VII. FOREIGN DIRECT INVESTMENT RESTRICTIONS IN OECD COUNTRIES

Introduction and summary

Inward foreign direct investment has often been restricted

Attitudes and policies towards liberalisation of international capital flows have been subject to considerable controversy.[1] This is because free capital movements raise concerns about loss of national sovereignty and other possible adverse consequences. Foreign direct investment (FDI), even more than other types of capital flows, has historically given rise to such concerns, since it may involve a controlling stake by often large multinational corporations over which domestic authorities, it is feared, have little power. For these reasons, governments have sometimes imposed restrictions on inward FDI. In recent decades, however, an increasing consensus on the benefits of inward FDI has led to reconsideration of these restrictions and this has been reflected in formal agreements on such capital flows (Box VII.1).

Box VII.1. **International investment agreements**

Formal international agreements on foreign direct investment are far less extensive than on international trade, despite the importance of FDI in the world economy. However, the 1990s have seen a substantial rise in the number of bilateral investment protection treaties, and regional and bilateral trade agreements in which investment disciplines figure prominently. These agreements include NAFTA, the recent agreements concluded by Singapore with EFTA, Japan and Australia and the Association Agreement between the European Community and Chile. The European Union had already completely liberalised intra-EU capital movements in the late 1980s.

The OECD has been an important actor in international discussions and agreements on FDI.[1] At present the OECD Code of Liberalisation of Capital Movements forms the only multilateral framework in force on international capital flows, including FDI. Under the Code, countries bind themselves to agreed measures liberalising capital movements. Moreover, under the OECD Declaration on International Investment and Multinational Enterprises, the 30 OECD countries and 7 non-OECD adhering countries are committed to accord national treatment to foreign enterprises operating in their territories and to encourage their multinational enterprises to engage in responsible business conduct in a variety of areas.

1. See OECD (2002*a*) for an overview of policies towards international capital mobility, with a focus on the experience of OECD countries.

There are several investment-related provisions in the agreements related to the World Trade Organisation. The Uruguay Round led to an agreement on Trade Related Investment Measures (TRIMS) that restricts *inter alia* domestic-content requirements. The General Agreement on Trade in Services (GATS) covers all modes of service delivery, including "commercial presence" which is closely related to FDI. The GATS commitments, however, apply only to industries where countries have explicitly agreed to open their markets to foreign providers. In 1996, the WTO also created the Working Group on the Relationship Between Trade and Investment, a forum for discussion among WTO countries. At the Doha Ministerial Conference in November 2001, the WTO members agreed on the principle of undertaking negotiations on a multilateral framework after the 2003 WTO ministerial meeting at Cancun (see OECD, 2002*b*).

1. Further discussion of OECD experience with investment rules and multilateral initiatives concerning FDI can be found at www.oecd.org/daf/investment and in Graham (2000), Robertson (2002) and Sauvé and Wilkie (2000).

This chapter shows that restrictions on FDI are...

This chapter reviews restrictions on FDI inflows in OECD countries. The barriers covered include limitations on foreign ownership, screening or notification procedures, and management and operational restrictions. The main findings are as follows:

… generally low…

- Overall FDI restrictions are generally low in the OECD area at present but important in the case of a few countries.

… concentrated in the service sectors…

- FDI restrictions are concentrated in service sectors with almost no overt constraints in manufacturing.

… and have fallen since 1980

- Barriers to foreign ownership have significantly fallen in virtually all OECD countries over the past two decades.

The different types of FDI barriers

Formal restrictions on FDI include limits on foreign ownership…

Restrictions on foreign ownership are the most obvious barriers to inward FDI. They typically take the form of limiting the share of companies' equity capital in a target sector that non-residents are allowed to hold, *e.g.* to less than 50 per cent, or even prohibit any foreign ownership. Examples of majority domestic ownership requirements include airlines in the European Union and North American countries, telecommunications in Japan, and coastal and freshwater shipping in the United States. Exclusive domestic ownership is also often applied to natural resource sectors with the aim of giving citizens access to the associated rents. For example, foreign ownership is banned in the fishing and energy sectors in Iceland, and in the oil sector in Mexico. Although not specifically aimed at excluding foreign shareholders, statutory state monopolies are tantamount to a ban on foreign investment.

