presence in the sector. For example, the Amplats Group has undertaken a R12.6 billion expansion of their platinum mining and processing capability, and Anglo Gold and Gold Fields have been deepening shafts at their Driefontien operation, corresponding to a R4 billion investment.

While investments in the natural-resource based industries appear not to have been adversely affected by the increased black-ownership targets set in this sector, there are limits to what a country can do even in these kinds of activity. When a draft Mining Charter was leaked to the press in August 2002, suggesting that the Government would regulate that 51 per cent of the industry should be transferred to domestic black owners, the share prices of major mining houses plummeted and industry leaders reacted strongly. In the end, the Government backed away from the idea of imposing a specific quota for domestic black ownership in the sector.

In instances where the potential returns outweigh the costs associated with the performance requirements, FDI has continued to flow into the country. However, where there have been deliberate restrictions on levels of FDI, as in broadcasting, the opportunities have not been sufficient to make investments viable.

I. Concluding observations

In light of the above review, what conclusions can be drawn, taking into account that FDI in South Africa has been largely constant between 1994 and 2001, and driven primarily by merger and acquisition activity?

Export and technology transfer performance requirements in the South African environment aim to increase FDI and advance the objectives of increased export and technology transfer. The most successful of these has been the Motor Industry Development Programme, while to a lesser degree the Foreign Investment Grant is experiencing some success. The success of this Motor Industry Programme rests on its synergy with the existing industry structure and evolving corporate strategies. The automotive industry is reliant on economies of scale in order to export and forms part of an international value chain in which components, and smaller volume vehicles, are sourced globally. The Programme has complemented this structure and made it more attractive to locate manufacturing in South Africa. While exports probably would have occurred

regardless of the Programme, it has strengthened that trend as well as facilitating increasing FDI into the automotive industry. As a consequence, there has been considerable recapitalization of the industry and fewer job losses than in the rest of the manufacturing sector. The performance requirements were closely aligned to the economic structure of the automotive industry in South Africa – crudely put, the need to export in order to achieve economies of scale and reduce costs of production – and thus aided investors rather than tried to extract development benefits other than those that flowed directly from their ordinary operations.

The performance of the DC Certificate scheme serves as an interesting counter-factual to the Motor Industry Programme. Notwithstanding the almost identical structure of the performance requirements and the attendant advantage, the DC Certificate scheme has largely failed both in terms of its development objectives and in attracting FDI. This serves to demonstrate the point that a ‘one size fits all’ approach to performance requirements is unlikely to be effective.

The Technology for Human Resources in Industry Programme is more generic and does not, in the short term, reduce the cost of production or the final selling price of the product. While it is difficult to prove that it has increased investment in R&D, since that investment may have occurred without the incentive, it provides a channel for investment to operate in a particular direction without jeopardizing the investment by increasing the costs of the operation.

On balance, therefore, it would appear, that the success of voluntary performance requirements is largely contingent on the extent to which they support existing economic tendencies in an industry. It is the recognition of this, coupled with the WTO obligations of national treatment, that have resulted in the Government's avoidance of placing performance requirements specifically on foreign investors seeking to service either domestic or export markets.

Conversely, mandatory performance requirements have to balance developmental objectives against the risk of discouraging investors. From the evidence available in the telecommunications and mining industries, it would appear that when the anticipated returns outweigh the costs of conforming with a mandatory performance requirement, investment continues to occur even in the presence of a requirement. Both of these sectors are characterized by the fact that their basic product is a public good subject to government regulation, which serves to increase government's negotiating power in these industries.

The telecommunications and broadcasting industries are characterized by a lack of international competition in the South African market as well as being domestic market-oriented. These characteristics raise the potential level of return to investors, thus the telecommunications sector has been the recipient of the largest foreign investments since 1994, notwithstanding both domestic equity requirements as well as other service obligations. However, in the broadcasting industry the constraints placed on FDI seem to have been greater than the potential returns to foreign investors.

The mining sector shares a similar characteristic with broadcasting, as the minerals, like radio waveband frequencies, are only available within a particular region although it also differs from broadcasting, as it is largely export focused. This means that it is considerably more sensitive to performance requirements that may increase its cost base than are companies in the telecommunications and broadcast sector that compete in a relatively protected domestic market. Thus, while the fixed location of mineral resources serves to strengthen the Government's position, it does not do so without limits. The story of domestic equity in the mining sector is instructive in this regard. While government set broad domestic equity targets and signalled a preferred policy direction, existing mining companies substantially increased the opportunities for domestic black ownership in the sector. However, the short-lived target of 51 per cent proposed in the draft Mining Charter shows that

there are limits to what the private sector perceives to be reasonable requirements.

It may be easier for a state to leverage performance requirements on "new" industries', that is, those that are either recently deregulated or that do not have any existing incumbents.¹³⁸ In both the telecommunications and broadcasting industries, the state successfully implemented a range of requirements with limited opposition from potential investors.

The impact of employment-related requirements arising out of the Skills Development Act and the Employment Equity Act on FDI is ambiguous. On the one hand, when respondents are probed on labour legislation it is viewed as a barrier to investment. On the other, when investors are asked to list barriers to investment, these pieces of legislation are not cited as primary impediments. Mandatory performance requirements need to be approached strategically. If they do not successfully address the specified developmental objectives, they risk becoming an effective permanent barrier to investment.

To conclude, it would appear that the optimization of investment through the creation of performance requirements requires an intimate understanding of the industry structure and corporate strategies. Moreover, requirements are more likely to be implemented effectively in areas insulated from global competition.

¹³⁸ This view was expressed by Mr Mandla Langa, chairperson of the Independent Communications Authority of South Africa (ICASA), in an address to the Business Map Foundation in September 2002.

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CHAPTER VI

THE EXPERIENCE OF DEVELOPED COUNTRIES

A. Introduction

This chapter reviews the extent of and experience with performance requirements for FDI in the developed countries, particularly during the 1960s to the 1980s.¹³⁹ Emphasis is mainly given to performance requirements with respect to joint ventures and domestic equity, export performance, technology, and employment and training.

The structure of the chapter, following this Introduction, gives in section B an overview of the incidence of related measures in the developed world, while section C briefly considers the origins of such policies. In sections D to H, the extent and nature of performance requirements are examined for three types of countries, of which the first category receives most attention:

- (a) Countries with formal review mechanisms for inward FDI and subsequent expansion by merger and acquisition. A distinction is drawn here between natural resource-based host countries (Australia, Canada, New Zealand, Norway, Sweden) and other countries (France and Japan).
- (b) Mainly host countries lacking formal review mechanisms (Belgium and Ireland).
- (c) Mainly home countries lacking formal review (West Germany, the Netherlands, Switzerland, the United Kingdom and the United States).

Section I turns to an evaluation of the effectiveness of the requirements in relation to stated objectives. This part will consider

¹³⁹ This chapter is based on a background paper prepared for UNCTAD by Safarian (2002).

how far the laws and regulations were actually implemented, how they affected FDI, what worked in terms of the objectives, and why some performance requirements were more successfully implemented in some countries. Section J considers the general move among developed countries in the 1980s away from the use of explicit performance requirements towards more reliance on incentives and various strategic industrial policies. Section K provides concluding observations.

The analysis draws on a wide range of sources, including private studies on policies and experience with TNCs in some of the countries covered here; national government documents particularly for countries where policy is extensive with regard to inward review; and studies from such international entities as the OECD and UNCTAD.¹⁴⁰

B. Overall patterns in the use of performance requirements

The most comprehensive source of information on performance requirements is that for United States outward FDI in the benchmark surveys published every five years by the United States Department of Commerce. In 1977, performance requirements were reported by 14 per cent of the entire listing of 23,641 United States non-bank affiliates abroad. Minimum export requirements were reported by 1.5 per cent of the firms, maximum import limits by 2.5 per cent, local content requirements by 2.5 per

¹⁴⁰ There are relatively few studies on the actual operations of the government agencies involved, including such matters as the actual implementation of laws and stated policies, any necessary trade-offs, the monitoring of commitments, and other important aspects of the policy process. There is also relatively little documentation on how effective such policies were in relation to their objectives. For these types of issues, extensive use is made of the study by Safarian (1993), which is based on interviews with officials of both government agencies and TNCs as well as intermediaries such as financial agents and lawyers; and of a few other such direct studies as well as case studies and theoretical and empirical tests. Where no source is given for the processes inside government agencies, the material is drawn from the Safarian study.

cent, a local labour requirement by 8 per cent and a cap on the parent's equity by 5.7 per cent. In 1982, the corresponding shares for a listing of 17,213 firms were 1.6, 1.5, 1.1, 7.6, and 4.3 per cent, respectively. It was also reported in 1982 that 3.6 per cent of the firms were required to transfer technology to the host country and 1.4 per cent had to maintain a given ratio of exports or foreign exchange receipts to imports or foreign exchange payments.

These ratios varied a good deal by country and sector. Equity requirements were relatively high for Australia, Japan, New Zealand and Spain, while trade-related requirements were relatively high for Australia, Greece, Ireland, New Zealand, Portugal and Spain. In both cases, however, almost all the figures reported were below 10 per cent. Moreover, the ratios were substantially higher for developing countries. The number of requirements was particularly high in industries where TNCs are concentrated, notably in electrical, transportation equipment (especially automobiles), chemicals, non-electrical machinery and some primary sectors such as mining and petroleum.

This relatively low incidence of requirements may seem surprising, especially in light of the review in section D of measures undertaken in a number of countries. There may be scope for interpretation of what is meant by performance requirements, since many were general statements and either not enforced or incapable of effective enforcement. A study by the Office of the United States Trade Representative, noted in Moran and Pearson (1988, p. 126), found that only 40 per cent of the 90 identified trade-related requirements involved specific numerical targets with a much lower percentage in the developed countries.

Another study concluded that the proportion of 50-50 and minority affiliates fell between the two United States census periods (Contractor, 1990). Regression analysis showed the degree of government regulation of parent equity to be the most important factor. Country-specific variables such as the size of the host market were the next most important variable. Performance requirements

were significant in the sense that joint ventures were more likely when such requirements were higher. For developed countries, market size and market importance for FDI were the key determinants of FDI, while government restrictions and political risk perception were more important than market size in developing countries.¹⁴¹ Finally, in a comprehensive survey of 74 FDI projects, 38 were subject to trade-related requirements (Guisinger et al., 1985). While some changes in trade patterns were reported, it was not possible to determine their effectiveness because some "requirements" were not binding and it was often not clear what firms would have done without the requirements since incentives were also involved. A statistical analysis of FDI determinants showed that the coefficient for performance requirements was significant and negative for new United States investment abroad in 1977 but not significant in 1982 (Loree and Guisinger, 1995).

C. Origins of policies

Performance requirements, including restrictions related to foreign equity ownership, were often introduced because of specific incidents, such as the foreign takeover of an important firm, or penetration of what was considered a key sector, or in response to the exercise by a home government of control over subsidiaries abroad. Table VI.1 gives proximate reasons for the introduction of inward review policies for countries included in this chapter. Underlying these proximate concerns were broader questions about the political and economic consequences of a substantial TNC presence.

In most cases the countries involved welcomed FDI, although all exempted some sectors from this welcome and many tried to assure or increase benefits either in certain sectors or more generally. The broadly related concerns centred on four issues which

¹⁴¹ These findings were largely corroborated in a similar study focusing on developing countries (Kobrin, 1987).

Table VI.1. Origins of inward review policies for FDI to 1980, selected developed countries

Proximate reason	Australia	Canada	New Zealand	Norway	Sweden	France	Japan	UK	USA
Existence of exchange control	Yes	No	Yes	Yes	Yes	Yes	Yes	Until 1979	1960s (partial)
Takeover of a key firm	Insurance 1968	Bank 1963	Media 1964	Resources 1906-17	Resources 1916	Computers 1964-66 some others	Takeovers discouraged	Motor cars banks	Defence OPEC
	Uranium 1970 Resources 1960s	Uranium 1970 Media 1960s	Resources 1960s		Others 1970s				
Concerns about performance	Weak	Strong	Moderate or weak		Moderate	Strong (high-tech)	Strong	Weak	Weak
Natural resource restrictions or rent participation	Strong	Strong	Strong land & energy late 1960s	Strong all resources 1906-17	Strong all resources 1916	Supply (petroleum)	Supply (petroleum etc.)	Moderate or strong energy	Weak
	All resources late 1960s	Energy 1970s							

/...

