Restrictions on foreign ownership during 1984-1994: developments and alternative policies

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This article summarizes a study of foreign ownership restrictions in ten countries over the period 1984-1994. This decade was chosen because it was a time of remarkable liberalization. The study discusses the rationales for originally imposing ownership restrictions, why and how these rationales changed and why certain restrictions were still in place at the end of the period. The ten countries—Canada, Ghana, India, Indonesia, Mexico, Morocco, the Philippines, the Republic of Korea, Spain and Venezuela—were chosen in order to provide a wide representation of forces that influence the type, extent and evolution of the regulatory framework of foreign direct investment, as well as to illustrate a broad range of ownership restrictions and liberalization reforms. On the basis of this material, the study proposes alternative policies for achieving the objectives of foreign ownership restrictions, and offers recommendations for the reform process.

An overview of liberalization

Dramatic reductions in foreign ownership restrictions took place during the decade 1984-1994 in the countries in the sample.[1] Liberalization was driven

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[1] The authors interviewed business and government leaders as well as academics in each country in order to elicit a broad spectrum of opinions with regard to this subject. It should be

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by a wide variety of rationales, including a more receptive attitude towards the market system, with less reliance on regulation and State-owned enterprises; a realization that national firms did not possess, and could not easily develop, the capabilities of certain foreign investors; a recognition that the regulation of foreign direct investment (FDI) had led to unexpected and non-optimal outcomes; an appreciation for the increased value that transnational corporations (TNCs) could bring to the economy as a result of the extension of global mandates for foreign affiliates; an understanding that enhanced trade and development had reduced the monopoly power and economic rents that could be accessed by foreign investors; a desire to increase growth and investment; and reactions to balance-of-payments crises. Furthermore, experience showed that many TNCs had not seen sufficient value in taking on domestic partners and, rather than doing so, had invested in countries with fewer restrictions. In addition, there was a lack of domestic entrepreneurs or firms with which foreign investors could form joint ventures in many developing countries. As a result, domestic firms were not able to replicate the competitive advantages of TNCs in many business activities, and often domestic partners did not develop expertise from their association with foreign investors.

The decision to restrict foreign ownership was linked in many countries to foreign domination during a colonial period. Public attitudes changed as the liberation struggle receded in memory, and as the economic operations of TNCs were no longer equated with foreign political domination. Leaders with more positive attitudes towards foreigners—acquired in many cases as a result of education in an industrialized country—gained positions of power and influence. At the same time, modern telecommunications broadened the perceptions of the average citizen, creating a new knowledge of, and interest in, other societies, particularly those high-income societies from which many foreign investors come. This internationalization of the political and cultural context brought with it a noticeable decrease in antipathy towards foreigners and their corporations.

When a government's development strategy relied upon active intervention and regulation of the microeconomy, as in the Republic of Korea, FDI was regulated as one of the elements of the microeconomy. As importantly, regulation of the microeconomy may also have necessitated FDI

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noted that the interview protocol was not structured so as to develop statistical analyses of respondents' answers. References and illustrations have been limited in this article owing to constraints on its length.

regulation for various reasons, including the potential for foreign investors to capture economic rents in distorted economies. As part of the trend towards greater reliance on the market, many countries turned towards a strategy of export promotion and away from import substitution. Pursuing an export-promotion strategy has several implications for FDI restrictions. Export-oriented FDI is clearly a supplement to—not a substitute for—domestic investment. Moreover, concerns about industry overcrowding, excess capacity and destructive competition no longer apply. Domestic consumers may be willing to bear the burden of high-price and low-quality products in the short term in order to support infant industries; but international consumers are not. For export-oriented projects, international competition has reduced economic rents and hence reduced the need for government regulation. Furthermore, as countries have launched export drives, the product and process technology, expertise and access to markets in other countries that TNCs already possess have become increasingly valued relative to the capabilities of domestic firms.

A change in development strategy from import substitution to export promotion has led countries to sign multilateral or bilateral trade and investment agreements. Membership of these agreements has required a reduction in foreign ownership restrictions, as has been the case in Canada and Mexico (under the North American Free Trade Agreement) and Spain (with the European Union). Indonesia's membership in the General Agreement on Tariffs and Trade (GATT) put some pressure on the Government to liberalize its foreign equity ownership restrictions. The desire of the Republic of Korea to join the Organisation for Economic Co-operation and Development (OECD) had the same effect. Such forces have also been important for Ghana, India, Indonesia, Morocco, the Philippines and Venezuela.

There were also substantial elements of coercion by economic events in the reduction of FDI restrictions. Fiscal constraints forced governments to privatize existing State-owned enterprises and to open industries to foreign investors. In addition to government budget deficits, many countries encountered international debt problems. This led to a need to attract FDI to strengthen the value of the domestic currency and to supplement other forms of international borrowing. The loan conditions of the International Monetary Fund (IMF) were sometimes a factor in motivating liberalization, as in India in 1991. Job creation also received new attention. Rapid population growth and migration to the cities combined to establish urban unemployment as a major problem in many countries. A post-1989 slowdown of economic growth in many countries also put pressure on governments to allow additional FDI in an attempt to meet growth targets.

An important means of attracting additional FDI has been the reduction of ownership restrictions.

General restrictions

Extent and forms

In 1984, five of the ten countries in the sample had general restrictions on the percentage of foreign ownership permitted in each business entity, although exceptions could sometimes be negotiated. India restricted foreign ownership to a maximum of 40 per cent; Morocco limited foreign ownership to less than 50 per cent; the Philippines had a 60 per cent limit; and the Republic of Korea had a 49 per cent limit. Indonesia allowed foreign ownership of up to 80 per cent, but required that this be phased down to 49 per cent within 15 years of the investment. Furthermore, in Ghana, Mexico and Venezuela, sectoral restrictions covered such a major portion of economic activities that one might regard them as general restrictions.

