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Foreign-Investment Regulation in Historical Perspective — Lessons for the Proposed WTO Agreemant on Investment

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Introduction

During the last several years, the developed countries have been stepping up their pressure to install a multilateral investment agreement that prevents countries from controlling transnational-corporation (TNC) investment activities, and possibly the activities of portfolio investors. There is now a move to initiate the negotiation for a multilateral investment agreement at the forthcoming Cancun meeting of the WTO in September 2003.

The developed countries argue that their free trade and free investment were the main channels through which they became rich and therefore the developing countries should also try to emulate such policies. However, an examination of the historical experiences of a number of today's developed countries — the USA, the UK, France, Germany, Finland, Ireland, Japan, Korea and Taiwan — shows that they have all regulated, often severely, foreign investment when it was in their national interest. This suggests that an investment agreement in the WTO is likely to hamper, rather than help, the development of the developing countries.

The USA

In contrast to its strong support for foreign-investment liberalization today, when it was a capital-importing country, the USA had all kinds of provisions to ensure that foreigners invested in the country but did not control its economy.

For example, the US federal government placed restrictions on foreigners' ownership in agricultural land, mining and logging. It discriminated foreign firms in banking and insurance, while prohibiting foreign investment in coastal shipping. It demanded that all directors of national banks had to be American citizens, while depriving foreign shareholders of voting rights in the case of federally-chartered banks. It also prohibited the employment of foreign workers, thus implicitly disadvantaging foreign investors that wanted to import skilled labour from their home countries.

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

Advanced European countries

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

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Poorer European countries

Finland and Ireland are arguably among the most impressive cases of industrial transformation in the second half of the 20th century in Europe. However, their respective policies towards foreign investment could not have been more different, at least until Finland's accession to the EU in 1993 — Finland basically blocking any significant foreign investment, while Ireland aggressively seeking it out.

The comparison of these two polar cases raises two important points: The first is that there is no one-size-fits-all foreign-investment policy that works for everyone. Finland built its economic miracle under arguably one of the world's most restrictive policy regimes *vis-a-vis* foreign investors, while Ireland benefited from actively courting and working with TNCs. The second point is that, however "liberal" a country may be towards foreign investment, a targeted and performance-oriented approach works better than a hands-off approach, which is recommended by the developed countries today. Even in the case of Ireland, a combination of carrots and sticks has been used *vis-a-vis* foreign investors since the early days, and it was only when it got the balance between the two right that the country started to truly benefit from FDI.

East Asian countries

Like the USA in the 19th century, the three largest East Asian economies have tried to use foreign capital under national management as much as they can, and consequently have used extensive controls on foreign investment, in terms of ownership, entry and performance requirements, throughout their developmental period. In particular, Japan and Korea (until recently) relied very little on FDI, while even Taiwan, the most FDI-friendly among the three countries, was below the international average in its reliance on FDI.

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

Conclusion: Lessons for today

In the same way in which they did not use free trade but protected their industries when they were trying to catch up with the more advanced countries (see my book, *Kicking Away the Ladder*, 2002, Anthem Press, for further details), all of today's developed countries had imposed strict regulation of foreign investment when they were net recipients of foreign investment. The exact strategies that were used varied across countries, ranging from the very welcoming (but not l*aissez-faire* and increasingly selective over time) strategy of Ireland to the very restrictive strategy of Finland, Japan, Korea and 19th-century USA in certain sectors (especially finance and navigation). In other words, there was no one-size-fits-all model of foreign-investment regulation.

However, one commonality between them is that they took a strategic approach, rather than a uniformly welcoming or uniformly restrictive one, to the issue of foreign-investment regulation. This meant that different sectors could be subject to different policies even at the same point in time. For example, while welcoming and subsidizing FDI in labour-intensive manufacturing sectors, Korea and Taiwan in the 1960s and the 1970s strictly restricted FDI in other industries. Also, over time, with changes in their economic structure and external conditions, their policy stances changed. For example, Korea had a relatively open policy towards FDI in the car industry, but when it decided in the mid-1970s to develop its own car industry, it started putting heavy restrictions on FDI in the industry.

In light of these lessons, we can say that the current proposals made by the developed countries in the WTO in relation to foreign-investment regulation are highly problematic.

Historical experiences show that: a strategic and flexible approach is essential if countries are to use foreign investment in a way that is compatible with their long-term development. By restricting such policy freedom, the developed-country proposal is going to damage the development prospect of the developing countries. In particular, the principle of "national treatment" that some countries emphasize is lethal to development.

At one level, national treatment sounds fair, given that it calls for a "level playing field". However, the principle of "level playing field" should be complemented by that of "comparable players".

If we match players of unequal abilities, the game will be patently in favour of the stronger players, and in recognition of this, in many sports where weight matters (e.g., boxing, wrestling, judo, weightlifting), we do not allow players of different weights to compete against each other. And history tells us that the policymakers of successful countries understood this when they designed their policies towards foreign investment.

(This Briefing Paper is a summary of a paper (with a similar title) presented by Dr Ha-Joon Chang, at the seminars on investment organised by the Third World Network and other NGOs, in Geneva on 18-20 March 2003.)

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