… screening and approval procedures…

Obligatory screening and approval procedures can also be used to limit FDI though their constraining effects depend on the implementation of such practices. Stipulations that foreign investors must show economic benefits can increase the cost of entry and therefore may discourage the

inflow of foreign capital. Such provisions apply, for instance, for a few industries in Japan and for the acquisition of more than 49 per cent of any existing enterprise in Mexico. Prior approval of FDI, such as mandated for all FDI projects in a few OECD countries, could also limit foreign capital inflow if it is taken as a sign of an ambivalent attitude towards free FDI, even though it may not be vigorously enforced. Simple pre- or post-notification (as required in *e.g.* Japan) is, however, unlikely to have much impact on capital inflows.

… and constraints on foreign personnel and operational freedom

Other formal restrictions that can discourage FDI inflows include constraints on the ability of foreign nationals either to manage or to work in affiliates of foreign companies and other operational controls on these businesses. Stipulations that nationals or residents must form a majority of the board of directors, as in insurance companies in member countries of the European Union, in financial services industries in Canada and in transport industries in Japan, may undermine foreign owners' control over their holdings and hence make them more hesitant to invest under such circumstances. Similarly, if regulations restrict the employment of foreign nationals (as *e.g.* in Turkey), investors may judge that they cannot make use of the necessary expertise to make their investment worthwhile. Also, operational requirements, such as the restrictions *vis-à-vis* non-members on cabotage in most European Union countries for maritime transport may limit profits of foreign-owned corporations and hence the amount of funds foreign investors are willing to commit.

Informal barriers may also be important

Apart from the formal barriers discussed above, FDI flows can be held back by opaque informal public or private measures. Indeed, claims abound that such practices are used systematically to limit foreign ownership of domestic businesses. Thus, the US Trade Representative has frequently stated that the system of corporate control in Japan has hampered investment by US companies and that regulatory practices in telecommunications in the European Union work as *de facto* FDI restraining measure. Similarly, the Japanese Ministry of Trade and Economy claims that FDI in financial services in the United States is restricted by the diverse and complex set of regulations at the state level and that barriers relating to interconnections hamper foreign entry into telecommunications in the European Union. Also, the European Union cites the continuing role of administrative guidance to firms in Japan by government officials as a practice that hampers foreign ownership of Japanese enterprises.

The openness of OECD countries to inward FDI *circa* 1998-2000

Overall FDI restrictions are now low in most OECD countries…

Notwithstanding the numerous barriers in specific activities, an aggregate indicator of FDI restrictions (Box VII.2) suggests that the OECD countries are generally open to foreign direct investment inflows (Figure VII.1).[2] There are, however, significant differences between countries.[3] The most open countries are in the European Union. Since 1992, intra-EU FDI flows are almost completely unrestricted. Furthermore, a number of EU countries have minimal overt restrictions on inflows from non-EU countries. Nonetheless, there are some important differences in restrictions imposed by EU countries on non-EU investors and, therefore, even the European Union is not a completely unified bloc in terms of policies towards inward FDI. The countries with the highest levels of overall restrictions are Iceland, Canada, Turkey, Mexico, Australia, Austria, Korea and Japan. The United States is slightly below the OECD mean.

Box VII.2. **Indicators of FDI restrictions**

Some indicators of overall FDI barriers are based on a count of the number of restrictions.[1] While this has the advantage of simplicity, some restrictions are more important than others. For example, a ban on foreign ownership is much more restrictive than a screening or a reporting requirement. The OECD FDI restrictiveness indicators therefore weigh different restrictions according to their perceived significance, even though such a procedure entails some arbitrary judgements. They are based on a variant of the methodology applied by the Australian Productivity Commission in a similar study for the APEC countries (Hardin and Holmes, 1997). The OECD indicators cover restrictions in nine sectors (subdivided in 11 subsectors), of which seven are services industries, where the bulk of FDI restrictions is generally found. This information is then aggregated into a single measure for the economy as a whole. Details of the methodology and data sources can be found in Golub (2003).

Some limitations of the measures should be noted. The indicators cover mainly statutory barriers, abstracting from most of the other direct or indirect obstacles impinging on FDI, such as those related to corporate governance mechanisms and/or hidden institutional or behavioural obstacles that discriminate against foreign firms.[2] It is also possible that some countries are more forthcoming than others in self-reporting their restrictions. It could then be that more transparent countries receive higher scores, not because they are in fact more restrictive, but because they are more complete in their reporting. The extent of enforcement of statutory restrictions, especially those concerning screening requirements, may also vary. Finally, standardising and putting into context idiosyncratic restrictions in individual countries often involve an element of judgement.