The perceived links between a certain percentage of foreign equity ownership and the nature and extent of foreign influence, control and dominance have been of concern to both host country governments and foreign investors. However, an examination of the sample countries indicates the uncertain nature of these links. In Indonesia, for example, a company in which there is any foreign ownership (except via the stock market) has been classified as a foreign-owned company. In Spain, in the 1970s, a company was classified as foreign-owned if more than 10 per cent of the equity was owned by foreign entities, or if a foreign entity had representation on the board of directors. In the Philippines, a company has been classified as domestically owned if foreign equity ownership has been 40 per cent or less. For most countries, the definition of foreign ownership has related to legal control which usually means more than 50 per cent ownership. Majority ownership entitles shareholders to pass resolutions and to elect directors at shareholders' meetings. Another focus with regard to the percentage of foreign ownership falls somewhere around 75 per cent of equity. Domestic owners with a 25 per cent share are thought to have a direct stake in the venture and some power to affect management decisions. Company law in many countries requires a "super majority" (often around 75 per cent of shares) for a company to make some fundamental decisions, such as changing the articles of its incorporation. If domestic ownership falls below the level required to prevent a foreign owner from making such changes, the influence of the local partner is seen to dissipate and become a mere presence. Yet even a domestic presence below 25 per cent can be valuable from a host government perspective. Presence allows access to information and learning, and at least a semblance of national ownership of domestic resources—a possible source of national pride. Indonesia, for example, has had a long history of trying to retain at least the presence of domestic investors in each business.

Foreigners with 49 per cent ownership or less can generally be outvoted by domestic shareholders. As issues arise, the domestic shareholders can determine the position of the corporation, presumably making decisions in the economic and political interests of the host country. In practice, however, it has not been clear whether the theoretical power of owning 51 per cent of the shares can in fact determine the position of a corporation on specific issues. Ownership is not linked in a precise way with control, and shareholdings may not reflect the decision-making structure. The literature in the field of corporate governance suggests the complexity of the relationship between share ownership and corporate decisions. Furthermore, it is sometimes unclear what the nationality of a shareholder is. Control most often is seen in relationship to legal voting control on the board of directors. And, most often, voting control is closely related to equity ownership percentages. There is, however, no necessary relationship between voting control and per cent equity ownership. A "golden share" of stock owned by the government, with unique veto power over votes on some issues, is an example of how the link between ownership and control can be broken. There can also be different classes of stock, some having voting rights, others not—a practice that is common in Canada. Mexico's position in this regard has been to institute certain restrictions for FDI, but to waive these restrictions for "neutral" shares which cannot be used for voting purposes until such time as they are bought by domestic investors. Some countries have regulations that require that a majority of the board of directors be host country citizens, thereby separating voting control from equity ownership percentage.

Control of an enterprise can also be exercised through the control of its key competitive strengths. The foreign partner can control vital technology either through a formal licensing agreement which can be revoked, or through its ability to control future flows of technology. Control can also be exercised via control of inputs, distribution channels, brand names, patents, trade marks and so on. It can be exercised through daily management decisions and through control of information flows within a firm. The board of directors can only vote on issues brought before it, and can only vote on the basis of information that its members possess, often provided by management. For example, the information and decisions about transfer-price manipulation are often buried within an enterprise, or even abroad, without a vote at board of directors' level. One of the factors behind the increased willingness of governments to relax equity ownership restrictions has been the realization that specific equity-ownership percentages do not translate directly into control.

Local ownership requirements can be met through a joint venture or by sale of shares on the local stock market. Governments have often viewed domestic ownership via the stock market as less positive with regard to the country's interests than a joint venture, since domestic ownership via the stock market is often diffused among many stockholders in the firm, and thus foreign investors may have control even if they own less than half of the stock. This situation can also reduce information flows, learning and the development of a domestic entrepreneurial group. Consequently, the Republic of Korea, for example, has had different restrictions for direct and portfolio investment, with a much lower ceiling on foreign ownership of listed corporations. Even its 1992 reforms still restricted each foreign investor to a maximum ownership of 3 per cent of a listed stock, and aggregate foreign ownership was set at a maximum of 10 per cent. Foreign investors have had a mixed reaction to provisions that have allowed them to meet domestic ownership requirements via the stock market. While their loss of control may be less, foreign investors cannot benefit from relationships with their domestic partners, and there is the risk that the publicly traded stock may be acquired by a domestic investor with which the TNC would not desire to be in a joint venture relationship. Some TNCs fear that instead of domestic ownership being diffused via the stock market, a single domestic investor may acquire the shares, with the TNC having no control over who that buyer is or what its objectives may be.

In recent years, domestic stock markets in developing countries have grown rapidly. However, in some countries, there is a general restriction concerning the maximum percentage of a company's stock that can be owned by foreigners if that company is listed on the stock market. In some countries, the ownership restrictions governing FDI and foreign portfolio investment differ. In general, the maximum foreign ownership percentage of listed companies is lower than the maximum for unlisted companies. These differential regulations have sometimes had the effect of barring firms from going public on the stock market.

Rationales

Interviews revealed a wide variety of rationales for these general restrictions. Some of them have already been discussed above. The following are additional comments. To the extent that private enterprises may be influenced by criteria other than profit maximization, TNCs may possess a bias towards their home countries, while domestic business persons may be perceived as aligning their goals and actions more closely with those of the host nation. In decisions concerning the location of investment and production, the development and diffusion of technology, the enhancement of job skills and so on, TNCs have been perceived by some as favouring their home country at the expense of their foreign operations. Domestic investors, for example, may have an interest in preventing transfer-price manipulation or the use of tax havens by a TNC that might seek to lodge profits outside the host country for the purpose of minimizing taxes. Also, domestic investors may tend to keep their dividends within the country, whether as savings or expenditures, while dividends to foreign investors may represent a capital outflow. Furthermore, there has been an awareness that the providers of resources other than capital are at risk in terms of the success or failure of an enterprise, and a consequent belief that all those at risk should be able to influence business decisions, with governments serving as their agents. Domestic equity ownership and membership on the board of directors can act as a window on the inner workings of a firm, providing information necessary to analyse the impact of a firm on the economy and for developing effective regulations. In addition, the experience provided by equity ownership may also lead to increased responsibilities and capabilities of host country nationals over time, and to an increased transfer of managerial expertise.

