



Retention and Expansion of Foreign Direct Investment

Political Risk and
Policy Responses

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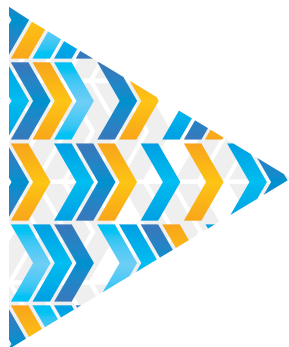


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ACRONYMS AND ABBREVIATIONS

BEA	Bureau of Economic Analysis
BOO	Business Ombudsman's Office
BOP	Balance of Payments
CI	Confidence Interval
EIU	Economist Intelligence Unit
FDI	Foreign Direct Investment
FE	Fixed Effects
FET	Fair and Equitable Treatment
GDP	Gross Domestic Product
GDPPC	Gross Domestic Product Per Capita
GIC	Global Investment Competitiveness
ICRG	International Country Risk Guide
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information and Communication Technology
IGM	Investment Grievance Management
IIA	International Investment Agreement
IIP	International Investment Position
IMF	International Monetary Fund
IPA	Investment Promotion Agency
IPP	Investment Policy and Promotion
ISDS	Investor-state Dispute Settlement
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OFIO	Foreign Investment Ombudsman Office (Republic of Korea)

PC	per capita
PPP	Public-Private Partnership
R&D	Research and Development
SIRM	Systemic Investment Response Mechanism
UNCTAD	United Nations Conference on Trade and Development



EXECUTIVE SUMMARY

INTRODUCTION

Due to its recognized benefits, most countries today—regardless of their level of development—compete for and dedicate significant resources to attracting foreign direct investment (FDI). Capturing the full positive spillovers of FDI is a long-term process and requires regulatory certainty and predictability to enable strategic business planning. Thus, policies that induce foreign investors to remain and reinvest in host countries are as critical as attracting new investment. Having gone through the effort to attract investors, it seems logical to assume that most host governments would have policies in place to ensure that those investments are retained and expanded.

Paradoxically, despite the obvious need to identify public policies that facilitate the permanence and expansion of FDI on the one hand, and the extensive literature on political risk affecting FDI on the other, neither academia nor policy makers seem to have fully connected these two topics. Most governments do not have the tools to monitor how many investors withdraw FDI projects or cancel planned expansion projects every year in their jurisdictions, nor do they have any clear idea of the factors behind such decisions. Fewer have mechanisms in place to cope with those factors.

This paper aims to fill this gap in evidence-based policy making, by contributing to the understanding of how political risks emanating from government conduct affect FDI and proposing a tool for governments to help investors retain and expand investments. Based on investor survey data

and empirical analysis of investor-state dispute settlement (ISDS), the paper aims to draw attention to this issue and to highlight that many countries may inadvertently be losing significant amounts of FDI. The paper responds to an urgent need for governments to provide a minimum institutional infrastructure that can enable a lead agency to identify, track, and manage conflicts arising between investors and public agencies as early as possible.

EMPIRICAL EVIDENCE ON THE IMPACT OF POLITICAL RISK

According to the survey data analyzed in this paper, the rate of investors divesting from developing countries because of irregular government conduct is approximately 25 percent. According to the new discontinued Multilateral Investment Guarantee Agency surveys conducted between 2009 and 2013, political risk was the most important constraint for FDI in developing economies. The types of political risk include factors such as adverse regulatory changes, breach of contract, and transfer and convertibility restrictions. Similarly, the 2017, Global Investment Competitiveness Survey found that 45 percent of investors rated investment protection guarantees as critically important or deal breakers when investing abroad, notably, this was the highest among all investment climate factors. In addition, 86 percent of investors identified the legal and regulatory environment as important or critically important when making investment decisions. Investors consistently ranked grievances related to expropriation, transfer and

convertibility restrictions, breach of contract, and adverse regulatory changes as the most impactful government actions leading to FDI withdrawals and cancellations. Despite being the most impactful regulatory risks, the frequency of expropriation and breach of contract has declined over the past decade, while risks associated with sudden, adverse regulatory changes have persisted in frequency. Problems related to transfer and convertibility restrictions have constantly remained in the middle of the curve in frequency. Lack of transparency and predictability in dealing with public agencies and delays in obtaining the necessary government permits to start or operate a business were also identified as factors that significantly impact investment retention and expansion. These two types of regulatory risks, together with sudden, adverse regulatory changes, indicates that the lion's share of the grievances leading to FDI withdrawals and cancellations relate to the ways in which government agencies perform their routine regulatory functions. Foreign Investors responded that direct engagement with governments is the most frequently used tool to address adverse government conduct. The findings show that, when problems arise, investors' first step is to engage in consultations with host governments, rather than turning to litigation. However, the survey data also show that investors have a high degree of dissatisfaction with the effectiveness of this engagement. Further, the data show that the high rates of FDI withdrawals and cancellations result not only from disruptive conduct, but also from lack of a timely and appropriate response by the authorities involved in resolving the problem.

To compliment the survey data, this paper contrasts the findings of investors' perceptions with factual trends identified by recent empirical analyses of ISDS cases. On ISDS awards, the most common types of regulatory conduct found to breach international investment agreements (IIAs) coincide with those that appear most frequently in the investor survey data: fair and equitable treatment (FET). Depending on its wording and interpretation, FET has been understood as requiring that government action be transparent, coherent, reasonable, proportionate, or consistent with the expectations of foreign investors

arising from written commitments undertaken by governments through contracts or investment authorizations.

This finding corroborates the survey data, which place lack of transparency and predictability in dealing with public agencies and sudden adverse regulatory changes as the most frequent government conduct inducing FDI withdrawals and cancellations.

On ISDS claims, there is also clear convergence between the specific types of government conduct leading to such claims and those inducing FDI withdrawals and cancellations. The most common breaches alleged by investors in ISDS proceedings are those violating the FET principle; indirect expropriation; full protection and security or similar; and arbitrary, unreasonable, and discriminatory measures. Among the four types of government conducts leading to FDI withdrawals and cancellations, lack of transparency and predictability of government agencies as well as adverse regulatory changes were found to be the main sources of contention between investors and host governments. Thus, this is an area where the empirical data from investor surveys and ISDS data coincide. The empirical data show that, although ISDS has occurred in a variety of sectors, disputes tend to arise in economic sectors that are characterized by high levels of state intervention. In the tertiary sectors, there are services that many countries consider of "public interest" and are thus subject to close state supervision, such as utilities, water and electricity distribution, telecommunications, transportation, and, to a lesser degree, financial services. There is also a high concentration of ISDS in services where public-private partnerships are typical, such as construction and power and transport infrastructure. Another area where ISDS tends to occur frequently is in natural resource industries, such as extractives—oil, gas, and mining—and agriculture, fishing, and forestry.

