1

Introduction

The Politics of FDI Regulation in the Twentieth Century

Foreign direct investment (FDI) are investments that corporations make to produce goods and services in foreign countries. For example, these are the investments that a manufacturing firm makes when it relocates factories abroad, an oil company makes to drill for oil overseas, or a bank makes when it purchases a bank based in a foreign country.

FDI is the lynchpin of today's global economy, because it is the single largest form of international capital flow. In many years, the total value of world FDI flows exceeds the total value of all other forms of cross-border capital flows combined (UNCTAD 2012). Multinational corporations (MNCs) also create a significant portion of global trade. In the 1990s, MNCs generated 90 percent of all U.S. trade (Bernard, Jensen, and Schott 2009: 536). Intrafirm trade – trade between subsidiaries of the same MNC – accounts for more than a third of total world trade (Yi 2003, Bernard, Jensen, Redding, and Schott 2012).

FDI also figures prominently in some of the most pressing challenges and opportunities that global economic integration presents. FDI is unparalleled in its potential to foster economic development. When MNCs produce abroad, they provide a conduit for the specialized technologies and skills that are critical to industrialization (Romer 1993). During economic crises, including the 2008 global financial crisis, MNCs tend to increase stability, expanding production while their local counterparts fold (Desai, Foley, and Forbes 2008, Alfaro and Chen 2012).

There are, however, prominent examples of MNCs that appear to have run roughshod over national laws, and even basic human rights, to pursue resources and profits. A 1984 gas leak at a Union Carbide plant in Bhopal, India, left thousands of people dead and hundreds of thousands injured. Decades later, litigation over Union Carbide's negligence continued in both

Indian and U.S. courts. In 2012, the U.S. Supreme Court heard the case of twelve Nigerian citizens who alleged that the multinational oil company Royal Dutch Petroleum aided and abetted torture and extrajudicial killings by the Nigerian government. It eventually ruled in favor of Royal Dutch Petroleum.[1] Although these are extreme examples, they represent a larger class of concerns about how MNCs use their vast resources and influence, and how national laws cannot adequately hold MNCs accountable for their actions.

Political economy research on FDI has long focused on how politics influences patterns of FDI inflows across countries. Put differently, existing research emphasizes questions of FDI supply: How does politics factor into MNCs' location decisions? How do domestic political characteristics systematically influence the expected profits of FDI in a given host country? When investors own firms in foreign countries, they contend with political risk, the risk that host governments will change regulations, enforce contracts poorly, expropriate assets, or otherwise act to lower investment returns. Examining the politics of FDI from the perspective of MNCs, current FDI scholarship seeks to identify the host country characteristics that correspond to higher risks (Jensen et al. 2012). This research generally treats FDI as something of a black box, giving little regard to the specifics of MNCs' production and sales activities in host countries. Similarly, empirical analyses almost uniformly characterize FDI only by estimates of its monetary value.

In this book, I analyze how and why countries regulate FDI inflows. By contrast to existing research, my focus is on the politics of FDI demand: Why do countries restrict FDI inflows? Why are FDI restrictions more common in certain industries? Under what circumstances do countries dismantle regulations to provide MNCs greater access to their economy? These questions come from the perspective of citizens and national policy makers in host countries, not the investing MNCs. To answer these questions, I open up the black box of FDI to examine MNCs' specific economic activities and how those activities affect host countries.

FDI's economic consequences derive from the firm-specific economic assets that MNCs introduce into the countries in which they invest. These assets include production technologies, production practices, and consumer brands that the firm itself develops. MNCs engage in FDI to expand their production and sales into foreign markets while maintaining control over these assets. Firms for whom it is profitable to become multinational

[1] Kiobel v. Royal Dutch Petroleum Co., 133 S.Ct. 1659 2013.

through FDI are firms whose assets confer exceptional productivity advantages. Indeed, MNCs are typically the world's most productive firms in their respective industries.

My theory of FDI regulation identifies how MNCs' production and sales activities redistribute income within host countries by increasing labor demand, and competing with local firms. National policy makers regulate FDI inflows to mitigate the expected costs to local firms. The most prevalent form of FDI regulation requires MNCs to form partnerships with local firms in which the local partner is the majority shareholder. These ownership restrictions facilitate local firms' access to MNCs' highly productive economic assets and the income they generate.