Another factor motivating ownership restrictions has been the desire of the host country to tap into economic rents. The firm-specific advantages of TNCs can place them in a position to earn higher than normal profits in host countries. This potential is particularly great in economies that are distorted owing to trade protection, limitations on entry and price and output controls by the government. For a country whose markets are at an early stage of development, foreign-controlled firms may have "market power" due to the existence of only a few competitors. Economic rents accrue to the owners, but so long as the owners are domestic citizens, these rents may be seen as socially and politically acceptable. Local citizens, for example, can be taxed in many ways so as to capture a portion of these rents for the general population, while foreign owners are not subject to host country taxation to the same degree. The potential for earning economic rents is often higher for investments oriented towards the host country's domestic market than for those oriented towards export markets, particularly for countries that have high levels of tariff protection. Consequently, countries have sometimes required a higher level of domestic ownership for projects oriented towards the domestic market than for those oriented towards export markets.

Host government restrictions on the percentage of equity ownership held by foreigners serve to compel foreign investors to accept domestic partners—if they are still willing to invest in the host country. Given this situation, host country partners are in a strong bargaining position as regards the amount of financial and other resources they bring to a joint venture in exchange for their equity share. To the extent that the resources provided by host country partners are below the value represented by the ownership share they acquire, equity ownership restrictions can act as a tax on foreign investors, a tax that accrues not to the host country government, but to host country nationals.

Screening

Many countries have had some type of case-by-case screening and approval process for FDI proposals. The nature of this process has varied considerably among the sample countries, and for most countries it has changed over time. Countries have often allowed exceptions to their general ownership restrictions for investments that are thought to bring exceptional benefits. Governments have been willing to trade off the perceived costs of foreign equity ownership for benefits such as increased exports, transfer of advanced technologies, upgrading of domestic raw materials, location in remote regions or job creation. A case can be made to the effect that externalities may exist in theory for projects with any of these characteristics. Furthermore, TNCs whose investment projects have had one or more of these characteristics have been more "footloose" and have had greater bargaining power than "standard" market-oriented or resource-seeking FDI. Hence governments wishing to attract FDI with these characteristics have had to make concessions, such as relaxing the maximum limits on foreign equity percentages.

Although cost-benefit analysis is straightforward in theory, in practice it has proved difficult to apply. Among other things, information costs are high, both for the foreign investor and for the screening organization. It has also proved difficult to factor in considerations such as the economic impact of a project on industry concentration, job creation and job characteristics, exports, technology transfer, regional impacts, as well as the political and social effects of a project. Screening organizations have often acted as bargaining agents with foreign investors on behalf of the government to try to increase the net benefits of the project to the nation. In practice, however, the problems associated with cost-benefit analysis have been compounded when the screening organization has tried to bargain with foreign investors. The screening and approval process can also become highly politicized as different government departments bargain with one another and with the foreign investor over the conditions under which an investment is to be permitted. A fundamental problem with the screening and approval process lies in the lack of transparency of the criteria, and of the process by which FDI projects are evaluated and approved. A non-transparent, conditional and discretionary screening and approval process can greatly increase both the time required and variations in the time required for the approval process.

Exceptions

Many countries have liberalized their FDI frameworks by gradually introducing exceptions to their basic restrictions, such as raising the size threshold above which approval is required. Governments have also stipulated shorter time-limits on the approval process. Some countries have moved to a ''notification'' and ''approval'' system, under which the foreign investor could simply notify the relevant screening organization and provide it with certain information. This organization could then accept the notification as received, request additional information or inform the investor that the application would have to go through a more formal approval process. If the investor does not receive a reply within a specified period, the application is deemed to have been approved. During the 1984-1994 decade, the mandates of screening organizations also changed radically. In some countries, the screening agency was abolished. In others, such as Canada, Ghana and the Philippines, an attempt was made to convert the screening agency's activity from investment regulation to investment promotion. This transition from regulator to promoter of FDI has proved to be a difficult one.

Two countries in the sample—Indonesia and the Philippines—have employed "phase-down" regulations. These regulations have required TNCs to reduce their equity ownership percentages over some specified period, either by divesting their shares to domestic investors or by increasing the share capital of the enterprise without increasing the amount of the capital held by foreign investors. In some countries, FDI licences have had limited terms (e.g. 30 years), and either expired at the relevant time or could be renewed if certain, often ill-defined criteria (such as "continued contribution to the national economy") were met. The rationale was that domestic investors would acquire over time both the capital and the expertise to own, manage and control FDI projects in which initially they had been minority investors. Governments also hoped that these regulations would speed up the flow of managerial training and technology as foreign investors, under the pressure of these regulations, prepared for the eventual transition to majority ownership by host country investors. The experience of the Philippines and Indonesia with phase-down has not been positive. In fact, the phase-down provisions have often had the opposite of the desired effects. There was reduced investment and product- and process-technology flows, and little, if any, enhancement of domestic capabilities. Foreign firms often saw little reason to transfer technology and to increase investment over time in their foreign affiliates when they faced the threat of reduced ownership percentage and loss of control in the future. By restricting technology flows and by not training domestic owners and managers, they reduced the possibility at the end of the phase-down period that they would indeed be forced to divest and to take a minority share. Faced with these realities, Indonesia and the Philippines have not consistently enforced phase-down. In 1994, Indonesia essentially removed its phase-down requirements.

The problems engendered by foreign ownership restrictions have induced foreign investors to engage in a wide variety of activities to circumvent them. Governments are often fully aware of these actions and sometimes have even cooperated in them. Consequently, it is important to be cautious in accepting a nation's legislative intent as reality. In Morocco, for example, corporate records may have indicated a transfer of shares to Moroccans but, at the same time, the Moroccan "investors" may have signed undated share transfer agreements, and they may not be involved in any corporate decision-making. Similar arrangements have existed in several other countries in the sample, including Ghana, Indonesia, Mexico and the Philippines. In Indonesia, back-to-back transfers of shares have been used to evade phase-down provisions. Governments can change their regulatory framework by simply enforcing or altering existing regulations in regard to such activities.

Sectoral restrictions

In this study, economic activities have been grouped into six broad sectors, on the basis of similarity of rationales for restrictions: manufacturing, land and natural resources, financial services, infrastructure, small businesses, and media and culture. For most of the countries, some kinds of restrictions were in place in 1984. However, the nature, extent and stringency of these restrictions varied among the sample countries. Furthermore, for most countries, while post-1984 liberalization has occurred within most of these sectors, some kinds of restrictions remain.