Table VI.1. Origins of inward review policies for FDI to 1980, selected developed countries (concluded)

Proximate reason	Australia	Canada	New Zealand	Norway	Sweden	France	Japan	UK	USA
Policies abroad									
Balance of payments controls USA, UK	Strong mid-1960s	Strong mid-1960s	Moderate or strong mid-1960s			Strong mid-1960s			
Extraterritoriality and independence		Strong, from late 1950s		Strong neutrality	Strong neutrality	Lack of EC policy military independence	Strong general	Weak	Strong reciprocity

Source: Safarian (1993), p. 411.

are central to public policy decision-making, namely, the micro and macroeconomic impact, income distribution, maintenance of political independence and distribution of power.¹⁴² In terms of economic effects, for example, there were concerns at the micro level that excessive reliance on FDI could limit technological development since R&D was largely concentrated in home countries. Hence the efforts by review agencies to secure local R&D as a condition of entry. At the macro level the importance of natural resources to some countries and a desire to share more fully in development gains often led to controls on FDI.

The second issue concerned distributional effects of FDI, always a sensitive issue for governments. This was partly a matter of the international distribution of potential gains or costs from TNCs. But it also had to do with the distributional effects within countries, which took many forms. For example, TNC activities impact unevenly within a country. The losers from such activities, whether in absolute or relative terms, are likely to receive or demand government attention. Hence the frequent provision that employment levels be maintained for a time in a takeover, as with the acquisition of shares in United Kingdom automobile firms by United States TNCs. A quite different case is that of rent seeking or protection in the face of TNC activities.¹⁴³

A third motive is the preservation of political independence. This is perhaps clearest in the case of extraterritorial application of law or policy by home country governments through subsidiaries located abroad. For example, a long list of incidents involving the United States from the late 1950s onwards influenced the development of Canadian policies on inward FDI. More broadly, it

¹⁴² For a more detailed examination of these four issues as they relate to TNCs, including a statistical test of how they affected the degree of restrictiveness towards FDI, see Safarian (1993, chs. 2 and 10).

¹⁴³ It is not difficult to conceive of objections to FDI that have nothing to do with preserving the level of employment or activity and everything to do with preserving a local quasi-monopoly.

was widely believed that excessive reliance on FDI complicated the capacity of a state to implement some of its policies. National security was only the most obvious of such questions, and led to many closed sectors.

Finally, the distribution of power within states, as distinct from political independence, was an issue. This included the differences in viewpoint about the relationship between the large firm and the state, of which the power of TNCs was one important aspect. It is clear that powerful government bureaux in politically centralized countries such as Japan and France tried to assure that TNCs did not substantially weaken their influence. In general, industry departments tended to be more critical of TNCs than were treasury departments. Moreover, in federal states it was often more difficult to restrict TNCs given the competition from other levels of government. The division of powers at the heart of a federal state sometimes led to conflicting policies regarding TNCs. One example is the generous Australian state subsidies to FDI which tended to offset the federal government's efforts to extract economic rent through provisions for Australian ownership. Another is the requirement in Canada that the relevant provinces be consulted when the federal agency reviewed inward FDI, a procedure which led to challenges of the agency's recommendations up to the Cabinet level of the Federal Government.

D. Nature and extent of performance requirements

Before considering performance requirements at the country level, it may be useful to take an overview of the review mechanisms that were in operation and also of the sectoral controls. Table VI.2 summarizes the characteristics of the general review mechanisms for inward FDI in the early 1980s for selected countries. Several of these countries had an interdepartmental committee rather than a defined agency. In many cases the procedures, criteria for evaluation of an investment proposal and other aspects were opaque. The relative emphasis on domestic ownership requirements as against others varied. Natural resources and high technology received special

attention in all cases. Monitoring of commitments given in the review process was uneven. If an advantage of some kind was also involved, such as a tax concession, the monitoring of related commitments was likely to be closer. There was also an uneven rate of rejection of proposals between countries.¹⁴⁴

Once approval to enter was given, foreign firms were usually free to proceed with the agreed line of business subject to fulfilling commitments made, any subsequent acquisition and the country's general laws and policies. However, depending on whether national treatment was offered to foreign-owned firms, there was sometimes differential access to subsidies, financing, tax obligations and government purchasing.¹⁴⁵

In considering sectoral controls on entry, it is important to distinguish policies directed to foreign investors as against the presence of publicly owned private or mixed monopolies which will also restrict entry by domestic investors. This distinction is made in table VI.3. Such sectoral restrictions, it should be noted, are in addition to review processes noted above. In terms of the OECD code of Liberalization of Capital Movements, as well as other types of sectoral impediments to FDI, examples of widespread restrictions in the mid-1980s included finance, insurance, air and maritime transport, real estate, and mining and petroleum. A number of other sectors were effectively closed to FDI because of monopolies of various types.¹⁴⁶ The fact that few manufacturing sectors are involved will be returned to below in section E. Finally, the picture given in table VI.3 has changed significantly in recent years due to privatization and capital liberalization policies in many sectors.

¹⁴⁴ Care should be taken, however, in interpreting the rejection rates specified as "rare". For countries such as Japan this could mean that, while a formal rejection was not offered, neither was a formal approval.

¹⁴⁵ For a list of these provisions in OECD Countries, see OECD (1985). A summary appears in Safarian (1993, p. 444).

¹⁴⁶ Table VI.3 does not adequately reflect the closing of sectors due to public interest concerns, especially military and security, which would require finer classification. In some cases the restrictions are not absolute: in banking, for example, there may be reciprocity provisions for admission.

Table VI.2. Characteristics of general review systems for inward FDI, early 1980s

	<i>Australia</i>	<i>Canada</i>	<i>New Zealand</i>	<i>Norway</i>	<i>Sweden</i>	<i>France</i>	<i>Japan</i>	<i>UK</i>
Year Established	1975 (1972)	1974-75	1973 (1964)	1906-17 1961-63	1916 (1983 general)	1966	1949-50 (1980)	(to 1979)
EXPLICITNESS								
Significant legal definition ¹	Yes for takeovers	Yes	Yes	Some (resources)	Yes	No	Yes (1980)	No
Defined agency	Yes	Yes	Yes	No	No	No	No	No
Explicit criteria for assessment	Yes	Yes	Yes	Yes (1963)	No (informal & broad)	No (informal & broad)	No (informal & broad)	No
Major decision criteria clear	Yes	No	Yes (resources)	No	No	Yes (varies re plan)	No	No (beyond sectoral)
Standardized and known procedures	Yes	Yes	Yes	some	some	some	some	some
Data publication significant	Yes	Yes	Yes	No	No	No	some	No
MAJOR OBJECTIVES								
Performance	No	Yes	No	No except petrol	No except structural	Yes	Yes	sectoral

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Table VI.2. Characteristics of general review systems for inward FDI, early 1980s (continued)

	<i>Australia</i>	<i>Canada</i>	<i>New Zealand</i>	<i>Norway</i>	<i>Sweden</i>	<i>France</i>	<i>Japan</i>	<i>UK</i>
Ownership: resources	Yes	Yes (energy)	Yes	Yes	Yes	Yes (energy)	Yes	Yes (energy)
other	Yes	Yes	No	No	some	Yes	sectors	Sectors
COVERAGE²								
New	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes
Takeover	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Indirect	Yes	Yes	Yes (pro forma)	Yes (pro forma)	?	Yes		?
Expansion new lines	Yes	Yes	Yes	Yes	?	Yes	Yes	
Expansion old lines	No	No	No	Yes (pro forma)	No	Yes (finance)	No	No
MAJOR CHANGES								
In system, 1960-early 1980s (exclude resources)	Yes	Yes	Some	Some	Yes	Yes	Yes	Some

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Table VI.2. Characteristics of general review systems for inward FDI, early 1980s (continued)

	<i>Australia</i>	<i>Canada</i>	<i>New Zealand</i>	<i>Norway</i>	<i>Sweden</i>	<i>France</i>	<i>Japan</i>	<i>UK</i>
PERCENTAGE								
Foreign ownership which triggers review	15 (40 if 2+associates)	5 (25 or 40 if 2+associates)	25	10	10 (20,40,50)	20 ex EC	10 (exceptions)	N/A
BARGAINING PROCESS								
For increased benefits ³	No	Yes	No	No	No	Some sectors	Pre-1980	Some sectors
Frequent search for domestic alternative ⁴	No (some)	No	No	No (some)	No (some)	Yes	No (takeovers difficult)	No (some)
Sectoral distinctions:								
Natural resource	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
High technology	yes	Yes	Yes	some	some	Yes	Yes	Yes
Maximum time to process (days)	30+100	60 or up	42	90 or up	N/A	60 or up	30+120	N/A
Regular monitoring of commitments ⁵	No	Yes	No	Short term	No	Short term	Not clear	No

/...

Table VI.2. Characteristics of general review systems for inward FDI, early 1980s (concluded)

	<i>Australia</i>	<i>Canada</i>	<i>New Zealand</i>	<i>Norway</i>	<i>Sweden</i>	<i>France</i>	<i>Japan</i>	<i>UK</i>
REJECTION RATE (FORMAL)⁶								
New firms	2.7 ⁷	7.1	5.4 (70-85)	Rare	Rare	Rare	Rare	Rare
Acquisitions	(76-84)	6.9 (75-84)	7.1 (65-85)					

Source: Safarian, (1993), pp. 430-31.

Notes: The table refers to establishment and merger or acquisition review rather than policy more generally, such as that on restricted sectors or exchange controls. In interpreting the necessarily brief summary given here, the reader should consult Safarian (1993) for fuller details and qualifications. Years in parentheses indicate important precedents for general review systems (Australia and New Zealand), major clarification of review (Norway and Sweden), and ending of formal review (Japan and UK).

¹ Apart from exchange control, which existed in all countries except Canada.

² France and Japan also approved licences and similar property rights, although in the former case this did not involve a general review.

³ All review systems ensure net benefits or the national interest. Those specified attempted to increase net benefits.

⁴ Excludes restricted sectors, including natural resources, where such a search is sometimes implied.

⁵ Apart from major resource projects and those related to fiscal incentives.

⁶ OECD (1979, Part III) gives data on number of rejections for three years in the late 1970s for the countries shown here as rarely rejecting formal applications. The totals for three years ranged from none for the UK to four for Norway.

⁷ Includes acquisitions.

Table VI.3. Position of OECD countries regarding sectoral controls and impediments to inward direct investment (August 1986)

Countries	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	
Australia	RI	R			RI	R	M				M	M	R	R	R	R	R	R	R		M	M				M	R									
Austria	RI	I	R	I		M	M			M	R	R	R		R	R	R					R				M	R				M	M				
Belgium				I		M	M				M	M	M									M														
Canada	RI	R		M	R	R	M					R			R	R	R					M									R					
Denmark				RI																			I													
Finland	RI	RI		M		M	M		M	M	M	R	R		R	R		R	R			R	R	R	R	M				M						
France	RI	RI	R	RI	I	M	M	RI	R		M	M	R			M	M	RI		M	RI	M	M		RI	R	R	R	I		M				M	
Germany	I					M	M				M	M	R				RI									M										
Greece	RI			I		M	M				M	M	MI		I	I	M						M				M									
Ireland	RI	I		RI		M	M				M	M	RI	R					R																	
Italy	RI			RI		M	M				M	R	R			I	R				M	M	M			M										
Japan	I	I				I	MI					I	I	R		R	R	R	R												M	M				
Luxemb- ourg				MI		M	M																M													
Nether-lands	RI	I				M	M				M	R	R										M	I												
New Zealand				M			R	M			M	M	R		R	R							M													
Norway	RI	R		RI		M	M				M	R	R	M	R	R		M				R	M			R	M			M				M		

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Table VI.3. Position of OECD countries regarding sectoral controls and impediments to inward direct investment(concluded)

Countries	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35			
Portugal	R			RI			M	R			M	M	MR				M					M	M		R									M	I			
Spain		I		MI		MR	M				M	R					M									R								M				
Sweden	R	R		I		M	M			M	M	R	R		R															M				M				
Switzer-land	RI	I				M	M	R			M	MI	MI		R		M				I	I	I	M									M					
Turkey	RI	I		RI		M	M			R	M	M			R	R	R																M	M				
United Kingdom	I	I		I		MR	M				M	R	R																									
United States	I			I		MR	MR				R	R	R	R	R	R	R																					

Source: Safarian (1993), pp. 448-449 and OECD (1987).