1. See *e.g.* Hoekman (1995) and Sauvé (2003).
2. Non-statutory barriers to FDI are very difficult to ascertain and quantify. However, some of them were included in the indicators, such as the absolute barrier represented by full state ownership of business enterprises and hidden institutional or behavioural barriers documented in official reports.

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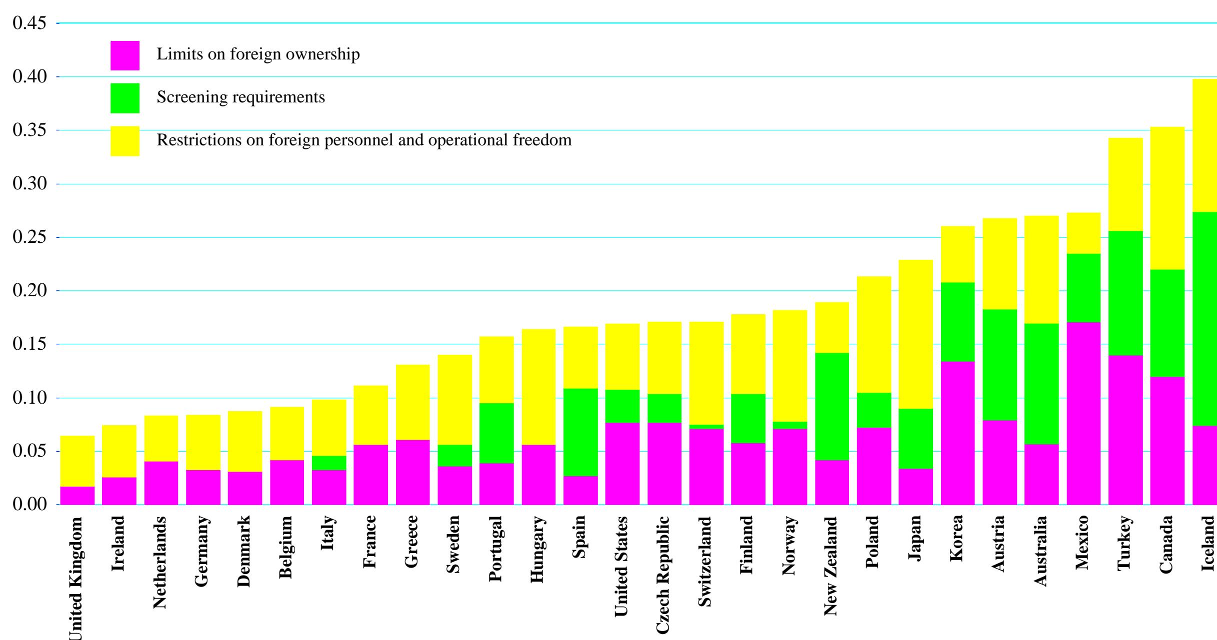
2. There have been important changes in some countries since 2000 that are not reflected in the results reported here.
3. With an aggregate restrictiveness indicator that excludes screening requirements, the least and most open countries generally remain the same as those in Figure VII.1, the main exceptions being New Zealand (that moves from below to above average openness) and Spain (that moves from average to above average openness). Australia also moves towards a more open stance, though it remains below the OECD average.

Figure VII.1. FDI restrictions in OECD countries, 1998/2000: breakdown by type of restriction[1]



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive).
Source: OECD.

… and concentrated on ceilings on foreign equity holdings…

Around 2000, equity restrictions were particularly heavy in Mexico, Turkey and Korea, but also remained relatively stringent in Canada and the United States. Management and operational restrictions were notably strong in Japan, Iceland and Canada. In a few countries (Iceland, Australia, New Zealand, Canada and Spain) statutory screening requirements were relatively pervasive.[4]

… in non-manufacturing sectors

The overall level of barriers masks wide differences across sectors.[5] Figure VII.2 suggests that, on average, the bulk of restrictions are found in non-manufacturing industries.[6] FDI inflows into manufacturing are almost completely free, aside from economy-wide restrictions such as notification or screening requirements. Within non-manufacturing, electricity, transport and telecommunications are the most constrained industries, followed by finance, while the other services industries are on average relatively unrestricted. Again, these average patterns mask cross-country differences in the extent of restrictions in non-manufacturing

