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PORTUGAL's LEGAL FRAMEWORK FOR FOREIGN DIRECT INVESTMENT 1943 - 1994: ECONOMETRIC ANALYSIS AND CAUSALITY TESTS[1].

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PORTUGAL's LEGAL FRAMEWORK FOR FOREIGN DIRECT INVESTMENT 1943 - 1994: ECONOMETRIC ANALYSIS AND CAUSALITY TESTS.

ABSTRACT: The following paper presents a historic description of the regulatory framework of the foreign direct investment in Portugal. A testing of the effects of the regulatory structure upon the amount of the flows is also attempted. The regressions' coefficients were not clearly significant, and no clear sign of granger-causality between legal liberalization and the size of the inflows was detected.

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INTRODUCTION

The main objective of this paper is to present an overview of the legal development of the foreign direct investment's (FDI) regulation in the Portuguese republic in the last fifty years. During this period of time, Portugal has evolved from a backward, closed country to a modern, open and integrated in the European economy.

Of course, to look only at the legal framework on FDI is somewhat artificial and incomplete: The legal structure of a market economy is a whole, its efficiency depends therefore on the adequacy of the totality of the regulatory framework.

The basic functions of the regulatory framework in a market economy are: *i*) to define the universe of property rights in the system; *ii*) to set the rules for trading those rights; *iii*) to define the entry and exit rules for the economic agents; *iv*) to control market structure and behavior to promote or protect competition[2]. The foreign investment's legislation belongs, of course, to item *iii*), but if, for example, a country allows the free entry of capitals and also the unhindered repatriation of profits, but does not have a clearly defined set of property rights, the consequent uncertainty may prevent the inflow of capital.

An OECD[3] study on the experiences of foreign exchange liberalization describes the "standard" process of liberalization as being a gradual approach. For instance, in continental Europe and "Sterling Area" countries more than ten years were needed to achieve full current-account convertibility. The sequencing followed began with the less volatile and more necessary to business activities' operations and agents. Therefore, outward FDI was liberalized before portfolio investment abroad, trade credits before financial loans, transactions with shares were liberalized before interest-bearing securities, the corporate sector before individuals, the banking and financial

[2]See Gray, C. "Evolving Legal Framework for Private Sector Development in Central and Eastern Europe", World Bank Discussion Papers nº 209, 1993.
[3]See OECD "Exchange Control Policy", Paris, 1993.

industries later than other sectors. Usually, the last sectors to be liberalized for tax reasons where those concerning deposit accounts with non-resident institutions abroad. Thus, there are many stages in a process of liberalization, each corresponding to a different level of currency convertibility.

But there are really no iron rules regarding the sequencing and speed of the liberalization. Some countries may opt for a “Big Bang” approach, to avoid losing political momentum, or when forced by the very liberalization process: this has happened in Germany in 1958, in the UK in 1979, and in Portugal, where the lifting of the final restrictions was concentrated in 1991/92. Therefore, the speed and sequencing depend on each country specific situation.

The “Big Bangs” in Eastern Europe were quite reaching but still did not arrive to the levels of liberalization and currency convertibility that Spain and Portugal have now. Eastern Europe will achieve full liberalization upon accessing to the EU if it accepts the full set of rules established by the Treaty of Rome, the Single European Act and the Treaty of Maastricht. Thus, the experience of Portugal may be useful to Eastern European countries.

After these brief remarks, we will now present on the following pages the evolution of the Portuguese FDI’s legislation.

1- PORTUGAL AND THE FDI: THE LEGAL PERSPECTIVE[4].

1.1 1943 -1960: THE CLOSED ECONOMY.

In much of FDI's long history in Portugal, the government had little control over the origin or even the amount of the flows, but FDI was restricted during most of the XX century, due to the isolationist and conservative tendencies of the dictatorial regime established after May 1926[5].

The usual "landmark" used to sign the beginning of a clear policy regarding FDI is the "Law of Capitals' Nationalization'' of 1943 (Law n^{o}.1994 of April 13)[6], the first generic and comprehensive restrictive legislation. It established that foreign firms should neither create, nor acquire, own or exploit enterprises in public utilities or public goods' sectors, in industries of ''regime of exclusiveness" or of "fundamental interest to the defense of the State or the Nation's economy"[7]. These industries were to be defined by Decree[8]. However, the Decree was never published, allowing the government extreme discretionary power[9].

The definition of a Portuguese firm used was the one established under the Portuguese legislation, that is, a firm with headquarters in Portugal and with Portuguese absolute majority in terms of capital. This majority was defined according to the type of the company: in joint stock companies, Portuguese citizens had to held at least 60% of the capital; in limited liability companies and

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[4]The Portuguese legislation has a separate legal concept for foreign *indirect* investment (FINI) - that is, domestic investment overtaken by a foreign firm already working in the country in other firms also in the country. This is not used in this work, since we believe it would only cause confusion.

[5]This is true even considering Portugal's participation in the Marshall's Plan second year (49/50). The decision to apply was partly a political one by the Salazar's dictatorial regime, due to post-war necessary strategic realignments, and partly due to more open positions of some members of the government, that wanted to use the resources to finance industrialization. The entry in the OECE - the organism that originally supervised the Marshall's Plan (renamed OECD, after 1961) - and in the EPU (European Payments Union) in 48, and at the BIS, in 51, follows this logic.