Some countries have administered their sectoral restrictions by means of a ''positive list'', while others have used a ''negative list''. A positive list sets out all the industries that are open for FDI; other industries are deemed closed. A negative list sets out the industries that are closed for FDI; all other industries are deemed open. In theory, the effects could be the same. In practice, however, they are substantially different, with a positive list usually being more restrictive than a negative list. This differential effect arises because a positive list generally includes fewer activities than a negative list excludes. A policy shift from a positive list to a negative list, then, usually signals a significant reduction in sectoral restrictions and a movement towards a more open and receptive FDI regulatory framework, as occurred in the Republic of Korea in 1984.

Manufacturing

The interviews found a number of reasons why governments excluded FDI from some manufacturing industries. Just as governments imposed restrictions on trade to foster the development of infant industries, they also limited entry by TNCs into some industries in order to protect domestic producers. The rationale in these industries was that domestic producers were not strong enough to compete with foreign firms. It was expected that these firms would become competitive over time, and then the industries could be opened to FDI. Often a government's industrial strategy, or the formal plan for economic development, has emphasized growth in the manufacturing sector. In countries in which the government has taken a more interventionist stance towards the microeconomy, this focus on manufacturing has often led to a large number of FDI restrictions. Governments have often distorted prices of inputs and/or outputs for public policy purposes in food products, energy, and basic materials (e.g. steel, cement and fertilizers). When such distortions have existed, FDI has been regulated or prohibited. Another reason for excluding foreign investors has been the desire of governments to control the allocation of capital.

By 1994, in most of the countries in the sample, only a few manufacturing industries remained closed to FDI, and there had been a significant reduction in restrictions on majority foreign ownership. The relatively rapid reduction in the restrictions in manufacturing was facilitated by the fact that most of these restrictions were based on economic rationales. When the basis for these rationales changed with changing domestic or international economic conditions, or when the rationales were seen to have been incorrect on economic grounds, the restrictions were eliminated. However, in India, where the rationales were more political and the political viewpoint retained considerable strength, some restrictions did remain. Also, in Indonesia, where a significant number of the restrictions were based on the political desire to preserve small businesses and traditional industries and firms, reduction of these restrictions has been slow.

Land and natural resources

In many countries, land and natural resources have been seen as belonging to the citizens as a whole, and to future generations. From this perspective, the sale of land and natural resources to foreigners was seen as a sale of the country's heritage. In Mexico, for example, this public attitude has continued with regard to the oil industry. In addition, FDI in land was not seen as creating a new productive facility, unlike businesses in which the foreign investor builds a factory. For these reasons, foreigners have been prohibited from owning land or from developing natural resources in many countries. The Republic of Korea, for example, drew a distinction between land ownership for manufacturing facilities or employee housing and land ownership for other uses, with special permission often being given for the former but rarely for the latter. Certain prohibitions are entrenched in the constitutions of some countries, such as Mexico and Venezuela, as well as in their FDI regulations. Government ownership has also been used as a means of capturing economic rents from natural resources, particularly in mining activities.

The countries surveyed for the study have imposed quite different restrictions in the energy, mining and agricultural industries. In the Philippines, ownership has been open to the private sector, but foreign ownership has been restricted to 40 per cent or less of equity. In Indonesia, no foreign equity ownership has been permitted, although there has been FDI under "contracts of work" in mining, forestry and land ownership, and under production-sharing agreements in energy (where ownership has been reserved for the State-owned company, Petramina). In India, some natural resource sectors still remain closed to FDI. Because much of Indian labour is involved in agriculture, farming is considered to be an essential activity for many Indians. Therefore, the Government has allowed only Indians to own a farm.

In the 1970s and 1980s, Canada's National Energy Program included restrictions governing exploration, pricing and ownership of oil and natural gas. Foreign affiliates were a particular concern, with constraints and incentives imposed differentially on foreign and domestic companies. In 1986, Canada established a new Oil and Gas Acquisitions Policy, which prohibited the sale of financially sound, Canadian-controlled oil and gas businesses to non-Canadians. A specific objective was to obtain 50 per cent Canadian ownership in the upstream oil and gas industry as a means of increasing the benefits that Canadians would receive from this natural resource. A publication of the Government of Canada (*Investment Canada*, 1992, p. 9) explained this rationale in terms that reflect views commonly held by the ten sample countries:

> "The rationale for a Canadianization policy was grounded on four factors: (1) a public view that Canadians should have the opportunity to own and control a strategically important industry that was benefiting from significant government assistance; (2) a concern that Canadians share directly in the large profits from oil and gas production; (3) a belief that Canadian-owned companies behave in a manner more sensitive to Canadian national interests; and (4) a distrust of the multinational oil companies."

Reductions in the restrictions concerning natural resources have generally been slow and relatively minor, but restrictions have begun to fray along the edges. In Ghana, for example, gold mining was under the control of the State for several decades, but in recent years the Government decided to privatize the industry and to allow FDI as part of this privatization. In Venezuela, the 1980s' slump in international oil prices was an impetus for some relaxation of restrictions. Foreign investment was seen as necessary in order to provide the capital and expertise to continue the development of Venezuelas' oil industry. Consequently, although the core oil business was retained under State ownership, peripheral deposits which require advanced technology and large amounts of capital for exploitation have been opened to TNCs. In Venezuela, the view has developed that so long as foreign investors are required to deal with the State-owned oil company, they can be controlled adequately through contractual agreements.

Financial services

Generally, ownership restrictions have been more pervasive in financial services than in manufacturing. The rationales have revolved around the perceived importance of the sector and the concern that foreign-owned financial firms would be less responsive to government goals than would domestically owned, especially government-owned, financial institutions. Governments have made extensive use of their banking systems to subsidize certain sectors and groups, and they have allowed financial institutions to recover these subsidies by paying low interest rates on deposits and/or by charging other borrowers higher interest rates. Governments have had concerns that private financial institutions, especially foreign-controlled private financial institutions, would take advantage of such a system. Foreign control of financial services has been seen as having large negative externalities in terms of loss of control over credit creation and allocation. Foreign-controlled financial institutions have been seen as less amenable to government suasion, since they could have easier access to offshore funds through which they could subvert government financial policy.