Notes:

R = Sectors in which some or all activities are subject to controls or impediments to inward direct investment that are regarded as restrictions in the sense of the Code of Liberalization of Capital Movements.

I = Sectors in which some or all activities are restricted by other impediments.

M = Sectors in which some or all activities are closed to investment due to public, private or mixed monopolies.

This table shows on a country-by-country basis those sectors which, to a greater or lesser degree, are restricted to foreign investment either because of *obstacles* which apply specifically or more severely to non-resident investors, or because of the presence of public, private or mixed *monopolies*. Where obstacles are considered as restrictions in the sense of the Code they are marked with an R. In other cases, an I (for Impediments) is used. Monopolies are indicated with an M. As a result of space limitations, some sectors include a number of specific activities (see, for example, maritime transportation); the presence of an obstacle or monopoly in any activity of that sector results, as far as this table is concerned, in a mark being entered against the entire sector. In some instances, an activity of a specific sector may be restricted in the sense of the Code and an R appears in the column, while in another activity of the same subject a monopoly may exist, which is reflected by an M. Thus, for the same sector, two letters may appear. Detailed information is not available for Iceland which maintains a general derogation from the obligations of the Code of Liberalization of Capital Movements.

Key to table VI.3

Banking	1
Other financial services (including stockbroking)	2
Auditing	3
Insurance	4
Press, publishing, printing	5
Broadcasting (radio, television, cable)	6
Post, telephone, telecommunications	7
Audio-visual works, film distribution	8
Health and social security	9
Employment agencies and services	10
Land transport (includes railways, buses, road construction and maintenance)	11
Air transport (includes airport construction and operation in some cases)	12
Maritime transportation (includes shipping, ship brokerage, forwarding, inland waterways, operation of seaports, cabotage, offshore supply, salvaging and dredging, ownership of fishing vessels)	13
Fishing	14
Real Estate	15
Mining, minerals	16
Petroleum	17
Agriculture, agricultural products	18
Forestry	19
Nuclear industries	20
Exploitation of water resources, water power	21
Overall energy production and public utilities (including water, gas, armaments explosives, gunpowder)	22
Security guard and private detective services	23
Tourism, travel services	24
Gaming, casinos, lottos, lotteries, etc.	25
Jurisprudence, legal profession	26
Teaching, education	27
Merchants and craftsmen	28
Import, export and distribution of alcoholic beverages	29
Tobacco, matches	30
Salt	31
Pharmaceuticals, medicines, narcotics	32
Steel	33
Public works and services	34

Source: OECD (1987).

E. Natural resource-based host economies with formal review mechanisms

Five smaller primary-resource countries had formal review mechanisms in the period covered in this study: four of these (Australia, Canada, New Zealand, Norway) had primary goods as a large share of exports and far more inward than outward FDI stocks. Sweden fits awkwardly into this group since outward FDI greatly exceeded inward, and primary goods had become a fairly small share of exports. Nonetheless, they shared a desire for some domestic ownership in natural resources as well as other domestic benefits from their exploration.

I. Australia

Australia was relatively open to FDI until the late 1960s except for a few sectors. Some financing institutions were established to help Australians participate in natural resource and industrial development. In the early 1970s, policies were developed to close some further sectors to FDI, to assure economic benefit in other sectors by a review mechanism, and especially to require at least 50 per cent Australian ownership in new natural resource projects.

Recommendations on industrial projects were made by the Foreign Investment Review Board, which worked closely with the Treasury. The evaluation consisted of two stages. A necessary condition of net economic benefit had to be satisfied with respect to competition, technology introduction or new managerial or workforce skills, new export markets, and an improved economic structure (box VI.1, part a). If it was decided that the proposal was not contrary to the national interest in these respects, the additional criteria noted in box VI.1 were applied, including local processing, R&D, and other factors.

Box VI.1. Criteria for examination of proposals, Australia, 1982

Whether, against the background of existing circumstances in the relevant industry, the proposal would produce, either directly or indirectly, net economic benefits to Australia in relation to the following matters:

- competition, price levels and efficiency;
- introduction of technology or managerial or workforce skills new to Australia;
- improvement in the industrial or commercial structure of the economy, or in the quality and variety of goods and services available in Australia; and
- development of or access to new export markets.

If a proposal is judged to be not contrary to the national interest on the basis of the above criteria, the following additional criteria are taken into account:

- Whether the business or project concerned could be expected to be conducted in a manner consistent with Australia's best interests in matters such as:
 - local processing of materials and the utilization of Australian components and services;
 - involvement of Australians on policy-making boards of business;
 - research and development;
 - royalty, licensing and patent arrangements; and
 - industrial relations and employment opportunities
- Whether the proposal would be in conformity with other government economic and industrial policies and with the broad objectives of national policies concerned with such matters as Australia's defence and security, Aboriginal interests, decentralization and the environment, as well as with Australia's obligations under international treaties;

/...

Box VI.1. Criteria for examination of proposals (concluded)

- The extent to which Australian equity participation has been sought and of the level of Australian management and control following implementation of the proposals;
- Taxation considerations (including the manner in which the proposal is to be financed);
- The interests of Australian shareholders, employees, creditors, and policyholders affected by the proposal.

Foreign investment proposals do not have to satisfy all of the examination criteria listed above in order to warrant approval. The list is drawn upon to the extent appropriate to the circumstances of each proposal and the importance of each criterion; and the extent to which proposals are required to meet the criteria varies from case to case:

Where proposals concern areas of the economy in which foreign ownership and control are already extensive or would become extensive as a result of their implementation, the Government expects the proposals to provide for significant economic benefits and/or significant Australian equity participation before approval is granted. Special requirements and guidelines apply to proposed foreign investment in the natural resources sector and in real estate, finance and in real estate, finance and insurance, the media and civil aviation.

Source: Safarian (1993), p. 90 and Australia, Department of the Treasury (1982, pp. 6-7).

Note: In 1983 the criteria were extended to include explicitly the opportunities for Australian contractors and consultants to engage in construction, the introduction and diffusion of technology and other skills, and limitations on export franchises. In 1986-7 the less demanding and less specific criterion of national interest was substituted for net economic benefit as measured above, except for the still restricted sectors.

All of this would prove extremely difficult to evaluate within the 140 days allowed (more than this for some natural resource projects) were it not for certain procedural and substantive decisions. Smaller proposals were generally not reviewed, and in many proposals one or two key aspects would be the focus of attention. Takeovers would be reviewed for benefits more fully than would those for new investments.

The Board was prepared to accept that full ownership was needed to protect proprietary technologies or information. However, it was also clear that a strong emphasis on Australian ownership in some sectors was the key to the entire policy. Some sectors such as broadcasting and life insurance were closed in part or whole to foreign ownership. In minerals, agriculture, fishing and forestry all but the smallest new projects were examined in terms of the criteria noted but, more specifically, had to involve at least 50 per cent Australian equity and Australian voting strength on the board. A delay could be allowed in meeting the Australian ownership provisions, for example, if financial market conditions were unfavourable, but this particular requirement was monitored.

In the mid-1980s, there was a significant liberalization of policy, partly in response to a sharp deterioration in Australia's external economic position. For example, the thresholds for review were raised and the 50 per cent ownership rule was withdrawn for new oil and gas projects, but not for mining. In the 1990s, a number of grants and tax concessions were developed or improved to steer FDI in a desired direction. Thus, "liberalization" of FDI policies, however, did not mean that the Government lost interest in assuring or increasing the potential gains from FDI.

Compared with those of other developed countries, Australian policies in the 1970s and 1980s can be described as relatively open to FDI (given the review mechanism), relatively stable and relatively clear in terms of priorities (Safarian, 1993, pp. 97-113). In terms of openness, only one-third of approved applications in 1976-85 had conditions attached to them. More importantly, most of

these conditions were about Australian equity participation (largely in minerals), resale of an acquisition (largely real estate), and taxation. They were not in the main about performance requirements on economic performance. A sentence on page 5 of the Review Board's annual report for 1984-85 states this very clearly:

"The Board has avoided recommending the imposition of conditions that would require the parties to alter aspects of their proposed investments relating to the operations and conduct of their business: such 'performance requirements' would not be in the commercial interests of the parties to the proposals and would represent an unwarranted incursion of foreign investment policy into business affairs."

This contrasts with the experience of, for example, Canada, France and Japan, all of which put major emphasis on performance requirements in the general review process. The Australian rejection rate for proposals was only 2.4 per cent on average before the liberalization of the mid-1980s. By contrast, there was strong emphasis on the policy of Australian participation in ownership of natural resources and real estate, and on preserving some domestic ownership where foreign ownership was already high.

The implementation of these policies sometimes ran into problems with state governments, which have direct responsibility for resource development, including responsibility to bargain with firms on supply of infrastructure and royalties. Several states had ownership-related policies of their own, for example, New South Wales attempted to get 51 (rather than 50) per cent Australian ownership. The main problems arising between the federal and state governments have been concentrated on how the former finances grants to the latter, and on large state subsidies to projects because of inter-state competition, which can reduce the rents which federal policies are intended to capture.

2. *Canada*

Canada's experience with FDI has some similarities to that of Australia but also some profound differences. It would be difficult to describe Canadian policy in this area as relatively stable, for example, or the policy priorities as being relatively clear. Canada's situation differed in some important respects. For most of the period of this study, foreign ownership of Canadian industry was higher than for the other countries, including the relatively high Australian figure. Such ownership rose dramatically in the period up to 1970, then fell equally dramatically until the late 1980s when it began to rise again. FDI flows into Canada was dominated by the United States, while in Australia the United States and the United Kingdom each played an important role on the inward side in the 1970s and Japan already had a significant though smaller role.

In the late 1950s and later, a number of sectors were partially or wholly closed to foreign ownership, culminating in the establishment of a Foreign Investment Review Agency in the early 1970s and a major new sectoral initiative in the National Energy Programme in 1980. Both political and economic concerns lay behind these policies. At the political level the United States extraterritorial law and policy in a number of sectors were widely resisted, as was foreign ownership in sensitive sectors. The entire question of FDI became linked with the problems of developing distinctive Canadian policies in a number of areas when trade, communications, military and other links with the United States were developing rapidly. In terms of microeconomics, there were concerns that substantial reliance on FDI was leading to a "truncated" or dependent form of development with weak R&D and manufactured exports combined with strong imports of high value-added products.

There was considerable questioning on whether FDI was the reason for the observed problems and whether the best measures were used to correct them. The concerns about FDI were also stronger in the industrial heartland, Ontario, than in many other parts of the country. Nevertheless, particularly after introduction of the United

States temporary import tax at the beginning of the 1970s, part of the so-called "Nixon shock", the Canadian Government began seriously to consider ways to reduce its susceptibility to external shocks.