In a globalized world where patterns of international production are leading to a higher level of interaction among foreign and local investors,

governments, and civil society, there is an evident need for an international investment regime to promote and maximize the positive impacts of foreign investments in host countries and mitigate the potential negative effects. To achieve such an objective, governments should have a minimum institutional infrastructure that allows them to identify, track, and manage conflicts arising between investors and public agencies as early as possible. Currently, this type of institutional infrastructure does not exist in many countries. However, it is encouraging to see good practices being gradually developed by several countries. With the support of the World Bank Group and other institutions, these practices are being used to develop coherent protocols for investor-state conflict management that may be implemented on a wider scale.

PILOTS FOSTERING FDI RETENTION AND EXPANSION

The World Bank Group's Investment Policy and Promotion (IPP) team has developed a solution package to help developing countries retain and expand FDI. The development of this tool has two additional objectives. First, it should be possible to implement the solution package within real political timeframes (maximum three to four years) corresponding to the timeframe of most government administrations. Second, the tool should be designed so that its effectiveness can be measured using objective impact indicators.

The design of this tool started with a review of the literature and a series of case studies of different experiences and good practices used by governments around the world to address the risks generated from government conduct. The research found that most policy makers have not yet made the connection between investment retention and expansion on the one hand, and political risk generated from government conduct on the other. However, some governments have started to take steps in different, yet convergent, directions. The study of global best practices revealed two patterns. The first one, focusing on investment retention and expansion, features the deployment of aftercare programs. For example, the Republic of Korea set

up a Foreign Investment Ombudsman Office, which is now considered one of the most sophisticated aftercare programs in the world. The second pattern shows that several governments have enacted policies that address political risk rather than investment retention and expansion. This has been the experience of various Latin American countries, which over the past two decades have been the most frequently affected by claims submitted by foreign investors to international investment arbitration under IIAs. Consequently, over the past decade, the issue of ISDS dispute prevention has resonated strongly with Latin American countries that have taken pioneering steps in this field.

Although governments may focus on aftercare, it will likely also have to deal with issues that go beyond the aftercare service, namely, government conduct that places FDI at risk of withdrawal or cancellation of expansion. It is difficult for investment promotion agencies (IPAs) to learn about grievances arising with investors who may not have interacted with those agencies in the first place. World Bank Group research shows that a significant share of grievances come from investors engaged in the tertiary sector and investors involved in public-private partnerships and other government contracts. Similarly, investors in the natural resource sector, particularly in extractives, often interact directly with the ministries responsible for mining, energy, and/or the environment. In those cases, investors do not usually enter the host economy with the support of IPAs and are therefore unlikely to seek their assistance when dealing with government counterparts. Further, IPAs do not usually have the mandate, legal attributes, or political clout to deal with other government agencies whose conduct is putting FDI at risk.

Dispute prevention policies focus on preventing the escalation of grievances into international legal disputes but not on FDI retention and expansion. The agencies that are interested in preventing investor-state arbitration are often those responsible for implementing IIAs and representing the host state in international arbitration proceedings (for example, the ministry of trade and investment and/or the ministry of justice or attorney general's

office). These agencies often have staff with technical skills and, in some circumstances, may even have enough weight to settle certain ISDS disputes. However, because the mandate of these agencies is focused on negotiating, implementing, or enforcing IIAs, they traditionally get involved in investor-state grievances only once the grievance has escalated to a legal dispute.

A review of practices around the world led to the design of the Systemic Investment Response Mechanism (SIRM) as a practical solution package designed to enable governments to identify, track, and resolve, in a timely manner, investor-state grievances that put investment projects at risk of withdrawals and cancellations. Some countries have started to focus attention on the beginning of the investor-state conflict continuum, addressing problems affecting investors at an early stage, before they have escalated to grievances. Other countries have focused on problems that place FDI at risk of withdrawal or cancellation. The SIRM collects data and identifies patterns in the source of government-generated political risks affecting investments. It quantifies investment that is retained, expanded, or lost as a consequence of addressing or not those political risks. The SIRM requires the empowerment of a reform-oriented government agency and establishment of an intergovernmental mechanism for systematically addressing grievances arising from government conduct, thereby reducing this type of political risk at its source. The lead government agency alerts the appropriate higher-level government body of the problems affecting investments, to address them before they escalate further.

This paper explains the process leading to the design of the SIRM concept and summarizes the experience derived from piloting it. The World Bank Group IPP team provided support in eight pilot projects in countries in Latin America, Eastern and Southern Europe, Central Asia, the Middle East, North and Southeast Asia, and East Africa. As of the writing of this paper, all the SIRM pilots except one are still under implementation. The pilots are at various stages and are being monitored by the World Bank Group every six months to

assess progress based on the implementation plans. Even for pilots where the implementation phase has just started, the IPP team has been working with its government counterparts, which have started to deploy the SIRM on a “learning by doing” basis. Therefore, although the sample may not be big enough to generate statistically relevant data, the pilots provide some preliminary, firm-level evidence on the types of grievances impacting investors; the issues that generate conflicts most frequently; the most common sectors and types of FDI affected by regulatory conduct; and some preliminary estimates on the magnitudes of investments at risk, retained, and expanded.

The pilots show that significantly fewer grievances are serious enough to place investment at risk compared with the number of more minor problems that investors face in their routine operations and that are usually dealt with through an aftercare program — however, the economic impact of such serious grievances is significant. Among the SIRM pilots, in three cases investment retention/expansion has been validated based on World Bank Group monitoring and evaluation methods. Collectively, these SIRM pilots contributed to US\$200 million in investment retained, US\$20 million in reinvestments, and a conservative estimate of US\$10 million in public cost savings derived from verified prevention of three investor-state arbitration proceedings that affected investors were ready to commence if their grievances were not resolved. Adverse regulatory conduct seems to be the most common type of grievance placing investment at risk. In almost all cases, the most common type of conduct leading to serious grievances falls within this type of regulatory risk conduct. Specifically, abuse of authority, abuse of discretion when interpreting laws and regulations, and lack of transparency are the most common sources of grievances. This finding resonates with the trend revealed by empirical research that alleged violations of the FET or minimum standard of treatment are the most frequent investment protection guarantees invoked in ISDS proceedings and the most frequently breached in international arbitration awards.

Grievances arise in primary, manufacturing, and tertiary sectors with a slightly higher concentration in the primary and tertiary sectors. Specialized and subnational regulatory agencies tend to generate most of the conflicts. Taxation problems, allegations of breach of contract, cancellation of land leases and operation licenses, as well as fines imposed due to alleged regulatory infractions tend to be the most common types of grievances affecting FDI in the tertiary sector.