Restrictions—and recent changes in them—have varied greatly among the sample countries. In some of the countries, foreign banks such as Citibank, Chase and Bank of America had 100 per cent foreign-owned operations in the decades prior to the institution of explicit restrictions on foreign banking. These ownership structures were often "grandfathered in" when regulations were imposed, often in the 1970s. In some other countries, however, all foreign ownership was prohibited in the financial sector. In several of the countries in the sample, sectoral prohibitions have been changed over the past decade into foreign equity ownership restrictions as the first step towards full liberalization. Furthermore, there have been linkages between liberalization of the foreign exchange system and reductions in the restrictions concerning access to international capital.

Liberalization has been implemented to stimulate efficiency and competition in financial services, to increase the integration of national financial systems into the world financial system and to complement and facilitate foreign investment in other sectors. A major force pushing towards more liberal FDI regulations has been a greater appreciation of, and need for, increased efficiency in capital allocation and capital markets. Liberalization of FDI regulations has often accompanied the domestic deregulation of financial services, with increased efficiency as a common objective. Governments have become increasingly aware that finance is closely linked with FDI and international trade, and that encouraging these activities requires additional FDI in the financial sector. The growth and internationalization of financial services worldwide has been an important phenomenon of this period. There has also been a need in some countries to tap into international financial markets because of debt problems.

While there has been change in some financial service restrictions in most of the countries in the sample, a high level of restrictions has remained in many countries, even ones with relatively open FDI systems. Despite the forces that have induced governments to liberalize, a deep-seated uneasiness has remained in many countries about allowing such an important activity as finance to come under the control of foreign institutions. In general, the perception that foreign control would reduce the ability of the government to manage monetary policy and credit allocation has retarded the liberalization of foreign equity ownership restrictions. Some governments have encountered severe difficulties in moving from a highly regulated capital market to a more open one. Consequently, in spite of initiatives to liberalize the economy and to open it to FDI, many governments have retained foreign ownership restrictions in the financial sector.

Infrastructure

Public ownership has often been stipulated for infrastructure activities, especially ports, roads, transportation, telecommunications and electricity. There are several basic rationales for prohibiting private investment and supporting government ownership in infrastructure, including concerns about monopolies, distorted markets, economic rents, cultural independence and the need to provide financial resources and to build strategic industries. Governments reserve strategic industries for the State when they feel that the optimal level of investment might not be forthcoming from private investors. In addition, governments have been concerned that if development were in the hands of private owners, enterprises would be run for private gain rather than in the interests of the nation. Economies of scale lead to natural monopolies in many infrastructure industries. The smaller markets in developing countries increase the likelihood that a scale-efficient firm would be able to attain a monopoly position. Some governments have closed these industries to private investment to create a monopoly for the State, in order to control pricing and profits for revenue reasons. Externalities have been seen as requiring subsidies, and these could be most easily implemented through government ownership. In cases where private enterprise was permitted in such sectors, these industry characteristics were often used to justify FDI restrictions.

In recent years, the rationale for government ownership has been altered by the realization that this approach had resulted in gross inefficiencies, which have become more serious as a result of the fiscal pressure of budgetary deficits. Furthermore, governments have lacked adequate capital to keep up with technological development and to finance the substantial investments necessary for supporting economic growth. Motivated by these realities, privatization has opened previously restricted activities to both domestic and foreign investors. For infrastructure activities, the liberalization of FDI restrictions has been an integral part of an economy-wide shift towards greater reliance on market outcomes. All countries in the sample have privatized certain infrastructure activities, with the scale of this effort being most notable in Canada, Ghana, Mexico, the Philippines, Spain and Venezuela. In recent years, infrastructure activities have come to be viewed as consisting of diverse parts; some can be privatized, while others are retained by the government. For example, electricity transmission can be separated, in terms of operation and ownership, from electricity generation. Certain port facilities have been privatized and opened to FDI, while the ports themselves have remained in government hands.

Small businesses

Countries have prohibited FDI in some activities in order to preserve small businesses, as well as traditional industries, products and employment.

Governments have been concerned that, if TNCs invested in these industries, they would soon have a dominant position, and the traditional producers would not be able to survive. Small businesses may also exert disproportionate political pressure in support of the barriers to entry that underlie their profitability. Governments have concluded, for certain activities, particularly in the distribution of products and services, that FDI will make no contribution to the economy beyond that which can already be provided by small, domestically owned firms.

Another group of service industries is often closed to FDI, namely the "sin industries", such as gambling, bars, nightclubs and dancehalls. One rationale for restrictions here is that any increase in the efficiency of these industries would only serve to increase their negative externalities. In many countries, FDI has been prohibited in a wide range of other service industries. The most important examples are in the professions, such as accountancy, law, architecture, engineering, education, advertising, medicine and tourism. The usual rationale has been that domestic persons and firms already possessed sufficient capabilities to meet national demand. Restrictions here have also been imposed to protect domestic firms from foreign-owned competitors in order to foster the growth of domestic capabilities and to preserve these professional jobs for nationals.

Nevertheless, even in the small business sector a gradual liberalization has taken place. It has been motivated by a new perception of the technology component of distribution, the need to link the national economy to export markets and the quest for improved efficiency in distribution. Increasingly, distribution has been seen as integral to production, with value being added by the distribution system. The traditional view of distributors as middle persons who create no value has gradually been replaced by these new perceptions.

Media and cultural industries

Most governments worry that their country's unique cultural identity could be undermined if FDI were allowed in media and cultural industries. Canada, for example, has been particularly fearful of being absorbed into the United States' cultural milieu, given the huge relative size of its southern neighbour and the ease with which United States radio and television broadcasting can cross the border. Similarly, Canada has sought to maintain domestically owned media networks to support a distinctive Canadian analysis of political and social developments. In some countries, the media have been an organ of the State used to carry out the mission of the government in power. Foreign investment in the media has been seen as diminishing this government regulatory power. Governments in many countries have controlled imports of foreign publications and tapes, prohibiting FDI in the media as an extension of the control over imports of media products. Foreign ownership has often been limited to minority equity ownership, when it was not barred completely. Often, nationalist arguments have been advanced by the media for continued protection from foreign entry. Over the period, however, there has been some gradual, but limited liberalization in the countries in the sample. The rationales for change have involved a growing recognition that technological advances (such as satellite broadcasting) have reduced the effectiveness of trade and ownership barriers at national boundaries. There has also been increased recognition that information has become a key competitive advantage, and that there is now a need to improve information access and speed up its flow internationally. However, the relative slowness of change in foreign ownership restrictions in mass media and culture reflects the predominance of social and political rationales for the restrictions.