Part of this effort was to increase Canadian capacities to undertake investment, involving a wide array of policies such as improvements to technological capabilities and institutions such as the Canada Development Corporation. Part of the effort, both before and after 1970, was to close a sector in part or whole to foreign ownership, sometimes, but not always, with an exemption for existing firms. Where partial foreign ownership was allowed, an effort was made to assure that effective voting control remained in Canada. Tax incentives by the federal government encouraged firms more generally to issue 25 per cent or more of their shares to the public. There was limited success with this latter programme.

The Foreign Investment Review Agency and the National Energy Programme formed two major and somewhat unusual policy instruments. From 1974-75 onwards review of inward FDI in new investments and acquisitions was required, with some exceptions. The investor had to show that significant benefit would occur to Canada as determined by five factors:

- (a) The effect of the investment on the level and nature of economic activity in Canada, including employment, resource processing, domestic sourcing and exports.
- (b) The degree and significance of Canadian participation in the business enterprise and in the industry sector to which the enterprise belonged.
- (c) The effect on productivity, industrial efficiency, technological development, innovation and product variety in Canada.
- (d) The effect on competition in Canada.
- (e) The compatibility of the investment with national industrial and economic policies, taking into consideration the industrial

and economic policy objectives of the province(s) likely to be significantly affected by the investment.

The Foreign Investment Review Agency process was quite formal. It had a clear legal basis and a well-staffed agency.¹⁴⁷ The individual decisions were made by the Cabinet after recommendation by the Industry Minister and after consultation in all cases with the province or provinces involved as well as the relevant federal ministries. The process was somewhat simplified by exemptions for smaller proposals and in other ways, but the burden was large since the Agency had to assure significant benefit on a range of issues going well beyond the Australian emphasis on ownership and natural resources.

The investor was required to note the benefits to Canada by way of a series of 'undertakings' in the proposal. The Agency did not hesitate to bargain in order to improve the undertakings. Once the undertakings were put into writing by the Minister in a letter granting entry, they had the force of law. Some of them were general or amounted to best-effort pledges, hence would be difficult or impossible to monitor effectively. Others were quite specific and unqualified. The Agency had to survey these more specific undertakings annually until they were met. It used random and detailed audits on the reports made in this connection by the firms. The Agency had a significant enforcement unit. Legal proceedings could be instituted if the foreign firm failed to file an application, or to meet the condition associated with entry, or to comply with an order of disallowance. Legal proceedings were, in fact, begun against a few firms (Harvey, 1981, 144-5, 174-7).

The annual reports of the Foreign Investment Review Agency showed the disposition of every case before it, and also noted the significant benefits expected in each case by the various factors of

¹⁴⁷ The Agency staff members numbered 130, half of whom were professional and technical personnel. Like other such agencies, it would draw at times on personnel from other departments.

assessment. The Minister's press releases showed the actual undertakings given by applicants as a condition of allowance of the investment. Unlike the Australian agency, the Canadian agency did not have a clear mandate on its priorities from the Cabinet, hence was not in a position to inform firms clearly on what was expected of them. While rejection rates are subject to interpretation, it is worth noting that the Canadian agency's rate was 7 per cent in 1975-84 while the Australian agency's rate was under 3 per cent. Withdrawal of applications was also more common in Canada.¹⁴⁸

Meanwhile, external criticism of the National Energy Programme also spilled over to the Foreign Investment Review Agency. In addition, the United States secured a ruling from the GATT that undertakings given to this Agency contradicted treaty obligations with regard to imports, and the United States Congress enacted a bill authorizing the President to challenge export requirements as a condition of investment. In 1985, with a new Government, Investment Canada replaced the Agency. Review became limited to larger acquisitions, although it continues for all cases in the cultural sectors and energy, and recommendations no longer go automatically to Cabinet level. New investments require only notification. No formal proposal was rejected up to 1990.¹⁴⁹

Under the Canada-United States Free Trade Agreement of 1989 each country agreed not to require new performance requirements but existing laws and regulations could continue. Takeover review for United States acquisitions was to be raised from

¹⁴⁸ The job of the Canadian agency would have been even more difficult if proposals made by the Government in 1980 had been put into effect. These involved systematic publication of proposed foreign takeovers together with subsidies for competing bids by domestically owned firms, as well as regular performance reviews for the larger established foreign-owned firms. These proposals were dropped under the pressures of the recession of the early 1980s and because of doubts about their feasibility. To the contrary, the FIRA was changed in 1982-3 so as to clarify its role and to speed up its decisions.

¹⁴⁹ For a summary of the undertaking given to Investment Canada in 1985-89, see Safarian (1993, pp. 135-36).

\$5 million to \$150 million, except for cultural industries and upstream oil and gas. National treatment was to be developed for each country's financial sectors. The NAFTA later imposed a string of restrictions on the use of performance requirements in Article 1106, far more, for example, than those in the TRIMs agreement (see also chapter I).

The National Energy Programme of 1980 involved several objectives, two of which were to reduce the high foreign ownership of oil and gas revenues and to allow the federal government more control on the development of the industry. These objectives were to be achieved by giving substantial fiscal incentives to public and private firms to buy out foreign-owned assets. Significant repatriation of assets did occur, but at some cost in terms of Canada-United States relations and in view of the collapse in the value of these assets with the fall in the price of energy. Most of the Programme was dismantled by the new Government.

Two differences of the Australian and some other country experiences should be noted here. The undertakings given by firms to the Canadian investment review agency as a condition of entry were similar to "performance requirements", unlike the conditions applied by the Investment Review Board in Australia, and there was a more consistent effort in Canada to follow up on the undertakings. The New Energy Programme actually intended to reduce existing ownership, not just to operate at the margin with shared ownership on new projects, and sought effective control beyond what was attempted in Australia.

3. *New Zealand*

In New Zealand, inward FDI began to be reviewed in or shortly after the mid-1960s. This evolved into an Overseas Investment Commission in the early 1970s. Proposals were recommended for approval by the finance minister (who in practice considered only about 5 per cent of cases) based on an assessment of benefits as noted in box VI.2. In addition some types of real property purchases required approval.

**Box VI.2. New Zealand: criteria for examination of proposals,
1973 and 1979**

January 1973 Statement

The Government's major objectives in supervizing overseas investment were stated as:

- (a) To ensure that New Zealand's natural and human resources are developed to the benefit of New Zealand, in a manner which accords with the best interests of New Zealand and consistently with the preservation of a social and physical environment which promotes the well-being of all New Zealanders;
- (b) Within this overriding objective, to maximize the benefit to New Zealand available from the international transfer of capital and technology, and thus to ensure that overseas investment contributes to the maintenance of a satisfactory rate of economic growth in New Zealand, while making certain that ownership and control of New Zealand resources is not unwisely or unnecessarily transferred to overseas residents.

The detailed criteria applied to each case were as follows:

- The extent to which New Zealand resources of raw materials and human skills would be combined and developed to the most advanced stage which is economically feasible or desirable and having regard to the impact on employment opportunities.
- The compatibility of the proposal with government policies on the protection of the environment and regional development.
- The degree to which the proposal would extend New Zealand's access to technological developments and scientific research conducted overseas and the extent to which research and development would be stimulated in New Zealand.

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**Box VI.2. New Zealand: criteria for examination of proposals,
1973 and 1979 (continued)**

- The extent to which the proposal would promote New Zealand's industrial growth and efficiency by increasing the degree of export orientation and helping to provide access to new or extended export markets.
- The impact of the proposal on productivity, with particular reference to the effects on costs and prices in New Zealand.
- The impact of the proposal on the structure and competitiveness of the industry or industries of which it would form part, and on linkages with other New Zealand industries.
- The contribution to product innovation, marketing expertise and consumer choice in New Zealand.
- Where the interests concerned with the proposal are operating on a multinational basis, the role of the New Zealand proposal in their total operations, with particular regard to the firm's export and pricing policies, its other international strategies and New Zealand participation.
- The taxation yield to New Zealand in relation to the benefits which the overseas company derives from its New Zealand activities, with particular reference to the taxation aspects of its pricing policies and the ratio of equity to loan capital.
- The balance of payments implications of its proposal, including the cost of servicing the investment, the amount of capital inflow and the extent to which this supplements or adds to the overseas capital available through other channels, either to the Government or to the private sector in New Zealand.
- The degree and significance of participation by New Zealand shareholders in relation to the nature of the individual overseas enterprise and the competing needs of New Zealand-owned enterprises for local equity capital.

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Box VI.2. New Zealand: criteria for examination of proposals, 1973 and 1979 (continued)

- Overseas interests wishing to acquire control of an existing New Zealand firm are required to demonstrate that their proposal will bring substantial new benefits to the New Zealand economy which would not be provided by continued local ownership. Due consideration is given in individual cases to the relative opportunities for the disposal of the assets to other New Zealanders.

July 1979 Statement

The aim of this revision was to make it quite clear that the Government welcomed foreign investment that can contribute to the development of New Zealand, and especially to underline that the 25 per cent level of foreign equity simply triggered Commission involvement rather than required local equity participation. The criteria to be applied to each case were as follows:

- (a) Added competition to local industry, lower prices and greater efficiency.
- (b) The introduction of new technology, managerial or technical skills.
- (c) The development of new export markets or increased market access.
- (d) The extent to which the proposal is likely to make a net positive contribution to the balance of payments.
- (e) The creation of new job opportunities.
- (f) The promotion of New Zealand's economic growth.

In weighing up the benefits of a proposal the following factors will also be taken into account:

/...

Box VI.2. New Zealand: criteria for examination of proposals, 1973 and 1979 (concluded)

- (a) The degree of equity participation by local shareholders in relation to proposals which involve the ownership and control of New Zealand's natural resources.
- (b) Potential impact of the proposal on the environment and on regional development.
- (c) The implications of the proposal for the Government's other economic and industrial policies and any other national policies which might be affected by the proposal.

The relative opportunities of shareholders in small private companies to dispose of their shares to the best advantage.

Source: Safarian (1993), pp. 158-59.

While the stated intent of the Overseas Investment Commission was to promote benefits and decline undesirable investments, there was no attempt to negotiate undertakings. A largely part-time Commission and a staff of only six persons could hardly fulfil such a task. The criteria on local equity involvement was considerably downgraded in 1979, except as noted below. In most cases no formal commitments on economic performance were required, hence no monitoring of these was needed. The conditions attached typically limited firms to existing or proposed fields, or referred to certain exchange control provisions.

However, the Overseas Investment Commission did encourage preliminary discussions which led to modifications or non-submission of proposals. The rejection rates rose for a time in the early 1970s with a Labour Government, which examined proposals more critically. Most of the subsequent rejections reflected proposals where a subsidiary was intended basically to serve as an import mechanism.

There was much concern about the impact of large projects. The Government required 50 or 51 per cent domestic ownership in petroleum and natural gas, and attempted to secure at least 51 per cent private or public New Zealand ownership in other major resource projects. Detailed cost-benefit analyses would be undertaken with a view to increasing domestic inputs and processing. Both domestic and foreign firms would be closely examined in these respects, but most would have a large degree of foreign ownership.

New Zealand also had fiscal incentives for investments, regardless of ownership, which met certain objectives: increased manufacturing and exports, greater innovation capacity and regional development. One technique was suspensory loans for exports and regional development, loans which were converted to grants if the objectives were realized. Such techniques had to be changed or ended with the 1980 GATT agreement and provisions of the Close Economic Relationship with Australia.

The Labour Government elected in 1984 and re-elected in 1987 began to unravel the regulatory framework that New Zealand had sustained since the 1930s, including foreign exchange controls, a high degree of import protection, and price and income controls. Interestingly, not much was done to unravel the controls on inward FDI, perhaps because they were already less stringent with review than in other natural-resource countries. The level for review, however, was raised and more proposals were routinely processed, but close analysis continued for FDI in larger resource projects.