[6]In fact, previous legislation had already restricted FDI's freedom. The Decree 19354, of March 1 of 1931 defined 11 industries in which sales and formation of firms by non-residents needed government permission, and in 1937 the Law nº 1956 - also know as the "Industrial Conditioning Law"- extended this to the whole of the manufacturing industry (in reality, it extended the need of permission to a whole series of acts, encompassing also the trading of property rights among *residents*). And even before that, the state's expenses in foreign currencies where controlled, through the Decrees n^{o} 14611 (November 23, 1927) and n^{o} 15519 (May 29, 1928).

[7]"Public Sectors" were defined in *legal* terms, and did not correspond to the economic concept of public goods (*i.e.,* goods with externalites, impossibility of consumption exclusion). For example, under the Portuguese legislation, the underground mineral assets are *"public goods", since they belong to the state*. Therefore, all mining industries are a concession of the state.

[8]See Torres, M. "Investimento Estrangeiro em Portugal, Conceito e Regulamentação", Masters Dissertation (mimeo), Faculdade de Direito, Lisbon, September, 1985.

[9]In practical terms, the industries that the government considered to be "Basic Industries", *i.e.*, the ones necessary for the nation's industrial development, and therefore, to be protected against foreign ownership: steel, oil refining, cements. See Macedo, J.; Corado, C. & Porto, M."The Timing and Sequencing of Trade Liberalization Policies: Portugal 1948-1986", Working Paper nº114, FE/UNL, April, 1988, Lisbon..

other types of collective societies or partnerships, the majority partners should be of nationals or naturalized citizens - for at least ten years. The upper administrative posts - including president and managing director - should be held by Portuguese nationals or naturalized citizens, also for at least ten years.

Firms already established and working in Portugal in the restricted sectors and industries were not affected by this legislation, *i.e.*, there was no real "nationalization" of the capitals. However, Portuguese nationals would have preferential rights in any changes in the capital structure (bar inheritance). In the public utilities or public goods' sectors, the State or the local administrative bodies held these preferential rights.

Legislation like this - specially legislation for capital flows' control, seen as essential economic policy tools - was in fact widespread in the period between the "Great Depression" and World War II, and also in some extent during the post-war reconstruction period in continental Europe[10], but in the Portuguese case it was kept long after other Western European countries opened up.

The result of this was a very little amount of FDI during most of this period (see Table I). This low capital inflow can also be explained by the country's level of development at the time. Portugal missed most of the strong flows of FDI observed during the fifties, and the projects that really entry the country were clearly of an import-substitution nature[11].

Table I
Private Capital Flows, 1950-74 (Averages *p.a.*)
In Millions of USD

	Inflows	Outflows	Net Total
1950/54	4.1	1.6	2.5
1955/59	3.4	1.6	1.8
1960/64	50	17	33
1965/69	161	96	65
1970/74	314	209	105

Source: Simões, V. (1985).

[10]See OECD, *ibid*.

[11]For instance, FDI was significant in the industries in the capital or basic goods sectors mentioned in note 9. See Simões, V. (1985, 1989 and 1993).

1.2 1960-1974: OPENING UP.

The legislation which really regulated private capital flows was only enacted almost two decades later ("Rules Approved in the Council for Operations of Import and Export of Capitals", of June 28, 1960). This legislation was partly needed because of the Portuguese international commitments: to comply with Article VIII of the IMF Agreement and especially with the OECD's Code of Liberalization of Capital Movements[12].

All kinds of private capital movements (for example: for the creation of new firms, to establish new subsidiaries, to acquire real estate property, to acquire partial or total capital stakes in existing firms, to repatriate profits or liquidation's revenues, for the subscription or buying of stocks and bonds and the repatriation their proceeds, the domestic issuing of stocks by foreign firms, the foreign issuing of stocks by domestic firms and any kind of credit concession) needed "special and previous" authorization of the General Inspection of Credit and Insurance, with a certification by the Ministry of Finance - MF - when the amount involved was over ten millions PTE.

Also an analysis on the monetary and foreign exchange aspects of the operation by the Portuguese Central Bank, the "Banco de Portugal" (BP) was necessary. Since no criteria for the evaluation were stated, the discretionary power of the Government, beyond its international commitments, was total. This legislation was extended to include the colonies by the Decree-Law n^{o} 44698 of November 17, 1962.

The Decree-Law n^{o} 46312 of April 28, 1965 marks the end of this dualistic legislation, that regulated both activities performed by non-residents and private foreign capital flows (this means that two different controlling criteria were, in effect, used by the government: the *residence* criterion and the *nationality* criterion)[13]. The authorization was now always given even for majority owned projects if the inflow was directed to a set of liberalized sectors

[12]The Article VIII of IMF provides for a liberalization of controls on payments on international transactions only, as an essential condition for an open multilateral trade system. Capital controls were seen in the Bretton Woods framework as legitimate economic policy tools (See OECD "Exchange Control Policy", Paris, 1993). The 1961 OECD's Code of Liberalization of Capital Movements - adopted by the Portuguese Council of Ministers, with derogations, in December 12, 1961 (check this date) - provides for a progressive liberalization on almost all capital movements (Portugal asked for a general dispensation in 1968. See table below). The OECD code has the legal status of an OECD decision that creates binding obligations for the member states (See OECD, *ibidem*).