Indirect restrictions

A wide array of domestic government policies may indirectly impede FDI, and many of these are beyond the scope of current trade and investment agreements. A government may impose restrictions on technology transfer and/or payments for technology. It may impose immigration restrictions and/or citizenship requirements for directors and managers. Tax laws may provide for differential treatment of foreign affiliates (for example, the tax deductibility of magazine advertising for foreign affiliates versus domestic firms). In some countries, bribery is commonplace in order to obtain necessary approvals from various government departments and agencies; bribery adds to uncertainties and time required, and so increases the costs of FDI, and it may require a domestic partner who does the bribing. In recent years, protection for patents, copyrights and trade marks has become increasingly important to TNCs. Domestic firms may be given preference over foreign affiliates in the allocation of regional development subsidies. In some countries, firms in which foreign investors have greater than some specified ownership percentage have not been granted "national status". Without national status, foreign affiliates have been prohibited from borrowing in the domestic market or accessing low interest rate loans. They have also faced prohibitions or discrimination in bidding on government contracts or supplying State-owned enterprises. Moreover, minimum capital requirements, debt/equity restrictions and access to foreign exchange have not been the same for national firms and foreign-owned firms.

In many countries, extensive legal manoeuvres have been available to prevent hostile take-overs. Management and the board of directors could utilize these methods to fend off a foreign take-over, and so could restrict FDI opportunities. Also, in many countries, a major portion of the economy has consisted of large conglomerates, often controlled by a family or a group of financial institutions. This has resulted in situations where certain businesses were simply not for sale. This segment is likely to increase with the expansion of national pension funds, where the growing size of these funds can result in their control of a considerable portion of the economy. A country may have a unique set of business practices and customer and employee relationships, such that foreigners cannot easily enter via FDI. Competition or antitrust policy can prevent an acquisition by a large foreign corporation, even though competition or antitrust policy may have been created with no intention of limiting foreign investment.

In view of their diversity, these indirect restrictions cannot be categorized as neatly as foreign ownership restrictions, nor can their future significance be predicted with much accuracy. Most of the sample countries in the study are still at a stage where government restrictions on foreign ownership are the obvious barriers, and their removal is a necessary condition for investment liberalization. After liberalization has been achieved, the indirect barriers may receive increased international attention.

Alternatives to ownership restrictions

Support for restrictions has diminished in response to a series of changes in public values and attitudes, and in response to changes in both domestic and international economic and political conditions. Yet certain ownership restrictions remain in many countries. Manufacturing, infrastructure, financial services and distribution are the sectors where changes have had their greatest impact in reducing the rationale for restrictions. In addition, alternatives to ownership restrictions have been most prevalent in these sectors. On the other hand, the rationales for restrictions are felt more strongly in natural resources and media and culture. Here, rationales rest not so much upon economic conditions, but rather upon values, attitudes and culture. There have been fewer changes in these forces and hence less liberalization of ownership restrictions applying to these sectors.

Many policies can be used to satisfy the objectives that underlie foreign ownership restrictions. Some, like the indirect restrictions mentioned above, may be supported or rejected for a variety of reasons other than, or in addition to, their impact on foreign ownership. Some alternatives may be seen by firms in other countries as creating "unfair competition", and so the use of these alternatives may be restricted by international trade and investment agreements, or their effectiveness may be reduced by the imposition of countervailing duties. Nevertheless, a major element of our conclusions and recommendations is that these alternatives may serve as a way of facilitating the FDI liberalization process.

- ***Assisting domestic firms***

  Governments can foster the growth of domestic enterprises as an alternative to placing limitations on foreign firms. As noted above, the size and strength of TNCs have led governments to impose restrictions in industries populated by small, traditional, domestically owned firms. Here the emphasis on protection is being replaced by the promotion and development of domestically owned firms so that they can either become competitive with foreign-owned firms or be viable joint venture partners with them. Canada, for example, has created an array of substantial government programmes that are aimed at assisting its small and medium-sized businesses. In low-income countries, there has been a dramatic strengthening of certain domestically owned corporations, with an increase in recent years in the amount of outward FDI. Pride in "national champions" that can compete with foreign TNCs in both domestic and export markets is reducing antipathy towards TNCs.

  Many governments have offered export assistance to their domestically owned firms. Such assistance has generally been directed through the government's network of embassies and consulates around the world, within which trade commissioners may be designated specifically for this purpose. In this way, even a small business may become international in scope, on the basis of government assistance, in linking with potential customers and with distribution networks in other countries.

In some instances, subsidies have been used to achieve the objectives of many of the rationales for restrictions. In the past, governments have often utilized State-owned enterprises, and have excluded FDI, as a way of achieving cross-subsidization in pricing between income groups and regions of the country. However, rather than being achieved within a State-owned enterprise, such cross-subsidization can often be achieved through explicit subsidies.

Governments can alter incentives and outcomes through the design of the tax system. Establishing tax rates that are lower for small businesses than for large businesses is a way of encouraging a small-business environment, instead of prohibiting FDI where small businesses have traditionally been prominent. While many countries have not used such a dual tax system, it has been used effectively in Canada as a powerful mechanism for strengthening small businesses in their competition with large, often foreign-owned companies.

Governments have created technology centres to train, disseminate information and match domestic firms with foreign partners. In addition, the amount and level of management education have increased dramatically over the past decade as these countries have sought to develop domestic managers and entrepreneurs. Of considerable significance has been the widespread trend for individuals to study in universities in economically advanced nations in order to acquire the skills and knowledge which they need in order to be effective managers in the international economy.

- ***Strengthening the domestic capital market***

The stock market is an important mechanism for diluting foreign ownership and control, and hence for making it more acceptable to a country. Domestic shareholders can participate in the profits of the enterprise and can exercise some degree of control at shareholder meetings and particularly in elections to the board of directors. Furthermore, stock-exchange regulations may require the provision of information about an enterprise, thereby lessening the general distrust that has been a basis for restrictions on foreign ownership.