Although SIRMs require country-specific customization, several common elements have been distilled through its piloting eight countries. For instance, common elements include the composition and positioning of the lead agency; design and deployment of the information and communications technology tracking tool to register, follow up, and measure the impact of resolving (or failing to resolve) grievances; and coordination protocols to ensure interagency coordination and collaboration in resolving investor-state conflicts. These common elements hold true despite the unique political-economic environment of each country. Investor protections found in IIAs play a key role in enabling the SIRM lead agency to negotiate in light of legal implication when seeking the collaboration of peer agencies in attempting to resolve a grievance. The same can be said of the very persuasive effect that diplomatic pressure exerted by investors' home-state governments can have in invoking international commitments with the host countries. The SIRM pilots demonstrate that rather than fostering power-oriented politics, IIAs are starting to play a catalytic role in fostering rule-based negotiation among different agencies within a host government, even to the benefit of domestic investors.

POLICY IMPLICATIONS

International investment law is multidimensional and entails much more than investor-state dispute mechanisms. Traditionally, IIAs have relied exclusively on ISDS to ensure respect for investment protection obligations. However, ISDS is not a mechanism for promoting the enforcement

of IIAs on the ground. Instead, it is a mechanism for seeking redress for damages caused by treaty violations, that is, for situations when IIAs have not been implemented. In other areas of international economic regulation, such as trade in goods, policy makers have included within the treaties a set of mechanisms to ensure that the agreements are fully implemented at the international and domestic levels.

Comparing the results of investor perception surveys with empirical data on ISDS shows a close convergence among the types of government conduct that investors seem to care more about, that generate FDI withdrawals and cancellations more frequently, and that escalate into international investor-state legal adjudication. Further, this research provides key insights on its most common patterns. Below describes the impact of political risk and policy implications that affect investment retention and expansion in developing countries.

- The types of government conduct generating FDI divestments as well as ISDS cases have evolved over time. The focus has shifted from expropriations to issues of transparency, due process of law, proportionality, coherence, and adherence to commitments. This may call for a more precise and targeted policy response that better addresses the needs of the investors in a more targeted manner.
- IIAs and ISDS rely on the one-state legal paradigm, but such an assumption is often contradicted by the situation in countries where specialized agencies at the national level or subnational agencies may lack competences or familiarity with those investment protection guarantees. This situation leads to a gap between the law “on the books” and in practice.
- Many developing countries lack mechanisms to enable them to articulate a coherent and timely response to grievances arising from government conduct. This exacerbates an already complex challenge to deal with investors' grievances in a timely and coherent manner.

- There is a sharp contrast between the investors' preference to engage with host governments and their high degree of dissatisfaction with such engagement in practice. Thus, there is a need for governments to establish new or more efficient ways to respond to investors' grievances, to prevent FDI withdrawals and cancellations.

The SIRM pilots, along with the empirical evidence, provide a proof of concept and illuminate some concrete ideas on how to move forward the agenda of investment retention and expansion. Policy implications to maximize investment retention and expansion are as below.

- Policy making on investment retention and expansion is critical, and the SIRM is a useful tool in this respect. Discussions that place too much emphasis on initiatives aimed at investment attraction have the effect of downplaying equally important initiatives on investment retention and expansion, which, paradoxically, are often much easier to implement.
- Investment retention and expansion and dispute prevention are distinct, and one may not necessarily entail the other. Governments

should therefore avoid confusing mechanisms to prevent investor-state disputes with mechanisms to prevent investors from withdrawing or canceling FDI projects.

- By inducing the desired behavior among domestic regulatory agencies, the SIRM can serve as a tool for properly implementing IIAs on the ground and in a way that is more in tune with their original intent to mitigate political risks in cross-border investment transactions. At the same time, by improving the domestic institutional framework and inducing positive changes in the investment climate, the SIRM would equally benefit domestic investors.
- The empirical research that led to the design of the SIRM concept and its initial positive performance draw attention to the merits of including FDI retention and expansion within the broader discussion on investment facilitation in various international forums. A mechanism such as the SIRM can respond to the need of governments, to set up an institutional infrastructure to coordinate statewide responses to investor-state grievances.



PART I

Beyond Investment Attraction: Impact of Government Behavior on FDI Retention and Expansion



INTRODUCTION

Research has shown that foreign direct investment (FDI) can be a powerful vehicle for better integrating national economies with international chains of production, diversifying exports, enhancing productivity, and creating better paying and more stable jobs in host countries (Echandi, Krajcovicova, and Qiang 2015). Because of its benefits for the host economy, most countries today—at all levels of development—compete to attract FDI and thus dedicate significant effort and resources to attract and facilitate the establishment of investment in their economies. Unlocking the transformative potential of FDI for development through the promotion of linkages and other spillovers requires time, and maximizing the benefits of FDI is not a short-term process.

This explains the consensus in the literature on the critical role that policies fostering regulatory certainty and predictability play in enabling the development and growth of private business in general and international investment operations in particular (North 1992; Jackson, 1989). Thus, policies that induce foreign investors to remain and reinvest in host countries are as critical as those used to attract new investment. However, through research and World Bank Group experience on the ground, this paper finds that most governments do not have policies in place to ensure that their investments remain and subsequently expand in their host countries.

Aside from incipient programs on investment aftercare, host governments have paid very little attention to evidence-based research to

inform the design and implementation of specific policies fostering the long-term permanence and expansion of FDI. Most countries do not track in a systematic way firm-level data on investment retention, expansion, withdrawal, or cancellation of expansion plans across sectors. Although many investment promotion agencies (IPAs) have tracking mechanisms for the specific investors who establish operations in their jurisdictions, such tracking is limited to the sectors under the IPA's jurisdiction (identified priority sectors), often leaving a substantial segment of investments uncovered. By the same token, most governments do not know how many investors withdraw FDI projects or cancel planned expansion projects every year, and most do not have any idea of the factors behind such decisions. This paper aims to draw attention to this issue and to the many countries that may inadvertently be losing significant amounts of FDI.

The existing literature discusses the extent to which FDI is impacted by perceptions of political risk (Kobrin 1979; Bernanke 1983; Schneider and Frey 1985; Nigh 1985). The notion of political risk, understood as the probability of operations of multinational enterprises (MNEs) being disrupted by political forces or events (Luo 2008), is practically as old as investment policy itself. It is widely recognized that, from a historical point of view, the evolution of the political risk insurance sector (Ziegler 2010) and the negotiation of thousands of international investment agreements (IIAs) (Vandeveld 2010) were in response to the need for mechanisms to mitigate and minimize the risks inherent in cross-border investment projects.