Portuguese Derogations to the OECD's Codes of Liberalization (1)

Capital Movements		Current Invisible Operations	
Invocation of Derogation (2)	Cessation of Invocation	Invocation of Derogation (2)	Cessation of Invocation
1968 (3)	1981	1968 (3)	1981
1977	1981	1977	1981
1983	1987	1977	1992
07/1991	11/1992	1983	1987

source: OECD (1993)

[13]See Torres, M. *ibid*.

and industries. A rather extensive set of liberalized activities was defined by the Dispatch of the Presidency of the Council of Ministers - PCoM - of August 24, 1965.

Nevertheless, a set of activities was still restricted for "national enterprises" in the public utilities or public goods' sectors and in activities related to the security of the State. The criterion of nationality was defined in the article 21º, along the lines of the one at the "Law of Capitals' Nationalization"[14]. The remaining foreign firms in these sectors were given a transition period to comply with these requirements.

This Decree had a chapter addressing the guarantees given to the foreign investor, in which the state assured him about the security of their property rights and about their equality before the law *vis à vis* Portuguese citizens. The liquidation of investments was not forbidden, and the repatriation of profits or of liquidation's revenues was automatically permitted, except in situations of "dangerous current account imbalances or serious economic or financial unrest". Even in these situations the amount allowed to be repatriated - defined by the Council of the Ministers, CM - could not be less than 20% of the total transferable capital. The remaining capital not repatriated was to be deposited at the "Caixa Geral de Depósitos" (CGD), the biggest, state-owned, Portuguese bank. The deposit would earn the maximum interest rate on long term deposits The rates where then administratively fixed. Expropriation was allowed - as for nationals - only in situations of "public interest" and with a "fair compensation", but was quite rare.

The necessary previous authorizations for current "invisibles" (services, etc.) and private capital operations were transferred to the BP by the Decree-Law nº 183/70 of April 28. They still had to be certified by the MF, if the amount surpassed 50 millions of PTE; the BP also had the power to authorize agreements of technology transfer, after an amendment of the MF to the Decree-Law nº 158/73 of April 10[15].

Due to these liberalization process and integration efforts we had a significant - in relative terms, anyway - increase in FDI : in 1961 alone the total FDI was bigger than in all the previous decade. These inflows had very specific effects in terms of industrial structure and of international specialization that are far beyond the scope of this work[16].

This process was partially rendered possible - and necessary - because of the Portuguese "Colonial Wars"[17].

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[14]The time to be considered a "resident" was reduced to one year by the Decree-Law nº 47919 of September 8, 1967.

[15]The limit for homologation was raised to 200 millions of PTEs in 1980 and to 500 millions of PTEs in 1983.

[16]The total of FDI's flows in the fifties was of 37.5 millions USD. See Simões, V., *ibid*.

[17]Portugal was the last European country to lose its Colonial Empire. During thirteen years - from 1961 to 1974 - it waged a war against the independence movements in its African colonies. Portugal is still - until 1999 - the administrative power of the Territory of Macao, in the southern China's coast.

The war increased the government financial needs. It was also necessary to search for greater international legitimacy. Further funds were necessary for financing industrialization. The growth of industrial production was one of the highest in the World in the sixties. Moreover, the growth of the domestic infrastructure and the urbanization also reinforced the need for liberalization. As a result of all these developments, and of a favorable international climate, FDI inflows grew at a rate of almost 12% yearly between 1960 and 1973. After 1966 there was also a growth of the Portuguese FDI[18].

We have during this period a subdivision that corresponds to a moment of greater internal political liberalization: the "Marcelist Spring" that lasted from around 1969 to 1972[19]. These liberalized tendencies, including liberalization FDI legislation, were reflected in the Decree nº 393/70 of August 19, 1970, and the Decree-Law nº 75174 of February 28, 1970 - known as the "Industrial Development Act". These laws reduced the number of restricted sectors and implemented a wide scheme of fiscal and financial incentives, available both to foreign and domestic investors: tax breaks, import exemptions and especial credit lines for exporting industries. The Law 3/72 of November 28, 1972 reduced even further the number of restricted industries, but it was never regulated. The cumulative reduction in the period 70/72 was of about one third of the listed sectors.

Summing up: Portugal had a liberalization and integration process that lasted from around 1960 to around 1973. This liberalization occurred simultaneously with the accession of the country to international trading blocks and with the necessity to comply with binding regulations of the international organizations to which the country belonged, and to a cycle of domestic and international sustained economic development[20].

[18]The inflows have grown to 6.5% of the GNP by 73, an increase of 1,857% when compared to 1958. See Simões, V., *ibidem*.

[19]Named after Marcello Caetano, Salazar's failed reformist sucessor.

[20]A cycle, by the way, that had stronger "real convergence" effects for Portugal than the present one. See Barros, P. & Garoupa, N., 1993.