- *Imposing direct regulations*

  With increasingly greater sophistication within the public service, regulations can now be directed to specific features and attributes of products and production processes. Governments can choose any of these elements as the focus for regulation, including, as examples, the working conditions of employees; the impact of production facilities and waste materials on the purity of air and water, or on the aesthetic appearance of the community; the appropriateness and accuracy of advertising and marketing programmes; the health and safety of customers who use the product; and the financial obligations of the producer to its suppliers, employees, customers and the government. A wide range of externalities can be dealt with through direct regulations rather than through government ownership or FDI restrictions. One of the reasons for this trend has been the perception by governments that domestic investors are no more prone to act "in the national interest" as regards those elements than are foreign investors, since the interests of these two groups may coincide. From this perspective, the alternative mechanism of direct regulation is more effective than simply limiting foreign ownership.

- *Developing and enforcing competition policy*

  "Competition laws" can be implemented to prevent the exercise of monopoly power by firms, foreign firms among them. Policy can be designed to give a government discretionary power to respond to each industry's market structure. In particular, the growth of a specific large business may be limited in order to retain a certain portion of the market for other competitors. In this way, once again, the distrust of TNCs may be replaced with a confidence that the host country and its residents will not be exploited.

- *Imposing price controls and limits on rates of return*

  The fear of exploitation by TNCs can be based on concerns about consumers paying excessive prices, and employees receiving inadequate wages. From this perspective, the efficiency arguments in regard to monopolies may be joined by arguments in terms of social justice and fairness. In these circumstances, price controls and limits on rates of return can be used in place of foreign ownership restrictions on State-owned enterprises. For example, many countries have recently liberalized foreign ownership restrictions in electricity generation, but the power generated has had to be sold to a domestic transmission company at regulated prices or with a specified ceiling on rates of return. By this alternative mechanism, governments have been able to induce FDI in badly needed infrastructure development, but at the same time they have retained substantial control over price, as a key variable in the firm's operations.

- ***Developing new arrangements with regard to ownership***

In some countries, government ownership in energy and mining industries is stipulated in the country's constitution or, if private investment is allowed, foreign ownership has been prohibited. Governments have developed a number of alternative mechanisms that have permitted FDI, while at the same time retaining the objective of sectoral restrictions. These mechanisms have ranged from long-term leases, renewable leases and perpetual leases, to restrictions on the rights of exploitation and use. Leases introduce a time profile to the issue of ownership. In terms of national sovereignty and the concept of land being a birthright of all future citizens, leases can be defended on the basis that eventually ownership will revert to domestic owners or the government. In the energy sector, even when ownership of major deposits has been reserved for the government (as in Indonesia and Venezuela), production-sharing contracts, exploration and development contracts, and management contracts have been used to replicate many of the characteristics of ownership, but without explicit foreign ownership of the resource. The revenues from this natural resource are divided between the government and the foreign investor by a system of royalties, negotiated pricing formulas and taxation agreements.

As mentioned above, different classes of shares have been used to separate ownership and control: those that participate in dividends and those that have voting control. Another arrangement with regard to ownership has been the retention by the government of a "golden share". An agreement between a government and a foreign corporation can include specific rights that are attached to the government's golden share. In this way, "ownership" can be divided into various components, with the government deciding which rights or components it will retain. In Ghana, for example, the Government has used the golden share approach in order to encourage FDI in the mining sector, while alleviating domestic concerns through maintenance of the right of government intervention in certain kinds of decisions on the part of the corporation.

- ***Regulating boards of directors***

In many countries, regulations require that a certain portion of the board be citizens of the country. Once again, this may allay fears that a foreign-owned company could undertake activities that would be contrary to the best interests of the host country. The presumption of this regulation is that host country citizens would object to such activities and would bring them to the attention of the government. These board members can raise issues of interest to the host country at the top decision-making level of the foreign-owned firm. Of more recent note is the practice of making board members personally liable for certain actions that might damage the host country. Of significance have been obligations that accompany the closing of a business, and obligations with regard to environmental damage. In both of these areas, Canada, for example, has in recent years imposed stringent personal obligations. In Canada, certain potentially damaging corporate activities can even make a board member personally liable to criminal prosecution. Another mechanism is to require membership on boards of directors of other stakeholders in the business, e.g. as representatives of labour and environmental groups, who are concerned with issues such as working conditions, training or environmental impacts.

- ***Reducing economic rents by lowering trade barriers***

As noted earlier, foreign ownership restrictions have often been put in place because trade barriers created economic rents in certain markets. This approach, particularly when accompanied by government intervention in pricing, has often led to a degree of oligopoly or monopoly that has resulted in higher than competitive profit levels. Government ownership was one mechanism to capture these excess profits. Foreign ownership restrictions were also used to transfer these profits to domestic residents rather than allowing them to accrue to foreigners. These profits could then be taxed in various ways, such as personal income taxes and capital gains taxes. Over the 1984-1994 decade, many countries participated in international agreements to reduce trade barriers, both through GATT and also through new regional economic blocs. A perception has developed that trade liberalization has removed many such "above-normal" profit streams by increasing the degree of competitiveness within market structures. Hence trade liberalization can be seen as a mechanism that reduces the need to rely upon foreign ownership restrictions.

- ***Strengthening a government's administrative capabilities***

A problem in using alternative mechanisms, such as the tax system, rate-of-return regulations or some sort of competition policy, is the complexity of these mechanisms and the consequent difficulty of administering them effectively. Administration depends upon the availability of detailed, accurate accounting data on costs and revenues, and it depends upon the government authorities having the requisite resources and training to analyse these situations. The problems of transfer-price manipulation can be particularly acute with these mechanisms. Administrative capabilities and management expertise are evolving over time, and telecommunications infrastructure and systems of information retrieval are enhancing the ability to supervise, audit and enforce. Yet in many countries, the administrative capabilities of the government's tax authorities, the accounting profession and the legal system still require further development.