To test my claims, I use an original dataset of annual country-industry foreign ownership regulations that spans more than 100 countries during the 1970–2000 period. While there are multiple types of FDI policy instruments, ownership restrictions are the most ubiquitous form of FDI regulation across countries and industries. To the best of my knowledge, this is the most comprehensive dataset of formal national FDI regulations ever collected. With this data, I show why countries vary in how often they regulate FDI during the last third of the twentieth century.

This research contributes to our understanding of FDI policies and the politics of international economic integration more generally. For FDI specifically, it highlights the political underpinnings of the dramatic FDI liberalization during the 1970–2000 period, the liberalization responsible for FDI's prominent and varied role in economic integration today. Further, by identifying politically salient variation in the content of investments, this research resolves an apparent contradiction in the politics of FDI: the presence of both vociferous opposition to FDI and extensive efforts to attract FDI inflows. In addition to providing a theory of FDI demand, my research suggests new and better tests of political risk theories. These tests that emphasize variation across MNCs in their vulnerability and sensitivity to risk as much as they do variation in host-country sources of risk.

This research also situates the political economy of FDI in the context of larger structural transformations of the world economy. FDI liberalization is a microcosm of fundamental shifts in both the scope of political representation within countries and the global organization of economic activity that took place during the last third of the twentieth century. Democratization, and the accompanying expansion of political representation, prompted policy makers to reassess their countries' engagement in the global economy. Simultaneously, the emergence of multi-country production networks altered the costs and benefits of economic integration.

The book also provides insights into the unfolding politics of FDI in the twenty-first century. FDI features prominently in the relationship between advanced industrialized economies and large emerging-markets like China, India, and Brazil. FDI contributes heavily to the remarkable growth of these developing countries, particularly China. Investments to produce goods for export draw these countries into global production networks in which individual MNCs fragment their production of a single good across multiple countries. Through these networks developing countries gain high-quality manufacturing jobs and augment their industrial capacities.

FDI, however, also generates some of the sharpest economic policy tensions between advanced and emerging economies. While emerging-market countries welcome FDI that produces goods for export, they frequently restrict foreign MNCs' access to the local consumer market. Robust growth in these large countries makes them attractive destinations for MNCs seeking to produce and sell goods and services to their citizens. In response, emerging markets often reaffirm foreign ownership restrictions in non-traded service industries like retailing, finance, and telecommunications where MNCs pose a particularly large and direct competitive threat to local firms in the same industries. At the same time, MNCs based in emerging markets face increasing hostility toward their FDI into advanced economies. As developing countries' economies rapidly ascend, some of their largest firms have become MNCs, albeit frequently with subsidies from their national governments. In response to these investments, the world's most advanced economies are reassessing their policies, citing both economic and national security concerns, despite, in many cases, their having long been open to FDI.

These trends suggest that FDI remains as politically contentious as ever notwithstanding the decline in average levels of formal restrictions in recent decades. To understand today's global economy, we need to understand FDI's winners and losers and the evolution of FDI policies. In the concluding chapter, I return to the question of FDI's politics in the twenty-first century to discuss how this book's findings illuminate current and likely future controversies about FDI's roles in the global economy.

1.1 The Politicization of FDI Inflows: A Brief History

FDI is an artifact of modern industrial production, and in particular the central role of intellectual property that emerged in the early twentieth century (Chandler 1962). At the close the nineteenth century, FDI comprised an estimated 10 percent of global capital flows and was concentrated in

infrastructure and natural resource extraction.[2] These investments flowed from major western European economies to their colonies and independent countries in the Americas (Teichova, Lévy-Leboyer, and Nussbaum 1986). Countries imposed few limits on FDI inflows. If anything, there were concerns in FDI source countries about dwindling investment capital for the domestic market.[3]

In the early twentieth century, private firms invested more heavily to create intellectual property through research, development, and marketing. Between 1921 and 1946, scientific personnel as a share of U.S. industrial employment increased sevenfold, because manufacturing firms established internal capacities for research and development (Frieden 2006: 165). These assets are firm-specific inasmuch as firms develop the assets for their exclusive use. The growing market for consumer products also raised returns on investments in product advertising. During the interwar period, European consumer products firms marketed directly to U.S. consumers. Switzerland's Nestle sold chocolate, and Britain's Lever Brothers Company became the leading soap manufacturer in the United States (Jones 2005).