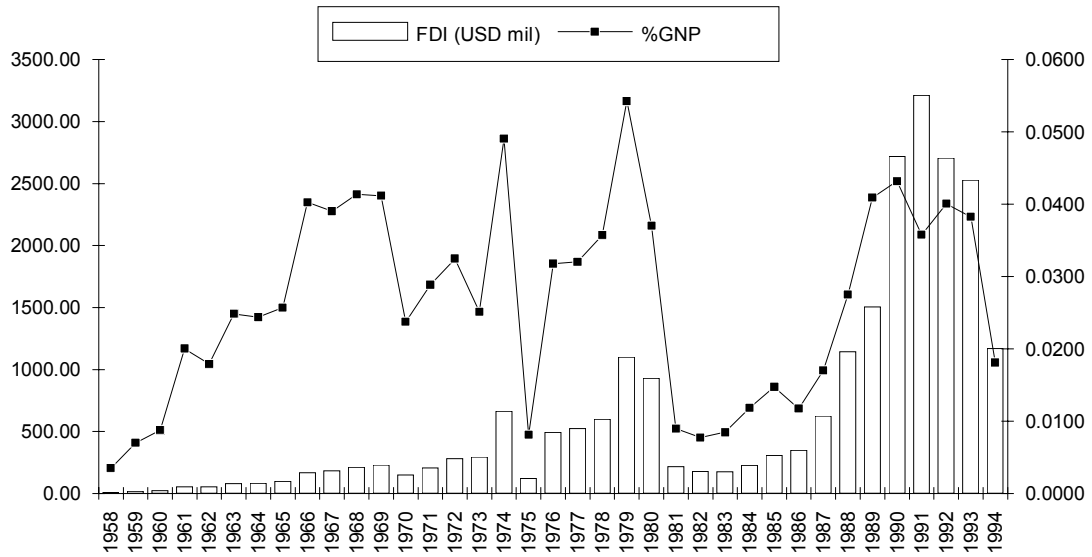
1.3 1974-1977: THE REVOLUTIONARY INTERMEZZO AND ITS AFTERMATH.

In April 25 of 1974 Portugal went through a historical political change. At this date, a leftist military movement overthrew the dictatorial government established in 1926. This process is known as “The Carnation Revolution” (after the flower that was used as its symbol).

It was a period of extreme economic and social uncertainty: for almost two years the country teetered on verge of a socialist revolution. All the major national economic groups were nationalized (we must stress that the firms with foreign capital stakes were excluded from nationalization) and reorganized in state holdings. A land reform was also tried in some parts of the country. The former African colonies all achieved their independence. Labor and social unrest soared.

All this, of course, had serious effects on the real flows of capital. FDI fell in the following years. Only in 1979 the flows regained the scale achieved in 1974. The oil shocks and the cyclical downturn in the World economy also compounded the problem (see Graph I below).

Graph I
FDI's Inflows and as a Percentage of the GNP.



source: BP's Reports.

During the revolutionary period the legal framework became quite restrictive. For the first time, a comprehensive body of legislation called Code of Foreign Investment was enacted[21](Decree-Law n^{o} 239/76 of April 6). This code - despite a preamble in which the “interest of the foreign direct investment for the national development” was recognized - marked in reality a downward inflection on the liberalization process initiated in the sixties. A general, previous

[21]See Rosa, E., 1984.

discretionary system was reintroduced, in which two types of authorizations were needed for the same investment project: a foreign exchange authorization from the BP, and an economic authorization by the newly created FII, Foreign Investment Institute (Decree-Law nº 239/76). The FII's authorization conditioned the foreign exchange one. In fact, the FII was the only recognized official representative for the foreign investors. FII collected all the technical evaluations on the FDI's projects by all departments of the government, all necessary authorizations and permits, and it also registered all the data on the projects.

Two types of previous authorizations were established in this first code. The first, the "general regime", was used for usual investment projects, in which the foreign investor had equal access to all tax incentives available to the national investors. The second, the "contractual regime", was for investments of special interest for the Portuguese economy, due to their size, profitability or with meaningful effects in the current account, regional development and technology transfer. The latter FDI projects could benefit from which additional tax incentives or subsides. The decisions concerning contractual investments had to be approved by the CM. The FII had a period of ninety days (which could be extended up to two times) to give or deny the investment's authorization. After that period, if a decision had not been given, it was automatically granted.

FDI in industries related to the security of the state, public utilities, finance, banking, insurance, advertising, publishing and communication services and also on the nationalized sectors was forbidden - but the CM could allow minority capital stakes in these sectors if deemed necessary. Foreign firms already in these sectors were not affected.

Also on guarantees to the FDI, this legislation was more restrictive. Repatriation of profits or of liquidation revenues was restricted, except in the cases when previous permit of the FII was given, and that after a BP report on the country's currency reserves. In general terms, repatriation of profits was limited to 12% of the invested capital. Exporting firms, however, had a 20% limit of the invested capital, if they earned enough foreign exchange to cover it and exported over 50% of their production.

The repatriation of liquidation proceeds was only allowed after five years of the original investment, and only 20% of the total per year. Assets' transfers among non-residents also needed a previous permit, and residents had preferential rights over foreigners. This was not applied to sales of assets in foreign currency among non-residents.