4. *Norway*

Norway's policies on inward FDI date back to the early 1900s. While it had antecedents, the concession law of 1917 involved a comprehensive approach to foreign ownership. FDI required a special permit to acquire waterfalls (the basis for electrification), mines, or other real property including forests. Concessions were also needed to lease property for industrial uses, and purchases of electric power required that the majority of the

firm's executive board members should be Norwegians. In effect, the concession laws provided the basis for domestic control of natural resources and also for review of incoming FDI. The basic rules for concessions in the law also applied to domestic firms in the case of waterfalls and mines and were focused on the following:

- (a) Regulation of the capital structure of the firm, including the proportion of equity to the total.
- (b) Norwegian labour, insurance companies and materials "should preferably be used".
- (c) Any approved exports (imports) be at prices no lower (higher) than normal world market prices.
- (d) Processing in Norway to the extent stipulated by the Government.
- (e) Approval by the ministry of any agreement regarding payment for financial, technical and commercial assistance.

As FDI into Norway expanded in the 1960s the policies were clarified. The Department of Industry in 1963 noted the following criteria on which a concession application would be judged:

- (a) The effects on income, production and employment.
- (b) Location of the project especially with regard to areas of low-income development.
- (c) The extent of foreign financing, and especially the need to import capital in large capital-intensive projects.
- (d) The development of new types of production.
- (e) The possibility of receiving new knowledge.
- (f) The possibility of cooperating with international concerns to secure better or more stable prices and guaranteed access to raw material or exports.
- (g) The extent to which the domestic sector is already developed.

- (h) The extent of competition on the home market and of established Norwegian firms and the danger of monopoly practices.

The Department of Industry had the main responsibility for the concession laws, but in practice this was divided among several departments or agencies which consulted closely, especially on major projects. There was no detailed information on how these criteria were applied to particular applications for concessions. It appears that the emphasis in preliminary discussion and subsequently was to clarify what needed to be done to secure the concession, rather than systematic bargaining to maximize gains. Acquisitions were examined more closely which sometimes led to a joint venture rather than full acquisition.

As a result of the concession laws, Norway had some experience in dealing with large resource projects when the oil and gas industries were developed. Rather than the auction system used in many other jurisdictions, the Government selected from among the proposals made to develop a portion of a field. The basis for choice was not entirely clear, giving the Government a degree of bargaining power. In terms of production participation, the state-owned Statoil was given 50 per cent in each case and could obtain much more in prosperous blocks, while 5 per cent went to smaller Norwegian firms. Typically TNCs received 5-20 per cent as did two larger Norwegian firms. Firms were expected to inform the Government of larger contracts or purchase proposals so that local firms could bid on them. Taxes and royalties were levied in addition to participation provisions.

5. *Sweden*

Sweden is a highly industrialized economy, and is also heavily engaged in the international economy. Three aspects of its foreign investment policy are worth noting here: concession laws on natural resources, inward FDI review, and – unusually – its attempts to review outward FDI.

The concession law of 1916 required the consent of the Government where natural resources were acquired. This law extended to Swedish firms, which would be exempted if the articles of association limited foreign ownership of the firm. However, it was not until the late 1960s and early 1970s that formal steps were taken to allow the Government to limit FDI beyond the natural resource sector. A new law in 1983 set out more clearly the approval process for inward FDI.

Review was restricted to takeovers and to increases in foreign ownership of a firm above specified limits. The Department of Industry was responsible for the review, consulting with other departments. There were no formal criteria beyond the broad ones in previous laws, such as consistency with essential national interests. The focus was on managing the structural changes which accompany most takeovers, such as reductions in the workforce and changes in supply sources, and assuring that such changes protected Swedish interests. Consultations with trade unions and professional groups took place on some of these matters.

The commitments were relatively few and ran for three to five years. The 1983 law stated that they could not be tied to approval, but also said they helped the Government to reach a decision. This somewhat informal and apparently ambivalent approach reflected at least two things. Except for a few sectors, foreign ownership in Sweden was low. Also, the debates preceding the 1983 law revealed deep differences, with trade union groups favouring something closer to the Canadian model and employers' associations adamantly opposed. Under the 1983 law the Government was in a position to say that performance requirements were not exacted in return for approval of takeovers, while also encouraging firms to make "voluntary" commitments. The restrictions on inward FDI, including those on takeovers, were removed in the early 1990s. FDI inflows increased greatly, with the result that foreign ownership is now much higher in several industries.

There was much debate in the period covered here on how outward FDI impacted the local economy and of particular groups. The exchange control was strengthened in 1969; one provision was that approval of outward FDI required promotion of exports or improvement of the balance of payments in other ways. Under an Act of 1974 the Exchange Control Board could consider aspects of employment and industrial policy in considering proposals for outward FDI. Such a proposal could be declined if it "would inflict extraordinary harm to the country's interests". No application was actually rejected, however, although some may have been withdrawn or revised. In 1981 the foreign-exchange law was revised so that only the financing aspects were taken into account.

F. Other countries with review mechanism

France and Japan are not abundant in natural resources, but had review mechanisms of considerable significance.

1. France

France is distinctive from other western European countries both in the relatively high degree of industrial planning and relatively more developed policies towards inward FDI. Both of these were aided by the existence of a large public sector and by a private sector consisting of large groups with close ties to the public sector. Restrictive policies on inward FDI date from the early 1960s when attempts were made to maintain a French presence in high technology firms, particularly in response to takeovers by United States firms. A new law in 1966 complemented the exchange control process used earlier. The French authorities then began more systematically to encourage FDI in some sectors while discouraging it in others.

In the early 1980s the review system had the following characteristics. A prior declaration of an FDI, regardless of its size, was made to the Treasury Directorate of the Ministry of Finance and Economy. The declaration would describe the activities proposed, including funding and the effects on the French economy. All but

routine cases would go to an interdepartmental committee, while sensitive ones would go to the Premier's office or even that of the President.

The central issue was the consistency of the FDI with both the macro plan and any industrial plans. There was no formal list of criteria beyond broad international policy statements but knowledge of plans for the sector helped, as did initial discussion. Four criteria were important in the 1970s: nationality of the investor, with preference for European Community investors and, at times, resistance to United States investors; economic growth effects, including employment, regional balance, and promotion of local R&D; effects on industry structure, such as whether foreign ownership was already high, how strong were the local firms, how the FDI would impact French attempts to create competitive French-controlled TNCs; and the likely effects on the balance of payments, especially of the attempt to increase exports (Bonnaud and Bossier, 1973, pp. 520-21).

The conditions attached to approvals were not made public. They were usually quite specific and short-run, hence realizable, such as carrying out a given amount of real investment in a given period, maintaining employment for a period, and maintaining a research facility. The follow-up on such conditions was not highly developed, often simply a request for a balance sheet or a report on a building plan. There were no penalties in law for failing to meet these and other conditions. However, it is important to add that many of the requirements were accompanied by financial or regulatory support. In a system where government and firms interacted a great deal in such ways, firms were likely to take seriously the conditions to which they had agreed.¹⁵⁰

¹⁵⁰ An FDI proposal might be allowed to proceed, or discussions on improvements in the proposal might begin in order to meet government plans for the industry, or the proposal could be postponed indefinitely as a way of avoiding outright rejection.

France had a number of sectoral restrictions on inward FDI as noted in table VI.3, many of which aimed at keeping a French presence rather than fully blocking FDI. Beginning in the early 1960s an attempt was made to keep a French presence in the computer sector, partly for defence reasons. Despite major financial and regulatory support at various times up to the 1990s, a commercially successful French firm (later, a joint venture) turned out to be difficult to maintain. The review of foreign entry was used to maintain a French presence in fields such as electronics, pharmaceuticals, food processing, paper, biotechnology and automated machine tools.

Even allowing for a high degree of pragmatism in practice, French policies on FDI were more ambitious than those of any considered here, except perhaps those of Canada and Japan. It should be noted that in the late 1980s the remaining foreign-exchange controls were largely ended, but a review process remained.

2. *Japan*

Japan's policies on FDI are unusually difficult to summarize. The intuition that Japan is distinctive begins with the fact that the stock of outward FDI was over eight times the stock of inward FDI in the mid-1980s.¹⁵¹ Despite huge economic change since the Second World War, and significant liberalization of trade and investment policies in the 1980s and later, Japan maintained very low levels of foreign ownership and rapidly growing levels of outward FDI.

Although the transition from one to the other took some time, a distinction between pre- and post-1980 should be made in policy on inward FDI. Before 1980 the key to policy was the Foreign Exchange and Foreign Trade Control Law of 1949 and the Foreign Investment Law of 1950. Until 1967 in principle, and longer in

¹⁵¹ This can be compared with small open economies such as Sweden and Switzerland where this outward/inward FDI ratio was four times and countries such as Germany, France, the Netherlands, the United Kingdom and the United States where it was between one and two times.

practice, policy favoured licensing of technology or, at most, joint ventures controlled in Japan. A Foreign Investment Council under the Finance Ministry, plus the relevant ministry – usually the Ministry of International Trade and Industry – considered applications. The criteria for approval were that the application should show a) a clear contribution to technology development, b) a contribution to exports (or a saving on imports), c) no competition with Japanese industry, d) less than 50 per cent foreign equity (*The Economist*, 14 August 1965, pp. 626-27). The president of a joint venture was usually Japanese.

In the period 1950-64 only 209 joint ventures were approved under this policy, of which 4 per cent were wholly owned abroad and 9 per cent were majority foreign-owned. A major exception was the 289 yen-based companies which were 100 per cent foreign-owned but did not have an unconditional guarantee to repatriate earnings and principal. Some major TNCs entered under this exception which was ended in 1963. In the meantime, between 1950 and 1964, Japan approved about 3,000 foreign technical-assistance contracts, a figure which was about 12,000 at the end of 1972 (Japan, Ministry of Finance, 1974, p. 28).

Liberalization of these policies began in 1967 in two quite modest phases, usually in areas which offered little competition to Japanese firms. Joint ventures with 50-50 participation were still the rule. The Finance Ministry issued informal guidelines in 1967 of the expectations from foreign firms.¹⁵² These included, among others, expectations on joint ventures, technological development, exports, and employment maintenance, and called upon these firms to:

- (a) Seek coexistence and prosperity with Japanese enterprises through joint ventures on an equal partnership basis.
- (b) Avoid concentration of investment in specific industries.

¹⁵² From Yoshino (1975, p. 279). The phrase "maintain proper industrial order" in point 4 can be understood as avoiding "excessive" competition with local firms.

- (c) Avoid suppressing small enterprises when entering into industries characterized by small firms.
- (d) Cooperate voluntarily with the Japanese effort to maintain proper industrial order.
- (e) Avoid entering into unduly restrictive arrangements with parent companies abroad, and do not resort to unreasonable restrictions concerning transactions or to unfair competition.
- (f) Take positive steps towards developing Japanese technology, and do not hamper the efforts of Japanese industries to develop their own.
- (g) Contribute to the improvement of the nation's balance of payments through exports and other means.
- (h) Appoint Japanese members to the board of directors and to top management positions and make shares of company stock available to the public.
- (i) Avoid closures of plants, mass dismissal, and unnecessary confusion in employment and wage practices by paying due regard to the prevailing Japanese practices.
- (j) Conform to the Government's economic policy.

Three further phases of liberalization followed in the 1970s. That of 1973 allowed 100 per cent foreign ownership of new firms, with some exceptions. Takeovers were now possible but until 1980 only with the consent of the acquired firm. In 1980 a Combined Foreign Exchange and Foreign Trade law was adopted. Administrative exceptions were to give way to those specified in law. Notification of inward FDI was retained to deal with a set of restricted sectors and companies, and also with other firms which met certain criteria. FDI could be modified or rejected if:¹⁵³

¹⁵³ All references are to Japan, Ministry of Finance, 1980.

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- (a) Emergency situations prevail "when a drastic change occurs in the international economic situation";
 - (b) "it might imperil the national security, disturb the maintenance of public order, or hamper the safety of the general public";
 - (c) "it might adversely and seriously affect activities of our business enterprises engaging in a line of business similar or related to the one in which the direct domestic investment, etc., is to be made, or the smooth performance of our national economy".