FDI for the production of goods and services grew more popular during this period, because it allowed firms to exploit the scale economies that their intellectual property assets create. Firms can deploy these assets in multiple markets simultaneously, because they are intangible, allowing them to recoup more readily the initial fixed costs of creating the asset. As Chapter 2 explains in detail, firms choose FDI over alternative routes for capturing scale economies, like technology licensing, because in FDI firms retain control over their most valuable assets.

Firms organize their multinational production that uses these assets in one of two ways. Beginning in the interwar period, most MNCs organized their multinational production by replicating production and sales activities in multiple countries. This allowed them to circumvent the rising trade

[2] Svedberg (1978) argues that this common figure is an underestimate because it is inferred from public stock offerings (countries did not systematically collect and report data on capital flows in this era). By his calculations, FDI accounted for a large portion of capital flows into specific economies, including up to 50% of total capital inflows for countries/colonies in Asia, Africa, and Latin America. In many respects royally chartered trading companies such as the British East India Company were predecessors of the modern MNC.

[3] In the United States, specific FDI projects were occasionally controversial but there was little formal regulation. The federal government and several states passed laws barring foreigners from purchasing land and owning banks. A handful of additional regulations discriminated against foreign-owned firms. For instance, a 1791 federal law charged foreign ships higher customs duties and an 1817 law closed coastal trade routes to foreign merchants (Wilkins 1989).

barriers in this era and to compete for foreign customers in non-traded industries. In the decades following World War II, a growing number of MNCs pursued FDI to forge a global production networks that fragment production of a single product across multiple countries. By organizing production in this manner MNCs take advantage of lower production costs in foreign countries and export their output out of the host country. Global production networks became more efficient as transportation costs and host country trade barriers declined.

The iconic American toy, the Barbie doll, vividly illustrates this larger phenomenon of globalized production.[4] Barbie's "Made in China" label belies the toy's multinational origins. In 1996, the southern California-based Mattel Corporation sold "My First Tea Party Barbie" in the United States at a retail price of $9.99 per doll. Of this, $7.99 went directly to Mattel as profit and to defray the costs of domestic distribution and marketing. Sixty-five cents was paid for the raw materials and their processing: Saudi Arabian ethylene, a by-product of oil refining, and Taiwanese refining to convert the Saudi ethylene into the plastic pellets used in manufacturing the doll's body; Chinese cloth for the doll's clothing; nylon doll hair from Japan; and American machinery, molds, and paints. Thirty-five cents contributed to the wages of the 11,000 workers who assembled these components in two factories in Guangdong, China. The remaining $1 of the doll's purchase price went toward the transport of production inputs and finished dolls between the raw materials source countries, the Guangdong factories, and the United States, the doll's ultimate consumer market. Hong Kong acted as the hub of the production network. Inputs and final products were transported over land between Hong Kong and Guangdong and by sea between Hong Kong and all points abroad.

FDI first became politicized during the interwar period. Controversy centered on the perceived national security costs to the foreign ownership of productive assets, but limits on foreign ownership simultaneously advanced the interests of local producers vis-à-vis foreign MNCs. For example, when during World War I the U.S. government seized all enemy combatants' assets, among them were some 6,000 chemicals and pharmaceuticals patents owned by U.S. subsidiaries of German companies. At the time Germany was the world's leading producer of industrial chemicals and pharmaceuticals. While the United States justified the seizure on national security grounds, it also proved lucrative for U.S. chemicals producers. The federal government licensed the German patents to U.S. companies at

[4] "Barbie in the World Economy," *Los Angeles Times*, September 22, 1996.

minimal costs, and the previously lagging U.S. chemicals industry flourished (Wilkins 2004). These countries' situations were reversed after World War II when Western European countries voiced concerns about the dominance of U.S. corporations over the Continent's industrial production. The noted French intellectual Jean-Jacques Servan-Schreiber articulated these anxieties in his 1967 Europe-wide bestseller, *The American Challenge*:

> The Common Market has become a New Far West for American businessmen. Their investments do not so much involve a transfer of capital, as an actual seizure of power within the European economy. Statistics fail to reflect the real gravity of the problem. … [T]he Common Market has become the New Frontier of American industry, its promised land. … If Europe continues to lag behind in electronics she could cease to be included among the advanced areas of civilization within a single generation. (Servan-Schreiber 1967: 11–14)

These examples demonstrate that even though politicians frame FDI inflows as a threat to national security or other vital national interests, there are also unmistakable distributive consequences to foreign ownership. U.S. subsidiaries of German chemicals companies dominated their American counterparts, but policy interventions transferred channeled German comparative advantage to U.S. firms. To be sure, there are genuine national interest reasons to regulate FDI, but to end the discussion at that would be to overlook these policies' clear distributive consequences.