Conclusions and recommendations

The liberalization of foreign ownership restrictions over the 1984-1994 period was motivated by significant changes in the environment of business, with the development of new political and economic realities. The generally accepted perceptions about the costs and benefits of FDI changed over this period, to some degree because the costs and benefits themselves changed. Ownership restrictions had been imposed on the basis of optimistic expectations concerning their impacts. In fact, experience demonstrated that restrictions brought greater costs and fewer benefits than had been expected. The costs of foreign ownership restrictions have grown with the increased integration of the world economy. Among these costs is the greater significance of forgone investment, as TNCs choose less restrictive countries for production facilities. With the decline of trade barriers, TNCs no longer have to locate in each country in order to sell there. Hence, trade liberalization has both reduced the benefits and increased the costs for ownership restrictions. These changes in costs and benefits suggest that governments should give priority to re-examining any remaining restrictions.

- ***Coordination of microeconomic liberalization and foreign ownership liberalization***

  Governments should attempt to maintain a "balance" between liberalization of the microeconomy and liberalization of their FDI systems. For countries in which markets are highly distorted, such that the prices of factors of production do not reflect their scarcity value and the prices of products do not reflect costs, liberalization of the FDI system may not be appropriate until these distortions are reduced. On the other hand, countries that have already taken significant measures to liberalize their economies could benefit if their FDI systems were also liberalized. This conclusion is relevant for specific sectors, such as financial services, as well as for an economy as a whole.

  Governments will have to accept some degree of loss of direct control over the host country economy if they liberalize ownership restrictions. Control will be lost to private sector decision-making, both domestic and foreign. Over the past decade, governments have generally placed more reliance on private enterprises, including foreign investors, to be the major forces in the economy. In doing so, they have had to give up some degree of control over economic performance and have been forced, increasingly, to rely on individual decisions made by privately owned firms.

- ***Division of ownership into components for purposes of restrictions***

  Governments that are concerned about foreign ownership in specific industries should study carefully the possibility of devising agreements through which both they and the foreign investors are able to achieve their objectives. These agreements can transfer important aspects of ownership to foreign investors while maintaining host country control of aspects that may be important for domestic political or cultural reasons.

Structuring liberalization by sector. In their evaluation of FDI restrictions, governments should be ready to eliminate those restrictions that relate to manufacturing, infrastructure, financial services and distribution, and to replace them with alternative mechanisms. Governments will encounter greater political obstacles in eliminating restrictions that impact on energy, mining, agriculture, land, media and culture. Nevertheless, there are effective alternative mechanisms for achieving a society's objectives with regard to these sectors as well, and governments should give these alternatives serious consideration.

Harmonizing domestic policies. Governments should examine the impact on FDI of a wide range of their domestic policies. They should consider the possibility of harmonizing their domestic policies, when possible, with other countries as a means of further liberalizing their FDI regulatory framework. This harmonization may extend far beyond "national treatment" of foreign affiliates; it may mean the implementation, where possible, of similar government policies across nations. For example, it appears that competition policy may well be included in future international negotiations concerning investment. A likely central objective will be to establish common competition policies among nations. In addition to providing a clearer set of rules with regard to international investment, such policies have the additional potential advantage of reducing the need for anti-dumping trade policy. A corporation that is alleged to be selling products in one country at prices lower than it charges in other countries might be prosecuted under international competition policy, rather than through binational trade-dispute processes or the unilateral imposition of anti-dumping duties.

- ***Choosing a path and pace of change***

It may be helpful to view liberalization of restrictions as a movement along a continuum. The pace of movement along this continuum is an important policy variable. With the passage of time, governments should re-examine their policies with regard to foreign ownership on a regular basis, in order to determine whether changes in a variety of environmental factors have altered the appropriateness of their restrictions. As part of this re-evaluation, governments should consider a greater reliance on alternatives to foreign ownership restrictions, such as those discussed above. To be successful, reforms may require significant changes in various elements of the economic system and also in the mechanics of government administration. Consequently, there may be an advantage to a gradual process of reform. The number of activities where FDI is prohibited may be reduced over time. Privatization need not involve the sale of all government-owned assets; rather, it may be pursued simply by allowing the private sector to expand, with government maintaining its traditional activities. Permissible foreign equity ownership percentages may be raised gradually over time on the basis of an established schedule, with 100 per cent foreign ownership being permitted at some future date. The screening processes in many countries have illustrated that approvals may be liberalized simply by raising the ceiling, expressed in sales or assets, below which proposals are automatically approved.

Much remains to be done with regard to the liberalization of foreign ownership restrictions. Governments at the national level have claimed most of the attention in this matter. Yet subnational governments may have constitutional powers that give them a major role as well, and in Canada and India, for example, their positions have created significant barriers to liberalization. For foreigners, the risk of policy reversals means that international investment agreements have an important new role, with provisions for compensation in the event of specific developments, particularly nationalization. It is clear that multilateral investment agreements deserve a prominent position on the agenda of the World Trade Organization.

While current political and economic élites may now operate within an international paradigm, the re-emergence of nationalism remains a possibility in many countries, especially where the general population has not been a part of the liberalization philosophy or practice, and may not yet receive much material benefit from this process. Venezuela illustrates the possibility of future reversals to a more restrictive regime. In 1989, President Carlos Andres Perez led Venezuela towards a more open economy. Yet the 1993 electoral victory of President Rafael Caldera, who had supported a restrictive regime in his first term as President in the 1970s, has brought with it the reimposition of at least some restrictions on foreign ownership of enterprises in Venezuela, along with a number of other interventions by the Government in the microeconomy. The risk of renationalization, for example, may face the purchasers of State-owned enterprises in many countries.

Consequently, it may not be enough to rely upon the automatic continuation of the trend of deregulation generally seen over the past decade. The entrenchment of "openness" through international agreements will be of major importance, including provisions for compensation in the event of expropriation. For many corporations, this entrenchment may be of limited value if it is based solely on bilateral treaties where enforcement may depend on the strength of the corporation's home government. United States corporations, for example, may have an advantage in this regard. For various reasons then, a multilateral approach to the entrenchment of liberalization reforms deserves support.

As this article has indicated, the issues involved in liberalization are extensive and complex. Many domestic policies can serve as indirect restrictions, and some of these policies may be advocated as alternatives to foreign ownership restrictions. Consequently, the liberalization of these restrictions is a necessary but not sufficient condition for complete multidimensional FDI liberalization. While some nations may be prepared to move towards national treatment for foreign affiliates, it is unlikely that many will move all the way to complete multidimensional liberalization and domestic policy harmonization, since this would involve significant changes in traditional business practices and in the public philosophy concerning the appropriate role of government. ■

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