It is difficult to comment on the approval process for inward FDI both before and after the 1980 law, given the differences compared to other business and government cultures. Details on the conditions attached to approvals are not known after about 1967. Two points may demonstrate the problems of making such comparisons with other countries. First, in the period 1975 to 1977 there were 1,898 applications for FDI of which one was refused and 28 withdrawn by the investor. Both before and after 1980 the authorities preferred to avoid outright rejection of an application as practised in some other countries: prolonged delays or impossible conditions had the same effect. Second, takeovers were difficult in any case and there was an aversion to hostile takeovers in particular. There was close holding of shares by the largest keiretsu and many mergers and acquisitions were simply intra-group rationalizations.

The exceptions to the permitted 100 per cent foreign ownership by FDI are worth noting. For a few years foreign acquisitions beyond 25 per cent in 11 major companies were monitored. In several primary resource sectors the third criteria noted above was invoked to allow close review, that is, entry would be difficult. The criteria could be extended to other sectors which were significantly negatively affected by an investment.

Only Japan has included some types of technological assistance contracts under its general review of inward FDI. Patents, trademarks and know-how licences were regarded as a form of FDI.

Review of three interrelated processes – import contracts in the earlier period, FDI, and technology assistance – gave the authorities considerable power in dealing with foreign investors. One study noted that the technology contracts Japan negotiated in the review process covered much of the technology which the United States and other countries had developed, and helped to develop strong competitors which entered the United States and other markets successfully (U.S. Department of the Treasury, 1978). Up until the liberalization process began in the late 1960s, this power was used frequently to revise technological contracts under consideration by the private parties, for example, to reduce the duration or royalty rates or attempt to limit export restrictions (Henderson, 1975, pp. 230-31). Review continued after 1980 under the second and third criteria noted above for FDI, with some speeding up of the process. This easing reflected the fact that it was becoming more difficult to import technology on terms as favourable as heretofore.

In addition to such review, both domestic and international agreements had to be filed with the Fair Trade Commission, which could reject or modify those which reduced competition or unreasonably restrained trade. Its role became larger as liberalization proceeded with trade and FDI.

In contrast with the inward FDI experience, Japan became a major outward investor. Such FDI was controlled after World War II because of balance of payments pressure. Individual screening was undertaken to promote exports, or to develop imports of natural resources; to assure that the competitive position of other firms in Japan was not damaged; and to support monetary policy (Frank and Hirono, eds. 1974, 59). Liberalization began in the mid-1960s in line with Japan's entering membership of the IMF and OECD institutions. However, prior notification continued for larger FDI after the 1980 law came into effect, particularly for certain local industries such as textiles where outward FDI could have adverse effects, as well as to limit adverse monetary effects. In 1991, prior notification for inward FDI was changed, with some exceptions, to notification after the event. This allowed Japanese authorities to retain a degree of discretionary review for some sectors.

G. Mainly host countries lacking formal review mechanism

1. Belgium

Belgium has been very open to FDI, reflecting the position of a small country trying to advance its investment position in the European Community and also trying to reduce development disparities between its Walloon south and Flemish north. In the time period covered here, foreign takeovers had to be notified for disclosure reasons rather than review. However, the Finance Ministry on several occasions blocked the public takeover of Belgian firms by non-EC firms (Boddewyn, 1974, p. 73). Performance requirements have otherwise only been used as a condition for the receipt of various generous and innovative forms of tax and expenditure programmes.

Supports were generally available to both domestically owned and foreign-owned firms, but FDI, being new to the region, often took more advantage of the opportunities offered by the expanding European Community market and the regional incentives. Belgian support had certain conditions attached to it, which varied with the economic needs perceived by the Government: they included plans for employment creation by the firms, the introduction of new products and technology, regional development, viability of the project, environmental impact, export development, and product or process development (OECD, 1983, pp. 88-89). One of the programmes geared to FDI offered special tax concessions to senior foreign personnel and researchers working in Belgium, a programme which influenced non-European Community firms in deciding whether to locate both senior personnel and European headquarters in Brussels. Where interest subsidies were large, one condition was that convertible bonds were issued to the Government. In such cases state agencies might also be involved in joint ventures, with the state equity purchased by the firm on a given schedule.

2. *Ireland*

Ireland also has a small home market and has until recently suffered from substantial long-term unemployment. In the 1960s, policy changed radically from keeping control of industry in Ireland and high levels of trade protection to introducing large incentives for new manufacturing, especially TNCs geared to exports. Various "voluntary" performance requirements were attached to these incentives.

Two points deserve emphasis: the tax concessions and the organizational framework for policy. There were many forms of industrial support, but the key support was a 100 per cent tax remission on export profits for 15 years. Partly because of its membership in the EC after 1973, Ireland had to develop other forms of incentives. The export relief system was gradually ended after 1981, and a special low rate of taxation for manufacturing in general was introduced for the period 1981-2000 (Safarian, 1993, 301-302).

Of equal interest was the concentration of these programmes in the Industrial Development Authority. This Authority conducted a full economic evaluation of larger projects, but also reviewed the job creation effects of other requests for support. The major objective was job creation, that is, to minimize grant cost per job while securing the investment. McKeon (1980) has summarized the procedure as follows. First, all projects were judged on their future commercial viability, basically their probable profitability based on the plans and capabilities of the firm. The grant cost per job was the key guideline, but the grant level could increase where the proposals showed higher value-added, skill content, R&D and marketing functions developed locally, spin-offs to existing local firms and other factors. Second, a comparison was made of the fiscal threshold with the proposed aid. The idea was that the Government would receive cash flows from extra taxes, as well as revenue accruing from reduced payments for unemployment. This fiscal threshold was then compared with the proposed financial aid, both in present value terms. If the project met the commercial viability and fiscal threshold tests, it was accepted.

Third, there was a much fuller economic evaluation for larger projects or of those where the grant level was close to the fiscal threshold.

This approach did involve the submission of much information on probable performance to help in deciding if a grant should be given and how large it should be. In the vast majority of cases the relatively simple cost-benefit involved in the first two steps noted above was sufficient. The follow-up which occurred was generally with regard to the employment goal, and also to encourage local sourcing in the larger projects in particular. Case studies by Guisinger et al (1985) suggest a lack of performance requirements as generally understood, except particularly on jobs. Some priority areas such as microelectronics also received more integrated policy attention.

Criticism of the policies centred on whether the incentives were larger than necessary, whether sufficient domestic linkage occurred and whether the policies favoured FDI too much. Older industry, largely locally owned, had serious problems adjusting to a more open economy. Some adjustments to policy were made in the 1980s, focusing more on international service development and electronics, and also promoting stronger Irish firms.

H. Mainly home countries lacking formal review mechanism

1. Federal Republic of Germany, the Netherlands and Switzerland

The Federal Republic of Germany, the Netherlands and Switzerland did not review inward FDI. However, in each case it would have been difficult for foreign firms to buy an important local firm, and especially to undertake a hostile takeover of a listed firm. In part this reflected a tradition of negotiating takeovers of listed firms as against hostile bids, and in part it reflected government ownership, particularly widespread in the Federal Republic of Germany. In all three countries a wave of takeovers in the 1960s led to firms taking a variety of measures to protect against hostile takeovers. Finally, bank

holdings of significant equity shares in firms, plus bank powers to vote proxy shareholdings in the Federal Republic of Germany, meant that bank approval would be necessary in many cases.

The measures served to limit domestic as well as foreign takeovers. Yet it is clear that at times the measures were directed at foreign firms in a fairly coordinated way, as in the somewhat exaggerated concerns about Middle Eastern investments in the 1970s. Each of these countries supplied significant incentives to investment by way of tax concessions, subsidies, and other means. The conditions involved tended to be eligibility criteria related to regional or sectoral development, productivity improvement, economic adjustment and similar objectives, rather than the performance requirements covered in this study directed at FDI. Some of the policies also allowed more discretion in awards. For example, state subsidies in particular were believed to be partly responsible for the large number of foreign-owned refineries which located in the Federal Republic of Germany (OECD, 1983; Franko, 1976, p. 151).

2. *United Kingdom*

In the United Kingdom the existence of exchange control until 1979, while directed to central bank regulation of balance of payments rather than screening FDI, did alert other agencies to potential problems regarding FDI. The Labour Government of 1964-70 in particular attempted to play a more direct role on inward FDI. By the late 1970s some types of undertakings were still being required of inward foreign direct investors with respect to domestic production, exports, minority local shareholders and other factors, often linked to investment incentives. However, this review process does not appear to have been very formal or consistent even in the period 1964-70 and it was abandoned in 1979 in conjunction with the removal of exchange controls.

The more important policies were directed to particular firms or sectors, such as automobiles and petroleum. When Ford Motor Company took over the minority United Kingdom shares in 1960, for

example, a string of conditions on exports, earnings retention, employment and import policies were imposed (Hodges, 1974, p. 188). Chrysler's takeover of Rootes in 1967 also involved conditions. Government support was furthermore given to mergers leading to British Leyland in 1964-68 in order to maintain a United Kingdom presence in the sector. These and later attempts to avoid bankruptcy or to slow employment declines involved substantial state subsidies. As for the effectiveness of the conditions attached, some evaluations described them as largely face-saving (*The Economist*, 21 January 1967). More measured evaluations were not more sanguine (Hodges, 1974, pp. 205-9).

In the petroleum sector both national and foreign firms found at each of the licensing rounds that they faced the need for a series of contributions, such as technological and other economic contributions made by the participants, the opportunity for linkage by domestic firms, and cooperation in working out the share of the state-owned firm. A particular attempt was made to assure local purchases (Noreng, 1980). The leverage given by the various licensing rounds was significant in the buoyant context of the 1970s. The share of United Kingdom firms in the offshore market was reported to have risen from 40 per cent to 72 per cent over the period 1974-1983 (Young et al, 1988, pp. 220-21).

3. *United States*

The United States, like the United Kingdom, was a major outward investor during this same period, much more interested in preserving access by its TNCs abroad than in reviewing inward FDI. But it had also become a major host country by the late 1970s. While relatively open to FDI, there were policies on both the inward and outward side that deserve a brief comment.

On the outward FDI side the main policy was the attempt to control a growing balance of payments problem in the 1960s, leading in 1965 to a request that TNCs voluntarily limit capital outflow and increase dividend inflow with affiliates in developed countries. This

programme was made mandatory in 1968, but gradually removed over the following six years. As noted earlier, some host countries such as Australia and France reacted by limiting borrowing by TNCs in their markets: the United States programme was also a factor in the introduction or formalizing of review of inward FDI.

The United States authorities also developed a view that other countries were using various investment controls, performance requirements and subsidies to capture gains from TNCs at the expense of the United States. In 1984, section 301 of the 1974 Trade Act was revised to include investment practices, in effect authorizing the President to withdraw trade concessions where practices on trade and investment by others were considered discriminatory. The United States also pressed for trade-related performance requirements and other investment issues to be included in GATT negotiations. The United States took strong exception to the activities under the Canadian Foreign Investment Review Agency and the National Energy Programme, and succeeded in limiting or ending performance requirements and other investment policies through both the Canada-United States Trade Agreement and the NAFTA (see also chapter I).

On the inward FDI side the major concerns rose, as in other countries, from debates over the possibility of significant takeovers in sensitive sectors by OPEC states in the 1970s. A Committee on Foreign Investment in the United States, established at the presidential level in 1975, concentrated on consultations with foreign governments interested in acquiring United States firms. In 1988 the Exon-Florio amendment to the Trade Act authorized the President to block an acquisition from abroad if it posed a threat to national security. This Committee rejected some proposed takeovers and also at times imposed what amounted to performance requirements. For example, Monsanto sold its silicon wafer division to a Federal Republic of Germany firm after the buyer agreed to keep production and R&D facilities in the United States.¹⁵⁴

¹⁵⁴ See *Japan Times*, 26 January 1989, p. 9.

