An Analysis of the Restrictions on Foreign Direct Investment in Free Trade Agreements

Shujiro URATA
John SASUYA
Waseda University

March 22, 2007

Introduction: *The Importance of FDI in International Economic Activities*

- **1980 to 2004 - world FDI increased 11 times vs world trade (4 times) and GDP (5 times)**
- **Economic growth in recipient countries- *e.g. employment, transfer of technology***
  - **resulted to high economic growth in developing countries like China**
- **Growth in FDI can be attributed to liberalization policies of different countries**
  - **Some countries also provide corporate income tax exemptions**
- **However, there are still rooms for further liberalization.**

Introduction: FTA and FDI Liberalization

- Countries started to use FTAs to liberalize FDI policies in FTA partner countries
- Provisions on FDI in FTAs are meant to give investors of the contracting parties more concessions in doing businesses
  - For easier market access and the right of establishment, the render of same national treatment and the none-requirement to perform certain conditions such as local content and employment
- However, FTAs still contain several measures that also include restrictions on FDIs based on laws and regulations in national level

Objective of the Study

- To provide analysis of restrictions on FDI
  - limitations on foreign ownership and market access
  - national treatment
  - screening and approval
  - management and composition of board of directors
  - entry of foreign investors
  - performance requirements.

  FTAs that are evaluated
- FTAs that are evaluated include Japan-Singapore, Japan-Mexico, NAFTA, US-Australia, US-Singapore, Korea-Singapore and Korea-Chile

Methodology

- This study used a modified Golub (2003) method of analyzing restrictions on FDI

Restriction on Ownership and Market Access (0.4)	
No foreign equity is allowed	0
1-19 percent is allowed	0.1
Reservation on ownership and market access	0.25
20-34 percent is allowed	0.4
35-49 percent is allowed	0.5
50-74 percent is allowed	0.7
75-99 percent is allowed	0.8
No restriction but unbound	0.9
Commercial presence is required	0.9
No restriction	1

National Treatment (0.20)	
No national treatment	0
Reservation on national treatment	0.25
No restrictions	1
Screening and Approval (0.10)	
Objections in case the investment is contrary to national interest	0
Investment are required to show economic benefits before approval	0.1
Reservations for future limitations	0.25
Objections based on the size of investment	0.5
Prior or post notification	0.9
No restrictions	1

Methodology (…cont.)

- Board of Directors and Management Composition (0.10)
  - All members of the management should be locals 0
  - Reservations for future restrictions 0.25
    Majority should be locals 0.5
    At least one is local 0.75
  - Should be locally license 0.9
  - No restrictions 1

- Movement of investors (0.10)
  - No entry 0
  - Less than one year 0.1
  - Reservations for further measures on entry 0.25
  - One to two years 0.4
  - Three to four years 0.5
  - More than four years but less than ten 0.8
  - No restrictions 1

- Performance requirements (0.10)
  - Local contents 0.75
  - Others 0.9

All in all, twenty one sectors that includes 158 ISIC three-digit subsectors were evaluated in this study.

Results and Discussions

	Limitation of Foreign Ownership Market Access	National Treatment	Screening And Approval	Board of Directors	Movement of people*	Performance Requirements	Total	Rank
US- Australia							0.838	1
US	0.340	0.174	0.098	0.097	0.100	0.096	0.905	
Australia	0.273	0.164	0.047	0.089	0.100	0.097	0.770	
US- Singapore FTA							0.825	2
US	0.326	0.172	0.098	0.096	0.100	0.096	0.888	
Singapore	0.278	0.157	0.096	0.039	0.100	0.093	0.763	
Japan-Singapore EPA							0.767	3
Japan	0.276	0.157	0.086	0.088	0.048	0.095	0.750	
Singapore	0.343	0.158	0.089	0.045	0.050	0.098	0.784	
Korea- Singapore FTA							0.741	4
Korea	0.259	0.156	0.082	0.083	0.075	0.038	0.693	
Singapore	0.310	0.173	0.095	0.046	0.075	0.088	0.788	
NAFTA							0.710	5
Canada	0.280	0.158	0.009	0.025	0.100	0.049	0.621	
Mexico	0.222	0.135	0.023	0.089	0.095	0.089	0.654	
US	0.292	0.180	0.092	0.094	0.100	0.096	0.855	
Korea- Chile FTA							0.689	6
Korea	0.271	0.146	0.063	0.082	0.050	0.091	0.704	
Chile	0.272	0.142	0.095	0.069	0.050	0.045	0.673	
Japan- Mexico EPA							0.687	7
Japan	0.305	0.162	0.084	0.084	0.048	0.090	0.773	

Results and Discussions: *Degree of Restrictiveness*

- Japan and Mexico EPA and Chile-Korea FTA - most prohibitive to foreign investments
  - Mexico has more restriction to foreign investments as compared to its EPA partner Japan.
  - Korea and Chile have almost the same degree of restrictiveness
- NAFTA - restrictive
  - Canada and Mexico maintained high degree of restrictions while the US is relatively open.