Paradoxically, despite the obvious need to identify public policies that facilitate the permanence and expansion of FDI on the one hand, and the extensive literature on political risk affecting FDI on the other, neither academia nor policy makers seem to have fully connected between these two topics. Studies identifying specific patterns of government conduct that affect investors' decisions to remain and expand their operations in host countries are scant, and the discussion on policy implications arising from examining this question is incipient.

The purpose of this research is to fill this gap in evidence-based policy making and contribute to a better understanding of how political risks derived from government conduct affect FDI. Based on the available empirical evidence from the past decade (2009–17), this paper focuses on three key broad questions. First, what are the patterns of government conduct affecting foreign investors who are already established in host countries? Second, how do such patterns of government conduct affect investors' decisions to withdraw and/or cancel plans to expand their FDI operations? And third, what tools are investors using to mitigate such political risks?

To address these questions, this research builds on two complementary sources of information. First, it focuses on a set of surveys targeting international investors from developed and developing countries, examining how government conduct has influenced their decisions to remain or expand their FDI projects in developing countries or withdraw or cancel investment plans. The analysis is based on the findings of a set of five annual surveys conducted by the Multilateral Investment Guarantee Agency (MIGA) in collaboration with the Economist Intelligence Unit (EIU) between 2009 and 2013, and a survey conducted in 2017 by the World Bank Group's Investment Policy and Promotion (IPP) team. Taken together, this set of surveys covers almost a decade and more than 2,500 international investors in developing countries.¹

To complement the survey data, this paper examines the findings of recent empirical analysis undertaken on all treaty-based investor-state disputes that occurred between 1987 and 2017 (Echandi 2019).² Although the paper is focused on FDI retention and expansion

and not on investor-state dispute settlement (ISDS),³ comparing patterns from investor surveys with those from ISDS empirical analysis allows for a better understanding of the political economy of investor-state relations.

The remainder of this part is divided into four sections. Section 2 focuses on the background and context of the research. It starts by examining the importance of investment retention and expansion for economic growth, justifying why governments should be concerned about this topic. It then explains the concept of political risk and subsequently presents a brief literature review on its relationship with FDI.

Section 3 examines the sets of investor surveys from 2009 to 2013 and 2017. The section focuses on addressing three questions: (i) to what extent have political risks arising from government conduct influenced investors' decisions? (ii) which specific types of government conduct have been most disruptive to FDI over the past decade? and (iii) what means have investors used to deal with grievances arising from government conduct?

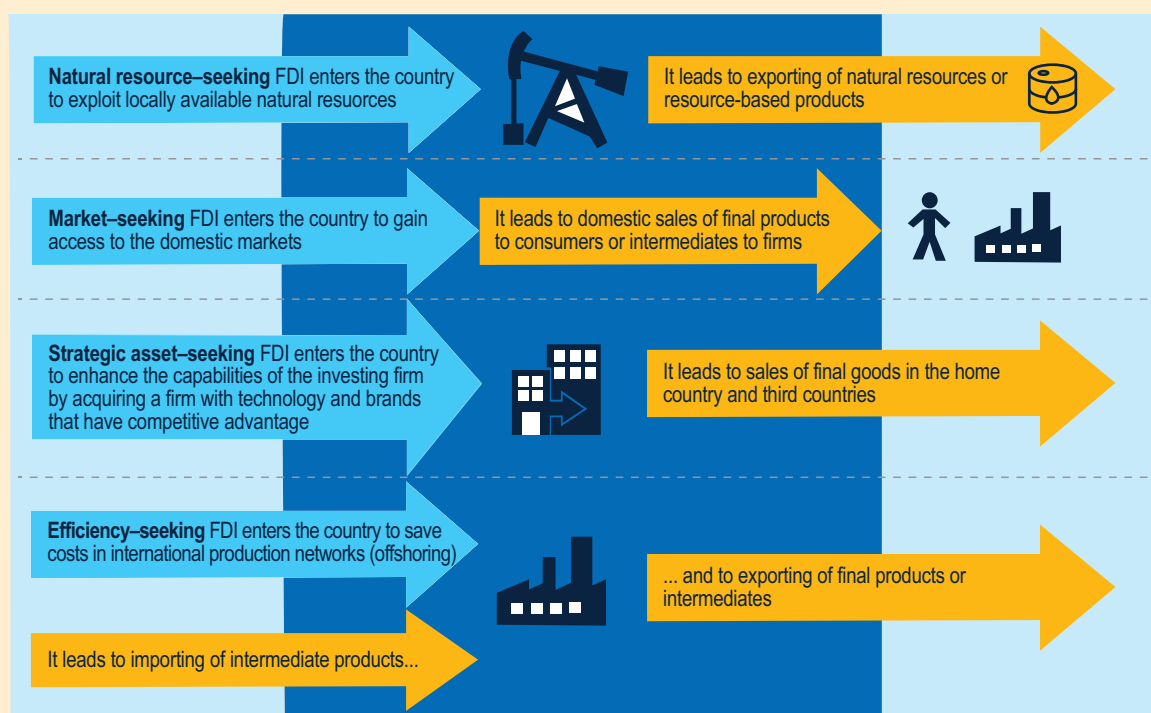
Section 4 contrasts the survey findings in section 2 with empirical evidence of investor-state disputes under IIAs. In particular, this section aims to clarify four key relevant aspects: (i) whether the types of conduct generating greater impact on FDI withdrawal and expansion or cancellation coincide with the types of conduct most frequently contested in ISDS claims, (ii) whether the types of government conduct generating FDI project withdrawal or cancellation coincide or not with the type government conduct in ISDS awards, (iii) whether the sectors and types of FDI affected by withdrawal of existing investment or cancellation of planned ones coincide with those most common in ISDS tends, and (iv) the circumstances under which investors opt to invoke ISDS.

Section 5 presents the overall conclusions and policy implications, with concrete recommendations that can be implemented by government officials to foster greater FDI retention and expansion in their host economies.

BOX 1. TYPOLOGY OF FOREIGN DIRECT INVESTMENT

A well-known framework that was proposed by Dunning and Lundan (2008) differentiates among four types of foreign direct investment (FDI): natural resources in the host country, access to the host country market, strategic assets of firms in the host market, and cost production savings through higher production efficiency. The last type of investment is typically associated with offshoring production stages to the host country and is the main vehicle for global value chains. The World Bank Group's Investment Policy and Promotion team built on Dunning's and Lundan's FDI motivation typology and took it one step further, observing that each category of FDI corresponds not only to investors' motivations, but also to objectively different types of FDI with distinct economic, social, and political impacts on development. All four types of investment can have important, although varying, benefits for the host economy. For example, natural resource-seeking investment often generates sizable government revenues. Market-seeking FDI can be associated with the availability of better and cheaper goods and services consumed by the population or used as inputs by other firms. Strategic asset-seeking investment allows domestic firms to expand their global networks. Efficiency-seeking investment is often seen as a means of job creation, technology transfer, and integration of a country into global value chains. The levels of benefits vary, and some carry more risks than others.