The FII had then also the power to authorize the agreements of technological transfer (the authority to allow technology's *exports* remained with the BP, after the Normative Dispatch nº 151/78 of July 6). Services, like technical assistance, didn't needed any permits and weren't even recorded, until the Normative Dispatch nº 327/76 of November 5 gave these functions to the BP.

This first code, in fact, was never used, due to several reasons. these were: the very own restrictive elements of the code, the fast changing political situation between 1975 and 1977, the country's international commitments, including the need to comply with the OECD's "Directive Principles Toward Multinationals" after 1976, and the need to adequate the legislation to the legal framework set by the new Portuguese Constitution. Thus, the 1976 code was replaced in the next year by a new Code of Foreign Investment.

The 1977 Code of Foreign Investment (Decree-Law n^{o} 348/77 of August 24) defined FDI using only a residence concept, but kept the whole system of previous discretionary differentiated authorizations (the "general" and "contractual" regimes) by a state organ: the FII[22].

The repatriation of revenues from profits or from the liquidation of assets was automatically permitted, except in situations of foreign reserves' crises, during which they could be postponed, but even then capital repatriation could never be below 20% of the transferable capital per year. Assets' transfers among non-residents do not needed a previous permit anymore, being also automatically granted in several cases. That is, the prior controlling structure was fully kept, but the restrictions were somewhat eased.

In the following years, Portugal slowly returned to a market economy. This was further accelerated by the entry in the EU, which, of course, also affected the FDI's legal framework.

1.4 1977 -1985: THE EUROPEAN YEARS I: THE ROAD TO THE EU.

This period is marked by a trend toward general and comprehensive liberalization of capital flows - interrupted by the foreign exchange crises due to the two IMF-led stabilization packages, in 1976/77 and 1982/83. Liberalization encompassed not just the EU's member countries but also third countries (the liberalization was much more intense, of course, towards the EU)[23] and was accompanied by an overall deregulation of the Portuguese economy :reprivatization, elimination of price controls, the opening up of formerly state-owned industries, like public utilities. Thus there was a general tendency to the increase of FDI's inflows into the country between 1986 and 1992, especially from the EU countries. There were cyclical reductions during the economic downturns at the early eighties and nineties.

Portugal applied, not for membership, but for a trade agreement with the then EC as early as 1962, and again in 67. This is allowed by the article nº 113 of the Treaty of Rome. These applications followed the first British and other EFTA countries' attempt to join the Community in 1961. The UK is a traditional

[22]For a list of the projects approved under the "contractual" category, see Annex I.

[23]The process of Portugal's integration into the EU also implied the liberalization of capital flows *among member countries.* Under the principle of non-discrimination a EU firm ought to be legally treated as a Portuguese firm. Otherwise, we would have a situation of discrimination between citizens of the member states, which goes against the first paragraph of the article seven of the Treaty of Rome.

Portuguese partner. The first UK application, and the second one in 67, were both blocked by France. The failures of both British attempts to join the EEC affected also the negotiations with Portugal. Only after the breakthroughs at The Hague Summit, in 1969 - that led to the 1971's first EEC enlargement to the UK, Denmark and Ireland - was a trade agreement possibly. Portugal, in fact, made two trade agreements, with the EC and the ECSC - European Community of Steel and Coal).

The revision of these treaties in 1976, extended the agreements to cover non-commercial issues (through the "Financial Protocol" and the "Additional Protocol"). The formal application for membership was made in the following year, in March 28, 1977. The official negotiations lasted from October , 1978, to March, 1985. However, during this period some legal steps were taken to prepare the country for membership ("Complementary Protocol" of 1979 and "Transitional Protocol" of 1982). Portugal finally became a member of the European Union in January 1, 1986.

1.5 1985 -1994: THE EUROPEAN YEARS II: TOWARD FULL MEMBERSHIP.

Even after the accession, Portugal went through a long transitory period toward full membership of up to seven years in some sectors during which several kinds of temporary derogations were allowed.

The "*acquis communitaire*" is included in the articles of the Treaty, implying a change in Portugal's law. Regarding FDI, the Decree-Law n^{o} 326/85 of August 7, that went into effect at January 1, 1986, replaced the system of discretionary previous *authorization* of foreign capital flows[24]. The new system of previous *verification* implied only the verification of the mere *reality* of the operation by the BP. The FII kept the control of FDI's establishment during the transitional period, until 1988[25]. The BP verified all foreign exchange operations on the Annex I, which contained a list[26] that included repatriation of in and outflows of profits and liquidation's revenues for several uses, real estate operations, several personal operations, operations with patents, trademarks and inventions (if they involved the trading of industrial property rights) operations with shares and bonds, since, if they involved more than 20% of a

[24]The Treaty of Rome has three exceptions to the free flow of capitals' rule: 1) article 68, which states that government's financing through other member states is subject to previous negotiation (BEI's issuings are not included); 2) article 73, which state that in cases of financial markets disruptions due to foreign capital inflows restrictions are possibly, subject to a Commission's authorization; 3) articles 108 and 109, which state that restrictions are possibly in cases of foreign exchange imbalances; the former demands a Commission's authorization *ex ante* , the latter, for really urgent situations, a *ex post.*

[25]Later named Portuguese Foreign Trade Institute (ICEP) and again renamed Investment, Trade and Tourism of Portugal (picturescally, with the same acronym).