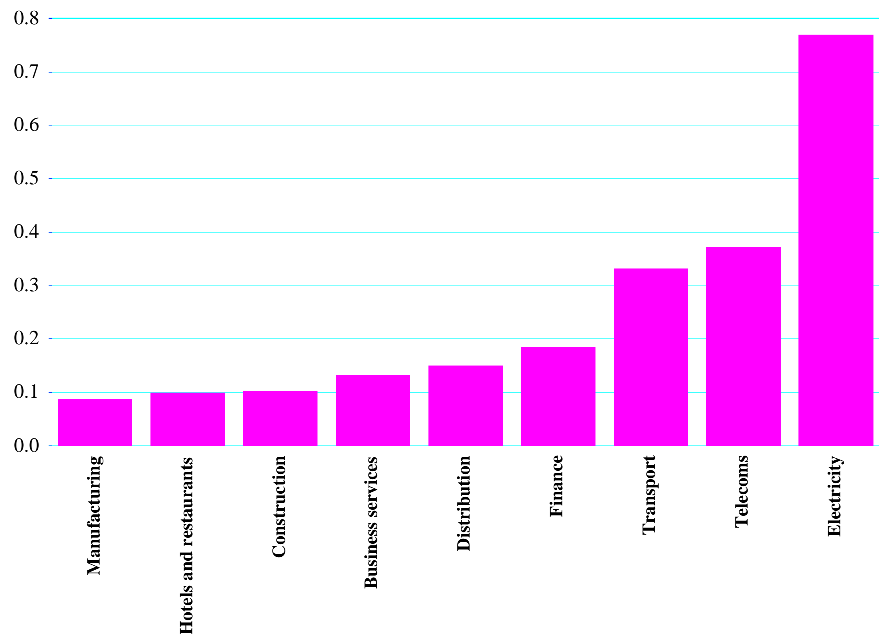
4. The indicators are unable to capture differences in the enforcement of restrictions, which might be particularly important for screening requirements. For example, some countries simply perform basic checks such as whether an investor has a criminal record.

5. For further details about FDI restrictions at the industry level in OECD countries, see Golub (2003).

6. A simple count of restrictions affecting different industries shows that 67 per cent of all restrictions concern the services sector (Sauvé and Steinfatt, 2003).

industries. In 1998-2000, barriers in the European Union were relatively low in all these industries, while in Canada, Korea, Mexico, Turkey and, to a lesser extent, Australia and New Zealand, they where at or above the OECD average in many of them. They were concentrated in the transport industry in the United States and in telecommunications in Japan.

Figure VII.2. Cross-sectoral patterns of FDI restrictions, 1998/2000[1]



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive).
Source: OECD.

The liberalisation of FDI since 1980[7]

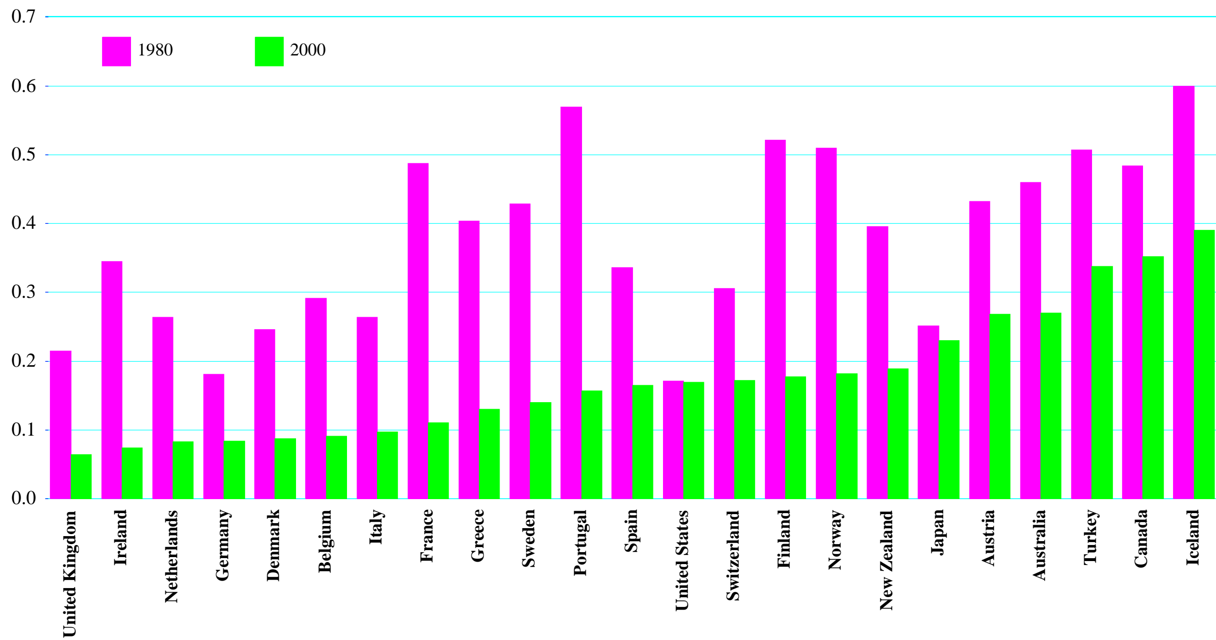
FDI restrictions have declined steeply since 1980