From an investment policy and promotion perspective, it is important to note that the four types of investment can respond differently to policy measures and the overall investment climate. Efficiency-seeking investors—whose investment decisions are driven largely by the motive to save costs—tend to be highly sensitive to any variables that raise their cost of operation or hinder their free exchange of goods and services with the rest of the world as part of global production networks. Natural resource-seeking, strategic asset-seeking, and market-seeking investments tend to be less sensitive to investment climate variables if the resource to be exploited or the firm that possesses competitive advantages can be found in the country or if the domestic market offers attractive opportunities.



Source: Global Investment Competitiveness Report 2017/2018, World Bank Group.



THE IMPORTANCE OF FDI RETENTION AND EXPANSION

MAIN CONSIDERATIONS FOR FDI RETENTION AND EXPANSION

Governments not only need to attract FDI into their economies, they must also facilitate its growth, diversification, and expansion. The key role of FDI in economic growth has been extensively documented in case studies of Singapore, Ireland, Malaysia, Vietnam, China, Chile, and Costa Rica, among others (Moran 2012; Moran, Graham, and Bolstrom 2005). In all cases, evidence shows that maximizing the positive impact of FDI on economic growth and diversification could not have been achieved without policies that provided investors enough certainty and predictability to operate and expand their business operations in the long term.

The topic of investment retention and expansion can be framed from multiple considerations. A first dimension is that there are factors that may affect FDI retention and expansion that are beyond the control of governments but should nevertheless be understood by policy makers to adopt mitigation strategies. In the current competitive global market, international investors must constantly revisit and adjust their business models to compete and grow their operations. Such revisions may entail relocating one or more projects from one country to another. Further, cross-border investments are inherently risky, and business failures may stem from factors that are totally unrelated to any government policy, such as inadequate business strategies, changes in market conditions, or technological changes affecting the economic sector concerned. The demise of analog telecommunications and the

obsolescence of compact disc players are just two of many illustrative examples.

A second dimension of investment retention and expansion is the role that government policy can play in enabling investors to remain and expand their operations. Research shows that all types of FDI require a minimum level of certainty and predictability to undertake business operations. However, different types of FDI may require different policy mixes to ensure their long-term permanence and expansion. (See box 1 on types of FDI.) For example, in the cases of natural resource-seeking and domestic market-seeking FDI, the pull factors luring investors into the host country, such as the quantity and quality of natural resource endowments or the size of the domestic market, may to a certain degree increase the level of tolerance of foreign investors to unfavorable government policies. By contrast, efficiency-seeking FDI is highly competitive, and host countries must be able to respond to the constant need for investors to upgrade their production processes and productivity. This includes supplying increasingly qualified human capital, efficient infrastructure, and connectivity. Anticipating such needs requires very fluid and close communication between key investment policy makers and investors and government capacity to respond in a proper and agile manner. Responding to the rapidly-evolving needs of firms involved in global value chains may represent a significant challenge for many developing countries and may affect their capacity to retain and expand this type of FDI in the long term.

A final dimension of FDI retention and expansion, which is the focus of this paper, is that identifying negative government actions and managing them may prevent the loss of investors and enable the retention and expansion of FDI. More specifically, the focus of this research is to identify the patterns of investor retention and expansion caused by “irregular” government conduct (table 1). Not all FDI discontinuation may be bad, and not all FDI retention may be good. This research focuses on the case of policies and actions that do not conform with the substantive or procedural standards expected by affected investors based on their reading of the applicable treaties, laws, and regulations in the host country. The empirical data reviewed for this paper show that host governments’ irregular conduct can be an important causal factor in making investors withdraw or cancel previously planned investment expansion projects.

For the purposes of this paper, investment retention and expansion are defined in terms of preventing government conduct from provoking investors to withdraw or close existing FDI projects or cancel already planned expansions of existing FDI. Retained investment is defined as any FDI project that remains in the host country despite having been at imminent risk of withdrawal due to government conduct; thus, it is retained as a direct result of a timely reaction by local public authorities. By the same logic, expanded investment is the expansion of an existing FDI project that goes ahead as planned,

despite having been at risk of being canceled as a result of disruptive conduct by the host government. Facilitating FDI permanence and expansion entails at least preventing host government conduct from pushing investors away.

INVESTMENT RETENTION

Although some member states of the Organisation for Economic Co-operation and Development (OECD) countries maintain divestment data, systematic global data on this is largely unavailable. For example, per Eurostat’s international investment position, over the past five years, the European Union’s FDI position has declined across some developing countries. In Africa, between 2015 and 2017, FDI declined by 21 percent, from a peak of €328 billion in 2015 to €260 billion in 2017. A similar decline was observed earlier in the Gulf states, a 22 percent decline between 2013 and 2014, from €66 billion to €52 billion. The U.S. Bureau of Economic Analysis provides data on the accumulated value of U.S.-owned financial assets in other countries and U.S. liabilities to residents of other countries at the end of each quarter. The United States saw its FDI position in Africa and the Middle East decline over the past five years. For example, in Africa, FDI stock declined 27 percent, from US\$69 billion in 2014 to US\$50 billion in 2017. In the Middle East a similar pattern can be observed—a 12% decline, from US\$55 billion in 2014 to US\$49 billion in 2016.

TABLE 1. TYPES OF FACTORS INDUCING DISCONTINUATION OF FDI PROJECTS

Context/Type of Factor	Market Conditions	Government Actions & Policies		Political Events (Wars, Civil Unrest, Terrorism)
		Regular	Irregular	
Corporate Strategies			Research Focus	
Host Country				
Home Country				
International Context				

Another source of divestment data is information maintained by national IPAs. Very few IPAs have such data—largely because of their focus on investment attraction—a point that this study highlights. Some national IPAs in East Africa maintain such information. For example, data compiled by an IPA show cancellations of investment projects during the establishment and post-establishment phases. In the post-establishment phase, there were cancellations of at least 101 registered projects, roughly accounting for the loss of at least US\$148 million (US\$1.47 million per investment) as well as at least 132,177 jobs (of which 6,808 were permanent, and 125,369 temporary).