[26]The European Council's Directives of May 11, 1960 and December 18, 1962 established four lists for capital operations with different liberalization speeds. Lists A and B provided for immediate liberalization; FDI is included at the list A (its difference from list B is that it uses the exchange rate for current operations in the conversion of the flows). The verification of the reality of the foreign capital operation is allowed by the article five, n^{o} 1, of the Council's Directives of May 11, 1960, but cannot be used to bar or retard the liberalized operations.

firm's capital, they were classified as FDI. The same happened with long-term loans, *i.e*, the ones with more than five years of duration.

The concept of nationality on commercial operations (establishing, acquiring or expanding a firm, among others) was extended to include EU's citizens and firms established in any EU member country. this is called the "Right of Establishment" (articles 52 to 58 of the Treaty of Rome)[27].

In the Portuguese case, several derogations and exceptions to the "Right of Establishment" were negotiated, the majority of them connected to the existence of state monopolies or nationalized sectors in several industries. The most important one (considering its extension in the Treaty) was in the Financial sector.

Derogations in the freedom of capital's movements were allowed for Portugal in its "transition period toward full membership". First, FDI and investments in real estate operations (not related to the "Right of Establishment" or the "Freedom of Circulation") by Portuguese residents in the other EU countries (article nº224 and nº227) were allowed to be controlled until December 31, 1992; second, investments in real estate (also not related to the "Right of Establishment" or the "Freedom of Circulation") by EU nationals in Portugal (article nº225) and the acquisition of foreign stocks or bonds by Portuguese residents - except for BEI or EU issuings, which had phased liberalized acquisition ceilings from 1986 to 1990 (article nº229) - were allowed to be controlled until December 31, 1990; third, personal capital movements - debts, donations, inheritances, transfers, gifts - and repatriations of proceeds from the liquidation of real estate business, which had phased liberalized ceilings from 1986 to 1990 - (article nº228) were allowed to be controlled also until December 31, 1990. Preferential treatment during this transitional period due to treaties with third-countries was not allowed (article nº226). Not all these derogations were fully used

They were also negotiated special derogations for Travel Agencies and Cinema related activities (for three and five years respectively, article nº 221).

It was agreed a transitional period of four years during which Portugal could keep its previous authorization scheme for all FDI projects of over 1.5 millions of ECUs (this ceiling was to be raised 20% yearly), with a maximum waiting period for the decision of two months (article nº222 of the Treaty of Membership). The Financial & Banking sector was exempted of this rule. It had a longer transition period (seven years) than the other sectors. During this transition period previous authorization for establishment was necessary. They were also specific phased expansion limits for the firms and also phased ceilings on domestic capital rising by these foreign financial firms - other than

[27]The only exceptions to the "Right to Establishment" accepted by the Treaty of Rome, were: 1) article 55 - which cover Union-wide sectors specifically excluded by a Commission's qualified majority Decision (the Commission never used this power), and the restriction by individual member states of foreigners in public authority positions 2) article 56, which covers the possibility of individual member states restricting access to sectors due to reasons of public order, public health and public security (economic reasons are not accepted).

banks -authorized to enter in the market (Annex nº XXXII of the Treaty of Membership). Permanent exclusions on FDI were accorded for the Savings and Farm Credit Institutions ("Caixas Económicas" and "Caixas de Crédito Agrícola Comum", Annexes I and XXXII, Directive 77/780/EEC). The possibility of temporary discretionary exclusions, *i.e.*, of defining other protected sectors by the Portuguese Government (for up to seven years), to be used in only the six months immediately after the membership.[28]

The process of reprivatization and de-monopolization was also, in practice, connected to the FDI's liberalization process in this period.

The initial "Reprivatization Law" (Law nº 84/88, of June 20, 1988) did not foresee complete privatization, and limited foreign participation to 5% of the capital. The new Law nº 11/90, of April 5, 1990, permitted complete privatization and did not set previous limits to non-nationals. A new Decree-Law, nº 380/93, of November 15, 1993, made necessary MF's authorization for sales of more than 10% of capital stakes, both for residents and non-residents, EU or third countries' nationals. Since it goes against EU legislation, its future is not certain.

The de-monopolization opened-up several former state monopolies to the private firms, both domestic and foreign, usually through systems of concessions. The Decree-Laws nº 449/88 and nº 336/91 opened the steel industry, oil refining, petrochemical, production and distribution of power and gas. The Decree-Law 379/93 of November 5, 1993, opened the water and sewage industry (with a ceiling of 45% to foreigners).

In the telecommunications industry, a former state monopoly, a ceiling of 25% on total capital was set for foreign investors, but the value-added services were liberalized through concessions after 1990 (Decree-Law nº329/90). The air transportation industry - also a former state monopoly - was liberalized after 1989 (Decree-Law nº 234/89). It was opened, through concessions of lines, to firms with headquarters in Portugal. In the sea transportation industry - a private sector - a firm must still have a majority national capital and its' headquarters in Portugal. The television sector was opened to the private enterprise by the Decree-Law 58/90 of September, 1990, which kept a ceiling of 15% of the capital for non-EU investors.