Defence is a sector where non-national treatment is allowed under OECD agreements, but the size of the sector in the United States as well as the way the exception is invoked makes it worth noting. Essentially, defence contractors had to obtain security clearances for facilities and personnel. In this time period facilities controlled by non-residents would not be cleared, except for Canada, the Federal Republic of Germany, and the United Kingdom.

Of particular interest are the limitations imposed by state governments on foreign-owned firms or non-residents often in direct opposition to federal policy positions. Some of these limitations are placed on out-of-state firms as against foreign-owned firms. As will be noted in the next section, most state efforts are directed to attracting FDI by various incentives.

I. Effectiveness of policies

What does the experience of the countries reviewed above reveal about policy effectiveness? Such an approach must begin with at least three questions. First, what were the governments attempting to achieve? The objectives should be clear if effectiveness is to be addressed. It was noted in the introduction that governments typically have four broad objectives with regard to policy in this area; micro and macroeconomic impact, income distribution, political independence, and preserving or enhancing political power. The country studies showed a variety of links between performance requirements and these objectives.

Second, what types of TNCs are involved and what strategies are they likely to pursue in response to given policies? Where a particular policy may reduce its expected returns, firms may actively accommodate to the policy; lobby for changes; try to cope, avoid, or insulate themselves from it; or, at the extreme, divest.¹⁵⁵ The strategies

¹⁵⁵ See Safarian (1993, pp. 459-62) for definitions and examples from the countries in section IV.

open to firms will differ by sector of industry and other variables, including the policy capabilities of the governments involved.

Third, what are the policy capabilities and bargaining positions of the respective governments? Clearly this will depend in part on what the country has to offer by way of market size, the skills of its workforce, material supplies, and the strength and numbers of domestically owned firms. It will also depend on how effectively the government can design and implement policy. In particular, opinions on the relative success of different countries in dealing with TNCs are conditioned by all three of these questions.

With these points in mind, the effectiveness of the ownership policies and of other performance requirements can be assessed. The summaries below deal with very different organizational and procedural approaches to policy. Three countries (Australia, Canada and New Zealand) had far more explicit policies than the other countries, not only in terms of a specific agency but also in terms of laws, criteria, procedures and publications. Moreover, while all countries had ownership policies, only Canada, France and Japan put major emphasis on performance requirements in the general review process. Such requirements also got considerable emphasis in dealing with specific firms and key sectors.

1. Ownership-related requirements

Ownership policies cover a range of approaches. Even after entry, with whatever conditions were involved, a foreign-owned firm might find it did not receive national treatment in terms of differential access to subsidies, financing, tax obligations and government purchasing. Even without an explicit review process, there are significant obstacles to takeovers (both domestic and foreign) in some countries because of close shareholdings, limited shareholders' rights, business attitudes, and laws which encourage all of this. Also, all of the countries in this study, with or without review mechanisms, found ways to review and often stop takeovers of "key" firms.

In a number of sectors foreign ownership was restricted to a minority position. This was true in services considered close to national identity, such as the media, and in aspects of finance where monetary control might be an issue. However, it was rare in the countries in this study to require majority domestic control across a broad set of industries. The closest one comes to this in the countries studied here is in Japan and in primary resource industries in a number of countries.

The restricted industries in table VI.4 are essentially natural resource and service sectors. Not a single manufacturing industry appears in this table. This is partly the result of the categories used to classify industries, but only partly. If one looks at the detail provided at the end of table VI.3, it is clear that few manufacturing sectors are involved.

Table VI.4. Industry concentration of sectoral controls and state monopolies

Of 23 countries	Sectoral controls	Public, private or mixed monopolies
6 or more	Real estate, mining & minerals, petroleum, agriculture products, water resources	Air transport, games
12 or more	Other financial services Air transport & facilities	Broadcasting Land transport Energy & related utilities
18 or more	Banking, insurance Maritime transport & related facilities	Post, telephone, telecommunications

Source: Safarian (1993), pp. 448-449.

There could be several reasons why the natural resource and some service sectors were more subject to ownership limitations while the manufacturing firms were more subject to performance

review. There was a view that rents could be exceptionally high for some natural resources, hence subject to domestic capture by ownership provisions. There was often a view that local benefits through technology transfers and otherwise were more likely to flow from manufacturing than in the other sectors, while developing substitutes was more difficult, hence that performance requirements were the appropriate policy. Moreover, the bargaining power of host countries is stronger with respect to firms seeking access to natural resources or domestic markets than for those firms which have alternative sites for producing exports. More precisely, bargaining power with respect to TNC location would be greater for a host with a large domestic market, weaker if the TNC was considering a site largely for exports, and weaker still if the host was located in a common market where alternative sites and tariff-free access were available. It was therefore no coincidence that countries such as Ireland and Belgium concentrated on incentives for TNCs which targeted the EC while countries such as Canada, (before her North American trade treaties) Australia and Japan used both import saving and export development mechanisms in the review process.¹⁵⁶

None of the developed countries discussed above, except Japan, tried to preserve for local firms the manufacturing sectors where TNCs were concentrated: chemicals, electrical machinery, non-electrical machinery, and some specific sectors such as automobiles. Instead, the emphasis was placed on using subsidies and other forms of public support to preserve some domestically owned firms in some of these sectors (section J).

In natural resources, the Australian objective was quite clear — to secure 50 per cent ownership in new natural resource projects — especially in order to share any rents from resource booms. Control was not the issue, since there was no requirement that the 50

¹⁵⁶ France, as a larger market with highly-developed governmental capabilities, attempted a somewhat more regulatory approach to TNCs for a time, but eventually had to modify such an approach under pressure from the EC and the growing trend towards a Single Market.

per cent voting interest on the Board by Australians represented an effective partner. Indeed, in the early 1970s the weakness of equity markets and lack of joint venture partners meant a few financial interests typically represented Australians. Without effective partners and with the timing and terms of local participation left to the TNC within broad limits, it is not difficult to conceive of TNCs capitalizing rents when shares are sold, leading to normal returns for Australian shareholders (Caves 1982, pp. 91-3; McKern 1976, p. 46). The rationale for the Australian policy was that it countered the absence of a capital gains tax, which was levied only in 1985, and also the heavy state subsidies induced by competition for the projects. Foreign ownership of Australian mining fell significantly in the decade after the 50 per cent rule was introduced while overall FDI inflows increased substantially.

Unlike Australia, which worked at the margin to reduce foreign ownership, Canada, in what was rare among the countries studied here, undertook to reduce directly the high degree of foreign ownership and control in petroleum. The National Energy Programme was intended to increase both the Canadian ownership and control of the sector, both of which were achieved to a considerable extent in the 1980s. The bargaining power of the Canadian Government, hence the risks involved, were negatively affected by three factors. First, the reaction of the province of Alberta, the major oil producer, to various aspects of the overall energy programme was quite hostile, both delaying and complicating it. Second, the timing could not have been worse. Shortly after this Programme came into effect, in 1981, interest rates rose sharply, an international recession took hold, and the price of oil collapsed. Third, the resistance to the discriminatory and retrospective aspects of the National Energy Programme drew strong criticism from the United States, something which was hard to ignore given the many and close ties with that country. Within a few years, much of the National Energy Programme and of the Foreign Investment Review Agency was modified and subsequently dismantled or greatly refocused towards a more welcoming stance towards foreign investors.

Norway's experience was more favourable to the country. The early experience with concessions for electric power, the existence of highly productive oil fields, and the early development of a clear set of objectives, all helped to ensure a high degree of success. The production participation agreements were well designed to capture some economic rents, state participation was assured through a major role for Statoil, and local sourcing was an important part of the awarding of concessions.

2. *Other performance requirements*

To be effective, requirements for increases in exports, employment and technological capacity should be achieved without adversely affecting the volume of FDI. Sectoral limitations apart, all but one of the countries in this group were interested in maintaining and increasing FDI while improving performance.

The Foreign Investment Review Agency in Canada represents the most explicit and, in some ways, the most ambitious of the review mechanisms. There is evidence that it bargained at times for increased benefits, monitored many of the undertakings given by firms, and had a rejection rate higher than other published rates. Japan and France achieved some similar results with more discretionary and opaque systems, and also had much more planning for a number of sectors.

Apart from monitoring the ownership provisions of various laws, the role of the Review Agency was to reduce the microeconomic costs believed to be associated with FDI. It was argued that FDI shaped an industry structure that was too reliant on imports and weak on exports, R&D and managerial development. Firms were therefore asked to give undertakings on these and other variables as a condition of entry in order to correct for these problems.

The Foreign Investment Review Agency had a more formal and thorough monitoring process than other review systems. There was significant follow-up not just on investment and employment but

on the more specific undertakings. Yet, as noted earlier, many undertakings were too general to be enforceable. There were thousands of undertakings, which in principle were legally binding. Yet, it appears that few cases went to court, or required other forms of action to secure adherence. The problem that this Canadian review Agency faced was that, while it was asked to implement a form of industrial policy, it had to do so with an inadequate political mandate in a decision-making process where every province and department of government could exert pressure.¹⁵⁷

The existing studies as to the effects on capital flows for the National Energy Programme and the Foreign Investment Review Agency give mixed results. Globerman and Shapiro (1998) found that the latter had exerted negative effects on both flows into and outflows from manufacturing, but the effects on overall FDI were overwhelmed by flows into and out of energy. The Energy Programme had reduced flows into both sectors, and had led more strongly to outflows.¹⁵⁸

One advantage of France's review process was that undertakings were relatively few, measurable and short term, as with the amount of investment and employment involved, hence capable of being monitored. These types of performance requirements, sometimes accompanied by incentives, had a far better chance of being realized than the many loosely specified requirements of some

¹⁵⁷ It is hard to understand why an agency would be given a task as difficult as the Foreign Investment Review Agency and then hampered by such an awkward institutional design. One view was that much public opinion at the time required some type of action, while the political process recognized other views, including the desire of many provinces to have continued access to FDI. One resolution of such a dilemma is to establish an apparently ambitious policy but hedge it in with constraints. This might seem like an extreme solution but it need not be when different views need to be taken into account. The New Zealand authorities recognized that one of the four objectives of a system to monitor FDI was "to allay public concerns about FDI which would arise in the absence of such policies" (New Zealand Reserve Bank 1987, p. 1).

¹⁵⁸ However, their 1999 article concluded that these two policies did not have significant effects statistically on flows, except outward flows for the Energy Programme.

other systems. The key issue is how well policy on FDI was more broadly integrated with industrial policy. A major goal of French governments has been to maintain a degree of French ownership in a number of high value-added sectors which are also competitive internationally. The degree of success involved in integrating the two related policies is not clear, since the information available on the review process is quite limited. It does appear that there was a significant lack of continuity in FDI policy as it relates to industrial policy. The recognition of how multinationalization was affecting industrial policy was slow. The nationalizations of the early 1980s, which were motivated in part to preserve a French presence, were largely reversed, albeit with a French stake kept in privatized firms for a time. The lack of well-defined and consistent policies over time towards FDI has led some observers to conclude that policy was quite open and pragmatic in practice (Michalet and Chevallier, 1985, p. 123).

The effectiveness of Japan's policies on FDI must be judged in the context of a country determined to keep domestic control of industry while borrowing technology on its own terms and developing a strongly competitive set of firms. For the period covered by this study, Japan succeeded with all these objectives. Industrial policy, and specifically that on FDI, may not deserve all the credit. Some would argue that rapid world growth and reasonable macroeconomic policies up to about 1980 were important factors, and that industrial policy imposed large costs on consumers and small firms in Japan (Yamamura, 1986; Baldwin and Krugman, 1988).

Yet there were aspects of Japanese government-business-labour relations which worked to favour Japan's objectives for some decades. First, foreign ownership remained low - less than 5 per cent of sales for all but two manufacturing sectors by the late 1970s. Second, Japan did liberalize in response to both domestic and foreign pressures, but at her own somewhat slow pace. A system of prior notification, which implies prior approval, was in effect as late as 1991. It was then ended, but notification ex-post was continued, with exceptions. Japan secured non-FDI forms of participation in sectors where FDI is frequently dominant if allowed to enter in that form.