Figure VII.3 shows that the liberalisation of FDI flows has been substantial over the past two decades in all OECD countries except the United States and Japan, both of which had what in 1980 were relatively low statutory restrictions. Particularly dramatic changes have occurred in several EU countries, notably Portugal, France and Finland. To a large extent, the generalised decline in barriers reflects full liberalisation of capital flows within the European Union (completed in the early 1990s) and the concomitant extensive privatisations both in the European Union and elsewhere, which have opened up previously sheltered public firms and monopolies to foreign capital. The fall in FDI barriers throughout the

7. Due to data limitations, results here are limited to a smaller set of OECD countries.

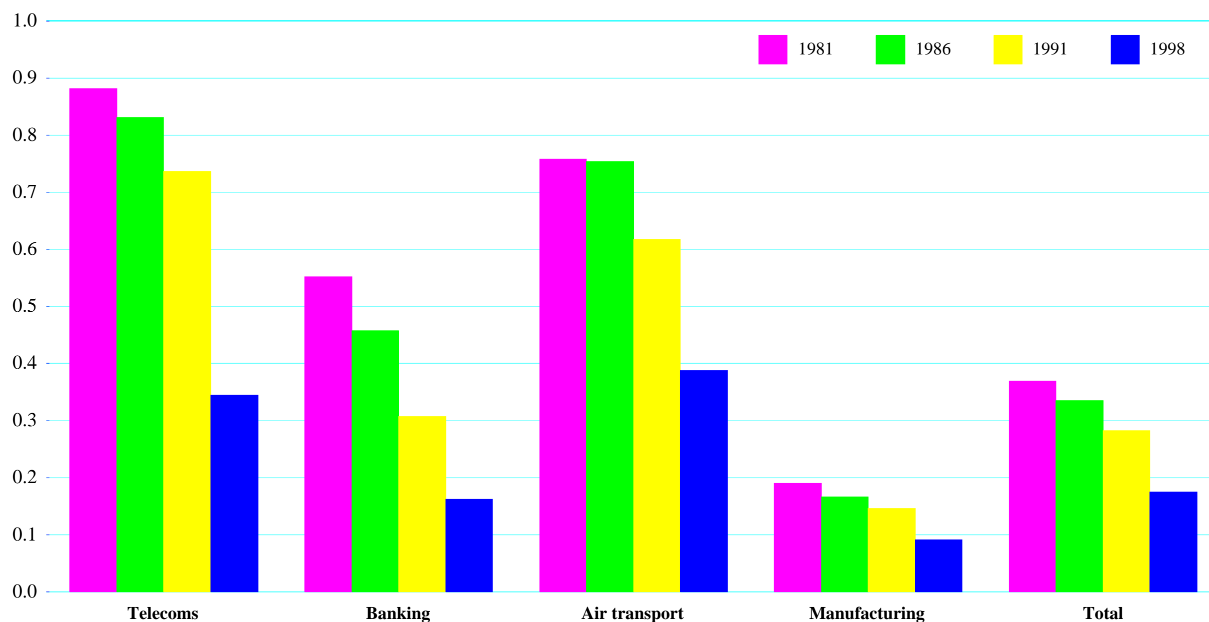
OECD area has been particularly noticeable in the telecommunication and air transport sectors, which were almost completely closed in the early 1980s (Figure VII.4).

Figure VII.3. FDI restrictions in OECD countries, 1980-2000[1]



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive).
Source: OECD.

Figure VII.4. Evolution of FDI restrictions in selected sectors, 1981-1998[1]
OECD average[2]



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive).
2. Average for 23 OECD countries.
Source: OECD.

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