Current transactions on invisibles (including technological transfers) with all third countries were liberalized by the Decree-Law nº 351-C/85 of August 26, but previous verification by the BP was still needed[29].

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[28]The "New Banking Law" (Decree nº 298/92 of December, 31, 1992) finally transposed the EEC's Second Banking Directive to the national legislation: the BdP is the authorizing body, concerning only prudential obligations. For non-EU nationals, an authorization by the MoF is required, for the banking sector; for the Insurance industry, non-EU nationals need a special deposit (as a financial guarantee) at the Portugal's Institute of Insurance (PII, the controlling body) and at least five years of previous activity in the sector.

[29]The operations included in the Annex III were immediately liberalized after January 1, 1986, with the exception of personal travel allowances, that were phased-out until 1990. After 1991, according to the Treaty of Membership, *all* current invisibles operations among member countries were liberalized.

The Decree-Law n^{o} 214/86 of August 2 extended the "Right of Establishment" to all third countries, with the restrictions allowed by the article 56 Treaty of Rome, through "contracts of temporary concession", and the derogations accorded in the Treaty of Membership, and finally revoked the Law n^{o}.1994 of 1943 and the Decree-Law n^{o} 46312. The Decree-Law n^{o} 197-D/86 of July 18 replaced the old the Code of Foreign Investment - the Decree-Law n^{o} 348/77. The new law established a regime of mere previous *declaration* of capital flows (at the BP) and kept the FDI's "contractual regime" through the Regulatory Decree n^{o} 24/86 of the same date.

The Decree-Laws n^{o} 13/90 of January 8 and n^{o} 176/91 of May 14, 1991, unified the liberalized foreign capital's legislation for non-residents (EU and third countries), waving the Portuguese's rights for some of the remaining derogations agreed with the EU. This was done through the adoption in the national legislation of the Council 's Directive n^{o} 88/331/EEC of July 24, 1988. The BP retained the power to verify if the operations occurred. Some final barriers were eliminated by the Decree-Law n^{o} 170/93 of May 11, which amended the two previous decrees.

In the end of this process, by the first half of the nineties, Portugal had became a highly liberalized economy. Most of the previous barriers to FDI and portfolio investment were liberalized along with the rest of the economy (This is resumed by Table II, below).

Table II
Operations Restricted by Portugal from 1945 to Early 1990s.

Foreign Exchange Outflows		**Capital Inflows (other than FDI and Real Estate)**
Capital Transactions	**Travel Allowances**	
Long-term securities and trade credit until late '80s	until 1990	Long-term securities and trade credits until late 1987
Other operations until end of 1992		Other operations until end of 1992

source: OECD (1993).

2 - A LIBERALIZATION INDEX.

Based on the previous discussion about the evolution of the Portuguese FDI's legal framework, we will try now to estimate a liberalization index, that will be used to measure Portugal's degree of openness to FDI during the last half-century. Our index is a linear function of the following criteria (C_j)[30]

C_1 : General Freedom of Entry;
C_2 : Existence of Restricted Industries;
C_3 : Freedom of Repatriation of Profits and Other Earnings;
C_4 : Guarantees to Foreign Investors;
C_5 : Tax Incentives and Subsides.

[30]For a more lengthy description of the construction of our main index , see Annex II.

The index is given by the following specification:

$$FDI = \Phi \sum (C_{i,t} * W_t)$$

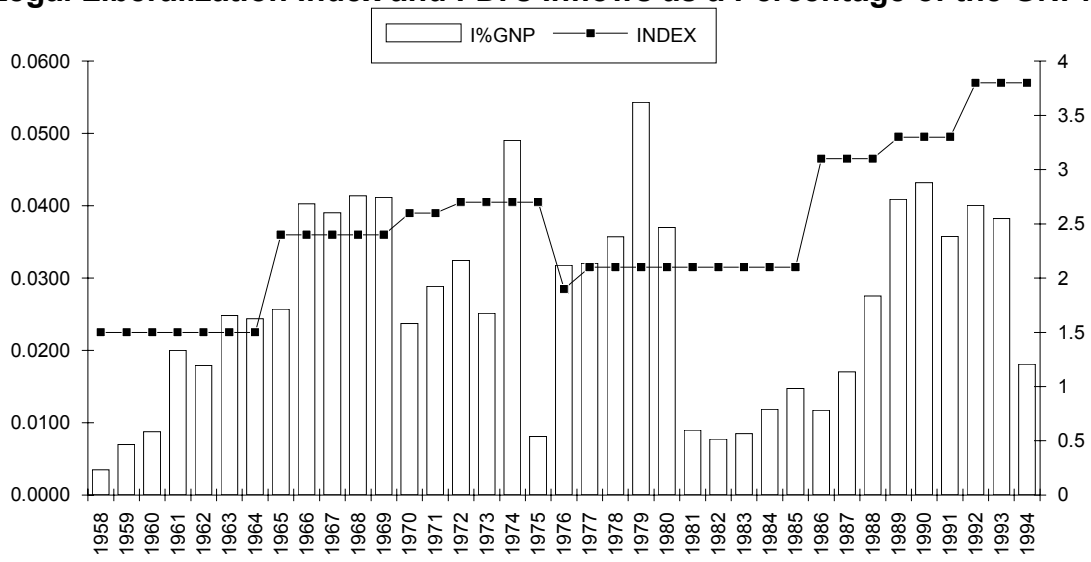
The greater the value of the index, the higher the legal openness' level.