My analysis of FDI regulation begins in the 1970s, the era of wide-scale adoption of foreign ownership restrictions as elements of broader industrialization strategies.[5] Although national security justifications first appeared following World War I, more explicitly economic motives for FDI restrictions first emerged following World War II. Decolonization in Asia and Africa produced an influx of new independent countries in the global economy. These countries, whose economies were previously centered around agriculture and mining, adopted comprehensive industrialization strategies

[5] A few industrialized countries including Japan, Australia, and Canada also frequently restricted FDI inflows (Chang 2003). The prevalence of state-owned enterprises and public ownership shares in private corporations have also been de facto barriers to investment. By law, foreign firms could not invest in sectors designated as public monopolies. MNCs often found it difficult to acquire ownership interests in firms with public participation because public shareholders could block such efforts. In Germany, tight connections between banks and industry made it difficult for MNCs to acquire local firms and to obtain local financing for investments. There is also anecdotal evidence of European countries pressuring MNCs to adopt production practices that facilitated technology transfer. For example, the United Kingdom allegedly pressured UK affiliates of Japanese electronics and automobile firms to source their inputs locally, restrict output, and export output rather than sell it domestically (Young et al. 1988).

to foster economic development. FDI regulations were a component of these strategies. Foreign ownership restrictions were designed to capture MNCs' production assets and a share of the revenue they generate for the gain of fledging local producers.

Ownership restrictions required MNCs to form partnerships with local firms, and policies like local content requirements forced MNCs to cultivate supplier relationships with local firms rather importing their production inputs. Many developing countries, particularly those in Latin America and Asia, restricted FDI most extensively. Although countries varied in their precise industrialization strategies, whether focused on producing goods for export or for local consumption in place of imports, FDI regulations served the same purpose: to secure access to production technologies necessary for industrialization that were otherwise unavailable (Haggard 1990). Many of these countries employed "complementary" policies designed to attract investments despite regulations, including weakening labor rights to keep MNCs' production costs artificially low. The next section describes these regulations in detail, as well as the transformation countries underwent toward greater FDI openness.

1.2 FDI Liberalization: Identifying Empirical Puzzles

By the end of the twentieth century, countries were considerably more open to FDI than they had been in the preceding decades. This transformation is evident on several dimensions. Figure 1.1 illustrates global trends in foreign ownership regulations and investment volumes.[6] In the mid-1970s, on average, countries protected nearly 35 percent of their industries by restricting foreign-owned firms to minority ownership (e.g., less than 50 percent equity). These regulations required MNCs to form partnerships with local firms to ensure that managerial control remained in local hands. Nearly three decades later, this figure had dropped to 10 percent.

MNCs also faced less hostile governments after making their investments. In 1975, there were more than eighty acts of expropriation against MNCs across nearly thirty countries.[7] Expropriations are host government actions that reallocate income generated by the MNCs' investment to domestic groups, such as ex post tax increases and the outright seizure of

[6] This figure plots the annual worldwide mean of *Entry Restriction*, an original measure of foreign ownership restriction. Chapter 3 and the Appendix provide extensive details on the sources and construction of the variable.

[7] Jodice (1980: 181). See also Kobrin (1980) and Minor (1994) for a detailed discussion of expropriation trends.