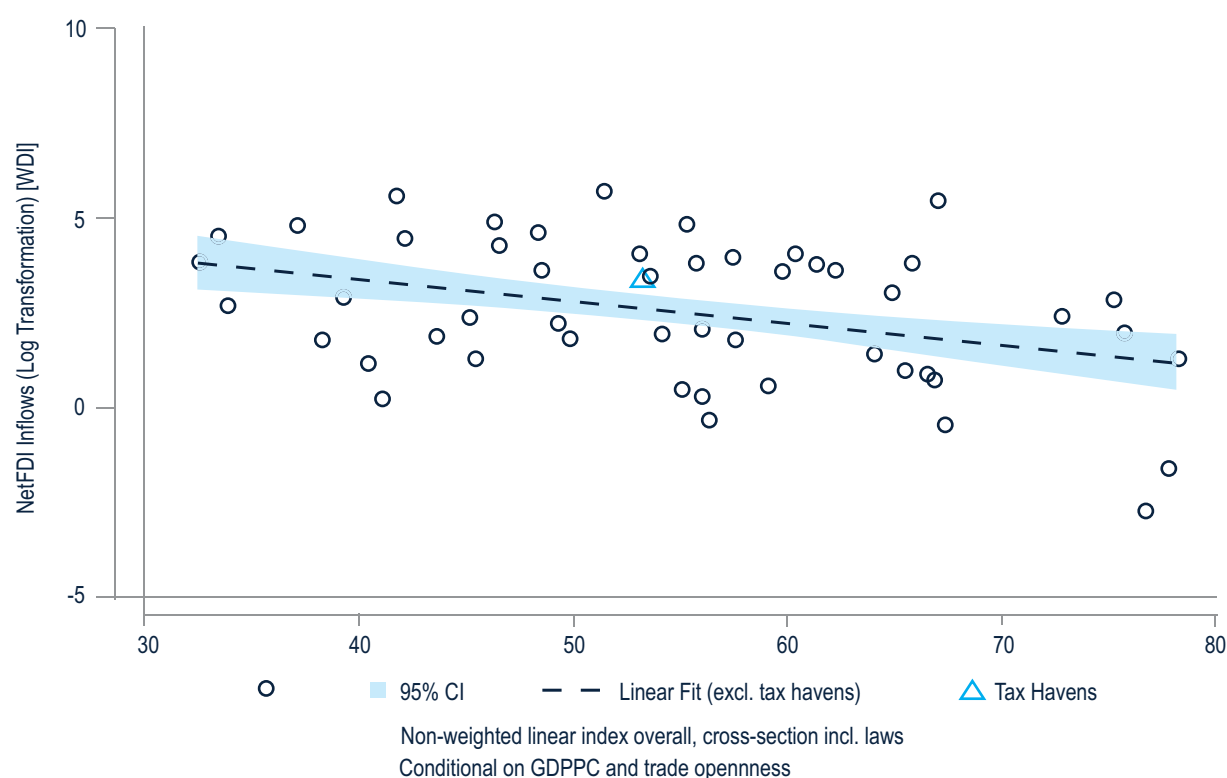
A study conducted by the OECD based on firm-level data from the OECD and G20 countries shows that about 21 percent of all foreign-owned firms in the sample in 2007 were divested by 2014 (that is, more than one in five foreign-owned firms) (OECD

2018). The study also found that the foreign-owned enterprises that were divested previously had, on average, 28 percent lower sales, 24 percent lower value added, and 13 percent lower employment than similar firms that stayed foreign-owned throughout the sample period.

These data illustrate that divestment does indeed take place and can significantly impact the positive spillovers of FDI. Further, irregular government conduct has a broader impact on the investment climate and negatively impacts FDI inflows to the host countries. In a recent study, high regulatory risk is associated with lower FDI inflows (figure 1) (Hebous, Kher, and Tran 2019).⁴ Detailed analysis is included in the annex B.

This reveals a worrisome paradox. Although governments in developing countries are competing to attract increasing FDI inflows, actions by their

FIGURE 1. FDI INFLOWS AND REGULATORY RISK



regulatory agencies are simultaneously pushing away an important share of investors who were already established in their host countries. Thus, it is important to frame the discussion on FDI retention and expansion in terms of the impact of host governments' conduct. This research aims to serve as a basis for devising concrete mechanisms to enable policy makers to identify, track, and address disruptive actions by host governments in a timely manner, so that they do not impede FDI projects that are already established or provoke investors to cancel already planned additional investments.

INVESTMENT EXPANSION

There are many ways in which FDI can expand. For instance, an original greenfield FDI project may generate profits that are then reinvested into the host economy, or investors may inject additional fresh capital, or start other greenfield FDI projects. Measuring total investment expansion is beyond the scope of this paper; therefore, the paper focuses on reinvested earnings as a proxy for expansion. Reinvested earnings are the undistributed profits of foreign affiliates resulting from operations in the host country that are reinvested in existing operations rather than repatriated to home countries as dividends. FDI equity inflows are composed of reinvested earnings and other types of equity, such as stocks. To increase FDI inflows, the country could attract new firms to enter or encourage existing firms to continue and/or expand their operations. Firms that expand their operations in the country may fund their expansion by reinvesting their earnings in the country (among other ways). As a result, reinvested earnings as a share of total equity FDI inflows then reflects the relative importance of existing firms, compared with attracting new firms, and serves as a proxy for expansion.

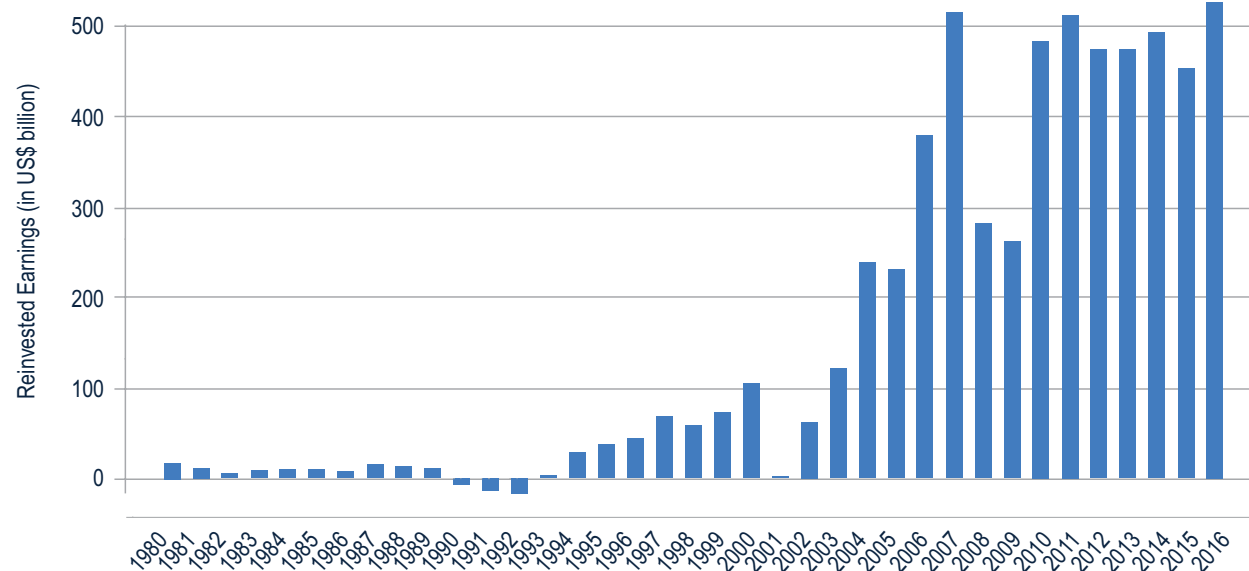
The justification for focusing on reinvested earnings stems from three fundamental considerations. First, focusing the analysis on reinvested earnings allows for a more precise impact measurement of investment expansion than covering all additional modalities of FDI expansion. Second, it is a useful means to examine the level of confidence of