The weight (*w*) given to the "Freedom of Entry" criterion is the greatest. The one given to the criterion "Fiscal Incentives" the lowest. The criterion "Fiscal Incentives" was included as an additional measure of the real interest of a country in attracting FDI's inflows. We do not discuss here neither their adequacy, nor their real effects on FDI's inflows nor on domestic investment levels (See Gray, C, *ibid*).

Sensitivity testing was performed on the Index to verify the adequacy of the chosen weights. For this, two alternative Indexes, one in which all the weights were homogeneous and another in which the criterion "Tax Incentives" was the most important -this one to test the proposition that tax incentives had a strong role in attracting FDI to Portugal- were also constructed.

Results of our main aggregated legal liberalization index are show in the next page, together with the ratio of FDI's inflows to the GNP.

Graph II
Legal Liberalization Index and FDI's Inflows as a Percentage of the GNP.



Our next model tries to explain FDI in percentage of the GNP as a function of our liberalization index. D stands for a dummy for correction of the 74-79 years

$$FDI_t / GDP_t = \alpha + \beta I_t + \chi D_t + \mu_t$$

The results for the several regressions used in our indexes are shown in the tables in Annex III. They are not very robust results.

Our legal liberalization index is positive and significant, as we would have expected. The global adhesion is good and the R^2 is quite high. The "revolutionary" dummy is significant, but not the intercept. Similar results are found for the lagged versions. But the presence of positive serial correlation (as show by the Durbin-Watson and Q tests) casts doubts about the significance of these results. The regressions corrected by the AR1 iterative procedure reveal that the index is significant only when a constant term - which is significant, when used - is not present. These results are found also with all the "alternative" indexes: in fact, for them, the results are even weaker (see Annex III).

To further clarify our results, we also tried the tests developed by Granger, by Sims and by Geweke, Meese and Dent (see box below).

Causality Tests: The objective of the "family" of tests used is to verify if a lagged additional independent variable increases the explanatory power of a regression, when compared to a time-series' analysis of the dependent variable. If it does, we may say that this independent variable "granger-causes" the dependent variable. The general specification tested is (see Granger, 1969):

$$Y_t = c + \sum_{k=1}^{m} \alpha k \, Y_{t-k} + \sum_{k=1}^{m} \beta k \, X_{t-k} + \mu t$$

The null hypothesis is:

$$H_0: \quad \beta_1 = \beta_2 = \ldots = \beta_k = \ldots = \beta_m = 0$$

See for this Granger (Granger, C., 1969, *ibid*). See also Sims (See Sims, C., 1972) and Geweke, Meese and Dent (See Geweke, J.; Meese, R.; Dent, W., 1982) that developed versions of this test that we tested as well.

These tests shown no causality between FDI in percentage of the GNP and our liberalization Index (see Annex III for the results of the Granger test). Thus, both our regressions and our causality tests seem to show that, specifically for the Portuguese case, the increase in FDI was due to other causes[31].

[31]One possible cause for the increase may have been the development of the portuguese domestic market, measured by the growth of the GDP. This agrees with the results of estimates made by Clérigo, N. (see Clérigo, N., 1995, paper number 3 in this collection). He finds sign of feedback between GDP and Fdi growth. Similar perceptions about the FDI motivation were found in a OECD study obout investment in Central-Eastern Europe (see OECD, 1994 (a)).

3 - CONCLUSION.

Portugal went through a progressive liberalization of its foreign exchange's regulatory framework. The FDI legislation was liberalized simultaneously. Initially there were quite high restrictions to FDI. Portugal is today almost totally opened. The present wave of liberalization began with the accession into the EU, but in fact it has its roots in the deregulation initiated during the early sixties. This process of liberalization was abruptly interrupted by the political and social upheaval caused by the 1974's "Carnation Revolution".

We discussed in detail the legislation regarding FDI inflows and constructed an index showing the level and the speed of this liberalization process during over half a century: 1943-1994.

We also conducted a regression analysis of the relation between our index and FDI inflows and used a variety of tests on the causality of that liberalization index and the inflows. In the Portuguese case we concluded that this causality does not exist, *i.e.*, that the legal framework and tax policy regarding FDI did not explain the amount of FDI inflows. Other omitted variables explain FDI. Naturally this deserves further work. But one conclusion is clear: after 1985, upon signing the Treaty for Membership, FDI increased substantially. This may point to the importance of a liberalization process that is seen as irreversible and, therefore, as credible in the eyes of foreign investors.

Eastern Europe is at a stage similar to that of Portugal in the sixties: then FDI was as small there as it is now in Eastern Europe. Further steps toward integration into the EU may enhance the credibility of the present liberalization process in the Eastern European countries.

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