During the period 1950-1980, fully 55 per cent of licensing contracts in manufacturing were concentrated in chemicals, machinery, and electrical machinery sectors (Ozawa, 1985, pp. 180-83).

Political continuity certainly helped in this process, in that it allowed for a consistency in policy toward FDI among the (closely related) political, civil service, and business groups. It helped greatly that Japan in the 1950s had highly developed firms whose skilled personnel could act as effective, indeed controlling, joint venture partners. It offered a large and rapidly growing market until about 1990. And the Japanese public and private sector personnel used these bargaining advantages very skilfully for a considerable period, moving on to opening markets and developing their own R&D at a relatively late stage in development.

The issue for Ireland and Belgium, both small countries in a common market, is partly whether the incentive systems worked in attracting export-oriented TNCs. They apparently did work in the sense that a great deal of FDI was attracted to each country for a period, and the performance of the TNCs in terms of wages, exports, productivity and other factors was relatively strong. In each case, however, the older domestically owned firms did not benefit as much from the incentives, and internal linkages were weak. Both countries revised their policies to focus more, for example, on attracting international service projects, and developing demands for skilled labour and advanced technologies including linkages to other domestic firms.

J. Developments in the 1980s and 1990s¹⁵⁹

During the 1980s, policy on FDI became less restrictive in many respects. FDI was allowed to a larger extent in sectors such as finance where it was formerly prohibited or limited. Investment review was ended, as in the United Kingdom, or sharply limited, as in

¹⁵⁹ This section draws mainly on Safarian (1991) and Safarian (1993, chapter 12).

Canada. New forms of incentives were introduced while others were increased.

These changes occurred for many reasons. The deregulation and privatization of some service sectors opened opportunities for private firms, including FDI. The collapse of primary resources prices in the early 1980s and a period of recession further opened some sectors. Rapid technological changes in sectors such as information technology and transport required major industrial adjustments. The change in organizational structure of TNCs, resulting in more decentralized and trade-oriented institutions drawing more freely on inputs wherever located, was partly a response to technological change, and partly driving it. In any case, governments often worked with these reorganizing TNCs to control industrial decline and to upgrade their industry structures. And, as we have seen, some of the older policies were not working well as time passed, at least in terms of some of the policy objectives.

It would be a mistake to think of the new policy regime simply as liberalization, even for the industrial countries. The fact that governments which privatized firms often kept a veto power by way of "golden shares" for a time suggests that their concerns about foreign control had not disappeared.¹⁶⁰ There was rather a form of selective industrial policy at an international level, sometimes known as strategic trade (and investment) policy. As Safarian has put it:

"The old policies tended to be restrictive on the inward side but also offered incentives to get steering effects, while on the outward side they were exchange control oriented or non-existent. The new policies rely more heavily on the steering effects of selective incentives, often backed up by various forms of non-tariff barriers, while also selectively promoting domestic TNCs as well as exports. A regional and, at times, global strategy of production by TNCs is being gradually met

¹⁶⁰ *The Economist*, 29 June 2002, p. 64, noted that 24 of Europe's largest firms by capitalization had some shares owned by a government.

by a regional and, at times, global strategy of national policies on trade and investment."¹⁶¹

Key elements of this approach include fiscal incentives, trade protection, and strategic trade and investment policies directed at TNCs.

Fiscal incentives, of course, have existed for a long time. What is of interest for present purposes is that the earlier emphases on support for declining sectors was supplemented in the 1980s with support for newer sectors and advanced technologies (OECD, 1989). This additional focus fitted well, when combined with other policies, to capture newer and high value-added sectors. Many were given on a discretionary basis, and often tied in with the review process for FDI. In some cases, such as Belgium and Ireland, major parts of the entire incentives programmes were geared to TNCs. And most international agreements allow exceptions for preserving domestic sectors (hence supports) for national interest reasons, and, in conjunction with some types of performance requirements, for developmental reasons (UNCTAD, 2001, pp. 39-43).

Another trend has been the substitution of performance requirements by trade policy measures that achieve similar objectives. These include rules of origin, screwdriver regulations, voluntary export restraints and anti-dumping (Belderbos 1997, Moran, 1998). The European Union countries have extensively used the screwdriver regulations, which are in effect like local content regulations, to deepen the local commitment of Japanese corporations in consumer goods industries in the past. Even currently the industrialized countries, especially the European Union and NAFTA member countries, taking advantage of exceptions that are available under Section XXIV of GATT, are effectively using the rules of origin to increase domestic value addition. Rules of origin determine the extent of domestic content that a product must embody in order to qualify as

¹⁶¹ Safarian (1993, p. 474).

an internal product in a preferential trading agreement. Hence, they have a similar effect as local content requirements.

Considerable evidence is now available on the use of rules of origin by European Union and NAFTA countries to increase the extent of localization of production by TNCs supplying products to their markets. EU countries have used anti-dumping measures to regulate imports of cars and other products from Japan and South-East Asia, and the United States has used similar measures in attempting to achieve reciprocity (that is, "substantially equivalent competitive opportunities") in trade and investment with Japan and other countries. In the United States, provisions of the "Buy American Act" have also acted as local content requirements (Krugman and Obstfeld, 2000).

Moreover, non-tariff barriers have soared as tariffs and foreign investment reviews have been reduced. In the 1980s, after the GATT codes on anti-dumping and countervailing duties were adopted, virtually all of the former were initiated by the United States, Australia, Canada and the EU, and the United States was the initiator of the majority of the latter (Anderson and Rugman, 1990). One well-known experience is that of the ways in which European Community countries used anti-dumping measures to regulate imports of cars and other products from Japan and South-East Asia, both to support declining older sectors and growing research-intensive industries (Messerlin, 1989). The United States has aggressively used similar measures in attempting to achieve reciprocity (that is "substantially equivalent competitive opportunities") in trade and investment with Japan and other countries. The trend is worrying. For example, the number of anti-dumping initiations rose from 157 in 1995 to 330 in 2001 (reaching a peak of 356 in 1999).¹⁶²

What has given new focus to all of this is the concept of strategic trade promotion. This has received support from two

¹⁶² See www.wto.org/english/tratop_e/adp_e/adp_e.htm#statistics/.

directions. First, in the context of regional or even global competition, import-substitution policies are less attractive even for larger countries: for example, at some point, entry to export markets is critical, to discipline competitors and to achieve economies of scale. Second, industries with imperfect competition offer the potential of gains from trade policy. If an export market can be secured by such a policy, the rents associated with imperfect competition can be captured, and more of the technological spillovers associated with such firms can be brought home. There are major complications in carrying out such policies, however, both in theory and in practice. The desirable policy can vary with the nature of the oligopolistic competition involved, other governments may intervene to counter the policies, measuring the externalities involved is complicated. These and other problems limit the potential gains.¹⁶³

One complication is the existence of both domestic and foreign TNCs. If foreign TNCs are located in a sector chosen for strategic policy focus, the government would have to discriminate in favour of the locally owned firms. It would not want to apply its fiscal powers to exports of a fully owned foreign TNC if its objective is to capture rents. If the government's aim is to increase employment in an imperfectly competitive export sector, however, subsidies to firms regardless of ownership can help to achieve this objective (Harris, 1991; Waverman, 1991).

The situation is also complicated once a country has its own TNCs located abroad. Some of the governments reviewed in this study tried to encourage exports or cooperative forms rather than TNC expansion abroad, a policy which ran into the TNCs preference for the latter as a more effective way of transferring technology or collecting maximum rents. Once the TNC was established abroad, the interests of a home government in pursuing strategic trade and investment policy to maximize rents and technology spillovers at

¹⁶³ Strategic trade policy has a large literature, for example, Brander and Spencer (1985) are usually recognized as initiating it. Stegemann (1989) offers a critique.

home ran into the interests of the TNC in trying to satisfy similar demands from the host governments. France was one country which found that, as its firms went international on a broader scale, their responsiveness to French industrial policies was somewhat muted. It bears emphasis that strategic trade and investment policies in imperfectly competitive markets are not simply the purview of the largest economies or firms.¹⁶⁴

A further complication arises in an integrated trade area and even more in a single market such as that attempted by the European Union after 1992. Along with a continuing desire to develop European Union-based TNCs there is the restriction on excessive use of fiscal incentives at the national level, the attempts to open countries to mergers and acquisitions, and other policies which limit national use of strategic policy on trade and investment.

This last point raises an issue we can here only touch upon. If FDI policies have moved in the direction of international industrial policies, then competition policy needs to be factored into the analysis more prominently. A weakening of FDI inward review as such leaves open a strengthening of competition policy directed, among other things, at mergers and acquisitions. Such deals have grown to where they dominate FDI flows for many countries. Competition policy is not a full substitute for FDI review and is directed at all firms, in any case, not just FDI. If, however, authorities believe FDI strategies differ, or they simply want to prevent a foreign takeover, then particular policies can be developed for such purposes.

¹⁶⁴ The struggle between Brazil's Embraer and Canada's Bombardier for supremacy in the world's medium-sized aircraft market, in each case with support of the home market, is one indication of such contests between smaller countries.

K. Concluding observations

To conclude, developed countries have made frequent use of performance requirements as a part of their overall policies to reap maximum gains from FDI and to limit the foreign influence over certain strategic industries and activities. During the 1960s to the 1980s a number of developed countries regulated TNC operations, both at entry to a country and on their subsequent expansion.

Indeed, foreign ownership was restricted to a minority position in a number of sectors in all of the countries in this study. This was generally the case in services considered close to national identity, such as media; aspects of finance where monetary control might be an issue; natural resources; some high technology sectors; and defence sectors. However, domestic ownership requirements have been uncommon in manufacturing generally, where other performance requirements were the preferred form of regulation.

While all the countries studied had some form of ownership restraints, only Canada, France and Japan put major emphasis on other performance requirements in the review process. Canada had the most explicit review process among these.

The review showed that the imposition of performance requirements can involve considerable costs if they are to be monitored and enforced. In the Canadian case, the agency in charge was staffed with more than 130 professional employees, and even so, it had a hard time performing its tasks. One advantage of the relatively informal French review process was that undertakings were relatively few, measurable and short term, as with the amount of investment or employment generated. Hence they were more likely to be successfully monitored, especially where incentives accompanied them.

It is also clear that the ability to impose restrictions and requirements depends a great deal on the bargaining position of the host economy. For example, small economies have generally tended to emphasize "voluntary" requirements linked to the provision of

incentives rather than stringent mandatory criteria imposed at the point of entry.

During the 1980s, policy on FDI became less restrictive in the sense that FDI was allowed into some sectors where it was formerly limited or prohibited, review mechanisms were ended or sharply limited, and incentives to FDI were increased. This, however, was not simply liberalization. The incidence in developed countries appears to have declined in parallel to the emergence of new forms of policy interventions to achieve the same objectives. Developed countries continue to use policy measures such as screwdriver regulations, buy local provisions, anti-dumping and rules of origin that in effect are like performance requirements. This can be seen as a more strategic approach to trade and investment policy in a world where TNCs are also moving towards a more globalized (or at least regionalized) structure of operations.

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<http://www.unctad.org/wir>.

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World Investment Directory, Volume VIII, Central and Eastern Europe 2003 (with CD-ROM) UNCTAD/ITE/IIT/2003/2, E.03.II.D.12, ISBN 92-1-112584-7, March 2003.

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Investment Policy Reviews

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ISBN 92-1-112569-3, June 2003.

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2003/1, June 2003

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25, March 2003.

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Guide d'investissement au Mali. 108 p. UNCTAD/ITE/IIT/Misc.24. <http://www.unctad.org/fr/docs/poiteiitm24.fr.pdf>. (Joint publication with the International Chamber of Commerce, in association with PricewaterhouseCoopers.)

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