established investors in host countries. Reinvested earnings reflect the interest of investors in expanding an existing FDI project. If investors are not willing to use reinvested earnings on existing FDI projects, it may be assumed that they would not invest additional fresh capital. Third, observing reinvested earnings as a share of total equity FDI inflows can be used as a proxy for the relative importance of host countries retaining already established firms compared with attracting new ones.

The focus of policy makers on investment attraction has led many to overlook the critical importance of reinvested earnings in the maximization of the potential benefits of FDI. This paper argues that there are at least three fundamental reasons why governments should better understand the dynamics of reinvested FDI earnings. Two of the reasons are directly related to the macroeconomic picture of growth, and the third reason is a critical finding for investment policies considering microeconomic variables at the firm level.

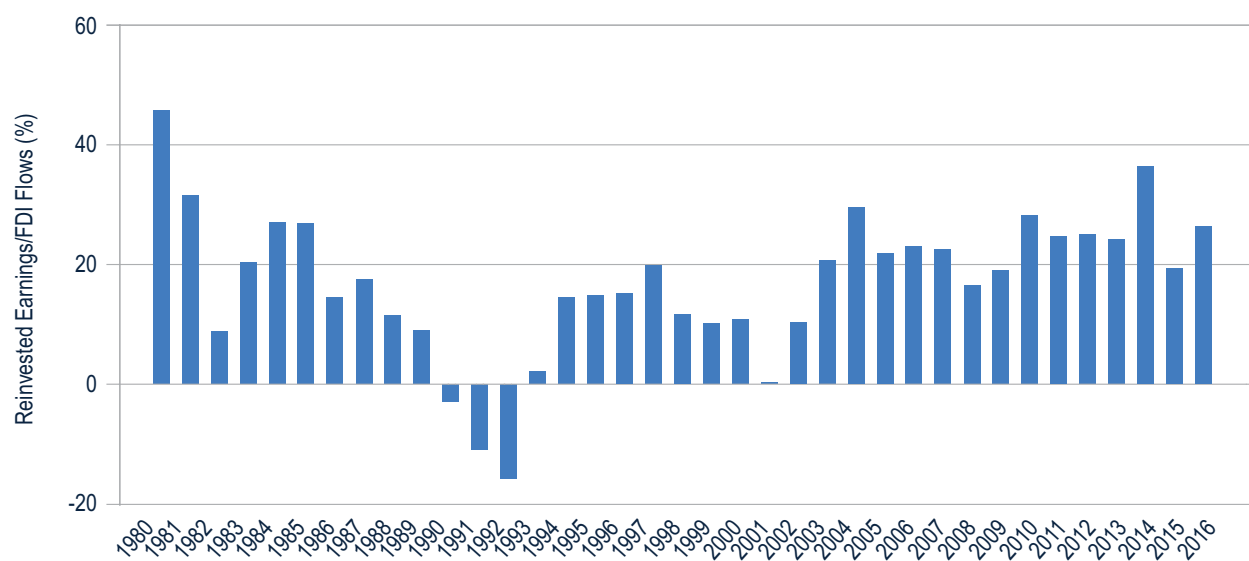
First, on the macroeconomic picture of reinvested earnings and growth, the data show that, during the past decade, reinvested earnings have increased considerably, and they now represent an important share (around 30 percent) of global FDI inflows. International Monetary Fund data from the Balance of Payments statistics show a substantial increase in reinvested earnings in absolute and relative terms over the past two decades. Figure 2 depicts the total amount of reinvested earnings over the past years, showing a dramatic increase between the early 2000s and 2007 and a subsequent collapse during the financial crisis in 2008 and 2009. In recent years, the amount of global reinvested earnings has recovered to the 2007 level of around US\$500 billion. Figure 3 shows the evolution of reinvested earnings as a relative share of worldwide FDI flows. Since 2000, the contribution of reinvested earnings to FDI inflows has mirrored the trends in aggregate reinvested earnings. The share tends to fluctuate between 20 and 29 percent, but it dropped significantly, to 18 percent of global FDI flows, in 2008–09. In subsequent years, the contribution of reinvested earnings to global FDI flows recovered to its pre-crisis level. Accordingly, it is important

FIGURE 2. WORLDWIDE REINVESTED EARNINGS: TOTAL



Source: International Monetary Fund Balance of Payments, 2019.

FIGURE 3. WORLDWIDE REINVESTED EARNINGS: SHARE OF FDI INFLOWS



Source: International Monetary Fund Balance of Payments, 2019.

Note: FDI = foreign direct investment.

for governments to focus their attention on FDI expansion, because an increasing source of total FDI comes not necessarily from prospective investors, but rather from investors who are already established in host countries.