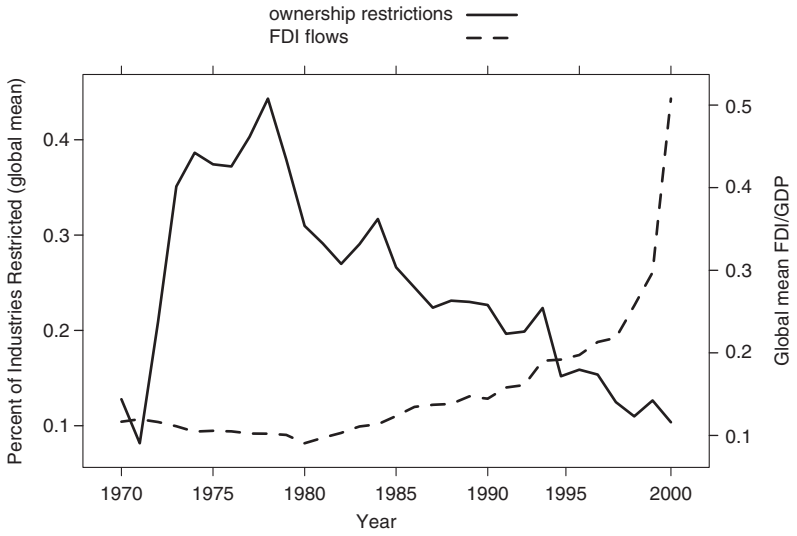

Figure 1.1 Global average foreign-ownership restrictions and FDI stock, 1970–2000.
Note: Foreign-ownership restrictions data are as described in text. Global FDI stock data are from Lane and Milesi-Ferretti (2007).

MNCs' property. A decade later, these acts were not only exceedingly rare, but many countries revised national investment laws to explicitly guarantee the property rights of foreign-owned firms.

Greater FDI openness is evident in international economic cooperation as well. In 1974, developing countries advanced the New International Economic Order, a set of UN resolutions intended to recast international economic rules in their favor. Among other things, those countries demanded an internationally recognized right to regulate MNCs' activities in their countries, and a right to expropriate foreign investments in order to secure a greater portion of the income they generate. These demands reflected a widely shared sentiment during this era that MNCs not only exploited developing countries but also reinforced global wealth inequality. By contrast, in the World Trade Organization's (WTO) Uruguay Round of global trade talks completed in 1994, most of these same countries signed the Treaty on Trade-Related Investment Measures to eliminate laws that required MNCs, operating in their countries, to source their production inputs locally. Many WTO members also formally pledged to provide MNCs with greater access to service industries like telecommunications and banking. A growing number of preferential trade agreements also stipulate openness to FDI from multinational firms based in other signatory countries.

Not only did countries dismantle policy barriers to FDI, but they also more actively courted MNCs. Between 1990 and 1995, the number of new bilateral investment treaties nearly quadrupled after three decades of minimal treaty activity (Elkins, Guzman, and Simmons 2006). These treaties codify extensive guarantees of MNCs' property rights to address firms' concerns about expropriation. Some of these treaties even grant foreign MNCs legal standing in domestic courts – an unprecedented right in international law. A growing number of countries directly subsidize MNCs' investments through tax incentives, land grants, discounted production inputs, and other de facto transfers (Oman 2000). For example, in 1996, Daimler-Benz established a manufacturing plant in the Brazilian state of Minas Gerais to produce Mercedes automobiles. National and state governments furnished tax breaks and financial incentives to the tune of $340,000 for each job that the plant directly created (Oman 2000: 32). In the 1980s, the state of Kentucky attracted a Toyota Motor Corporation assembly plant with a combination of land grants from the state, $47 million in new road construction to meet the plant's transportation needs, and a further $65 million of public funds for employee training programs (Graham and Krugman 1995: 89). Many countries streamline regulations so as to regulate foreign firms less than native firms. All of these measures are designed to attract FDI with the expectation that their investments will foster economic growth and development by creating high-skilled jobs and introducing productivity-boosting technologies.

Within this general trend of FDI liberalization, there are distinct patterns of variation in frequency of regulation across countries and industries. These patterns reveal country and industry characteristics that influence FDI policy making. Temporal changes in these country and industry characteristics help pinpoint explanations for why countries liberalize their foreign investment regimes.

The clearest trend across countries is that developing countries impose higher average ownership restrictions than do industrialized countries. Figure 1.2 plots the same measure of average foreign ownership restrictions as in Figure 1.1 but disaggregated into two groups: the advanced industrialized countries that belong to the Organization for Economic Cooperation and Development (OECD), and non-OECD countries, a proxy for low- and middle-income countries. The figure reveals that non-OECD countries account for most FDI restrictions historically and continue to regulate at higher average levels than the most advanced countries. At the height of restrictions in the mid-1970s, the average non-OECD country restricted ownership in half of all industries in its economy. By comparison, the average OECD country rarely restricted more than 10 percent of industries.