Results and Discussions: *Degree of Restrictiveness (…cont.)*

- Korea-Singapore FTA
  - Korea has maintained most of the restrictions in most sectors on foreign investments as compared with Singapore, which is relatively more open to foreign investments
- Japan-Singapore EPA, US-Singapore FTA and US-Australia FTA have lower degree of restrictions

Results and Discussions: *Degree of Restrictiveness (…cont.)*

- Differences of Scores with Different FTA Partners
  - US has less restrictions on its FTA with Australia as compared to the one it signed with Singapore and Mexico and Canada
    - the principle of reciprocity is a feature of US FTA
    - Competition
  - Japan is more open to Mexico than to Singapore
    - Singapore economy is relatively open compared to Mexico

Results and Discussions: *By Country Assessment*

	Limitation of Foreign Ownership Market Access	National Treatment	Screening and Approval	Board of Directors	Movement of people*	Performance Requirements	Total	Rank
US	0.319	0.175	0.096	0.095	0.100	0.096	0.881	1
Singapore	0.310	0.163	0.094	0.043	0.075	0.093	0.778	2
Australia	0.273	0.164	0.047	0.089	0.100	0.097	0.770	3
Japan	0.291	0.159	0.085	0.086	0.048	0.093	0.762	4
Korea	0.265	0.151	0.073	0.083	0.063	0.064	0.699	5
Chile	0.272	0.142	0.095	0.069	0.050	0.045	0.673	6
Mexico	0.228	0.139	0.023	0.077	0.071	0.089	0.627	7
Canada	0.280	0.158	0.009	0.025	0.100	0.048	0.620	8

Results and Discussions: *By Country Assessment*

- **Canada, Mexico, Chile and Korea - very restrictive when it comes to FDI**
- **US and Singapore - relatively open**
- **Contrary to popular views, Japan in not restrictive to FDI**

Previous Studies

- Golub (2003): evaluation of FDI regimes for 28 OECD countries. Ranking, the US (14), Japan (21), Korea (22), Australia (24), Mexico (25), and Canada (27).
- PECC (2002): evaluation of FDI regimes for 19 APEC economies. Ranking, Australia (2), Japan and Korea (3), the US (5), Singapore (7), Canada (10), Mexico (14).

Results and Discussions: *Types of Restrictive Measures*

- **restriction on foreign ownership and market access- most salient type of limitation on foreign direct investment**
  - **For instance, Mexico restricts foreign ownership on oil and petroleum sector while Australia restricts ownership on Qantas Airlines and Telstra**
- **FTAs are expected to give the same national treatment to the investors of each of the party involved, however, there are still some restrictions**

Results and Discussions: *Types of Restrictive Measures*

- **Canada, Australia and Mexico - provide the highest degree of restrictions on the screening and approval of FDI**
- **Performance requirements**
  - **For instance, Mexico requires investors in manufacturing sector to export certain amount of goods while Chile requires employment of local people**

Results and Discussions: *Degree of Restrictions of Selected FTAs by Sectors*

- the primary and tertiary sectors have the most numbers of restrictions on foreign investments
  - Primary- Agriculture and Mining (oil, mineral ores, etc.)
  - Tertiary- transportation, information and communication and financial sectors

	Primary Sectors	Secondary Sectors	Tertiary Sectors
US- Australia			
US	**0.920**	**0.940**	**0.901**
Australia	**0.805**	**0.850**	**0.761**
US- Singapore FTA			
US	**0.940**	**0.940**	**0.879**
Singapore	**0.873**	**0.885**	**0.743**
Japan-Singapore EPA			
Japan	**0.310**	**0.780**	**0.797**
Singapore	**0.825**	**0.775**	**0.779**
Korea- Singapore FTA			
Korea	**0.675**	**0.675**	**0.696**
Singapore	**0.900**	**0.880**	**0.789**
NAFTA			
Canada	**0.395**	**0.685**	**0.643**
Mexico	**0.210**	**0.555**	**0.708**
US	**0.890**	**0.900**	**0.848**
Korea- Chile FTA			
Korea	**0.695**	**0.750**	**0.702**
Chile	**0.520**	**0.650**	**0.691**
Japan- Mexico EPA			
Japan	**0.393**	**0.730**	**0.817**
Mexico	**0.213**	**0.545**	**0.648**

Conclusions

- Although countries under study aim to liberalize, not only trade but, investment sectors, as well, there are several restrictions that will affect the flow of capital among boarders of FTA signatories. The most salient feature of restriction can be seen on foreign ownership or the degree of participation that foreign investors can influence the enterprise. Primary sectors, mining and agriculture, are the most restrictive ones. The United States and Singapore are among the most open to foreign investments, as the results suggested.