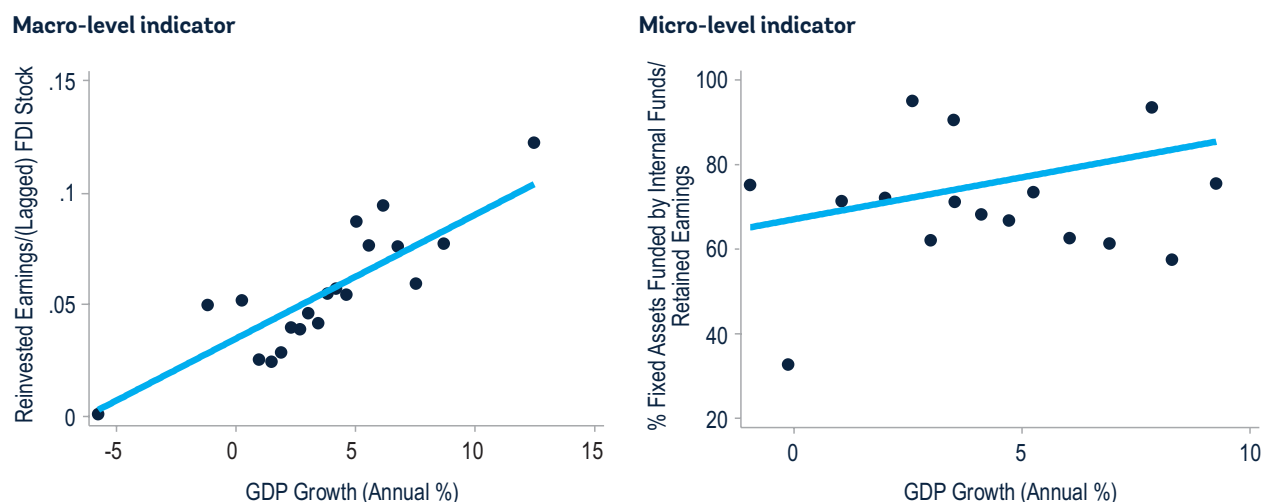
A second reason why governments should care about investment expansion is because research shows a positive correlation between reinvested earnings, at aggregate and firm levels, and host countries' economic growth. To the extent that gross domestic product (GDP) growth captures profitability in host countries, reinvested earnings may be the cause and effect of greater investment opportunities. Lundan (2006) suggests that the most important factor encouraging reinvestment, as opposed to repatriation, is comparative investment opportunities in the host country (for example, as measured by income earned at the industry level). Polat (2017) and Taylor et al. (2013) also find a positive relationship between comparative investment opportunities, as measured by the

host country's GDP growth rate, and reinvested earnings. Consistent with their results, as shown in figure 4, recent research at the World Bank Group finds that reinvestments at the aggregate and firm levels are positively correlated with the host country's GDP growth.

Notably, reinvested earnings tend to account for a larger share of FDI inflows in developing countries compared with higher income countries. Figure 5 shows that the share of reinvested earnings in FDI inflows is significantly and negatively correlated with a country's level of development as measured by GDP per capita. This result suggests that developing countries' governments should place particular emphasis on ensuring investment permanence and expansion.

A third reason why understanding investment expansion through reinvested earnings is key for policy making is that economic research shows that reinvested earnings and internal funds of firms are

FIGURE 4. REINVESTED EARNINGS AND GDP GROWTH



Source: International Monetary Fund Balance of Payments.

Note: The graphs depict the relationships using binned scatterplots, a nonparametric method for exploring the relationship between two variables visually. Binned scatterplots are created by grouping the x-axis variable into equally sized bins, computing the mean of the x-axis and y-axis variables within each bin, and then creating a scatterplot of these data points. A linear fit line using ordinary least squares is included as well. GDP = gross domestic product.

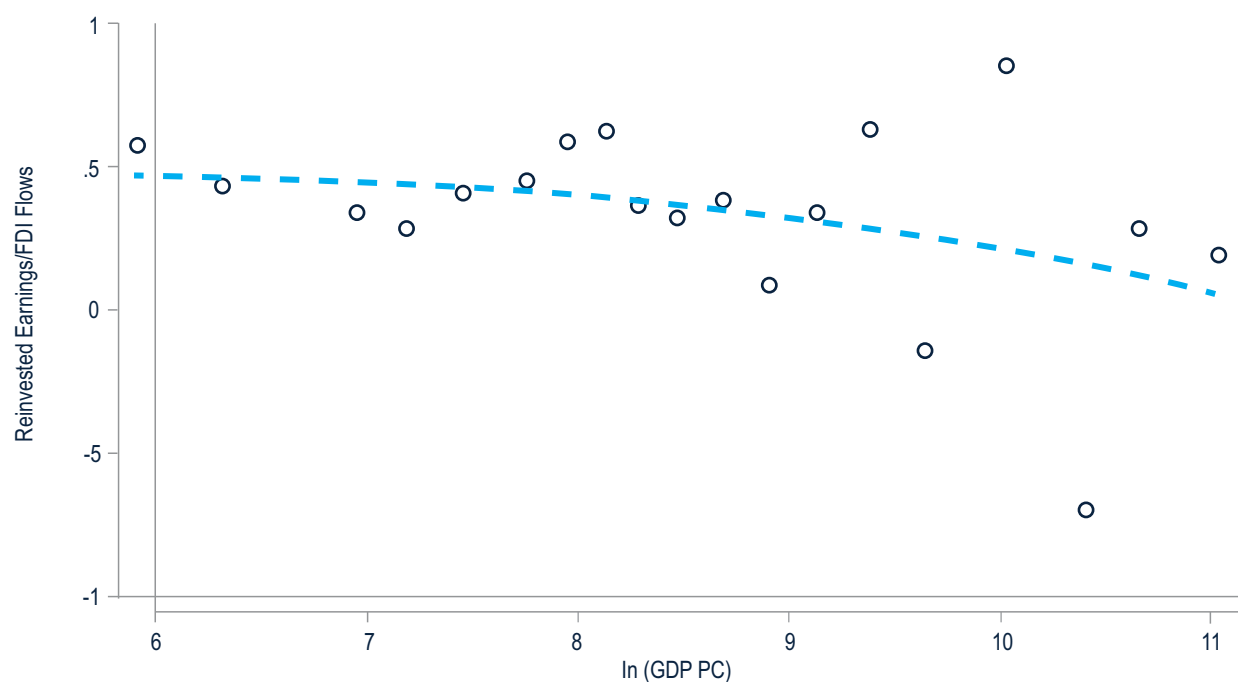
the major sources of funding for FDI expansion in fixed assets of foreign affiliates. For the purposes of this paper, research was undertaken by examining the micro pattern of reinvestment earnings, using firm-level data from the World Bank Enterprise Surveys.⁵ For each firm, the study observed the share of total purchase of fixed assets that was financed by internal funds and retained earnings.⁶ Figure 6 shows average values of the micro measure for foreign-owned firms since 2005. Across the years, this measure follows a similar pattern to the macro indicator of reinvestment (shown in figures 2 and 3), whereby reinvestment post 2008 financial crisis is almost back to the pre-crisis levels. Quantitatively, the micro indicator reveals that reinvested earnings and internal funds play a significant role in financing foreign firms' growth in fixed assets. In 2011, about 94 percent of fixed assets was financed internally by FDI firms; the average over 2010–17 was 73 percent.

The analysis tends to coincide with a trend shown by the 2017 Global Investment Competitiveness (GIC) Survey results. In that survey, as shown in figure 7, over a third of investors investing in developing countries stated that they reinvest all their profits in the host country, and another 14 percent reinvest more than half. Once more, this trend highlights the importance for host economies to retain and expand existing investments in addition to attracting new ones.

DEFINITION OF POLITICAL RISK AND HISTORICAL OVERVIEW

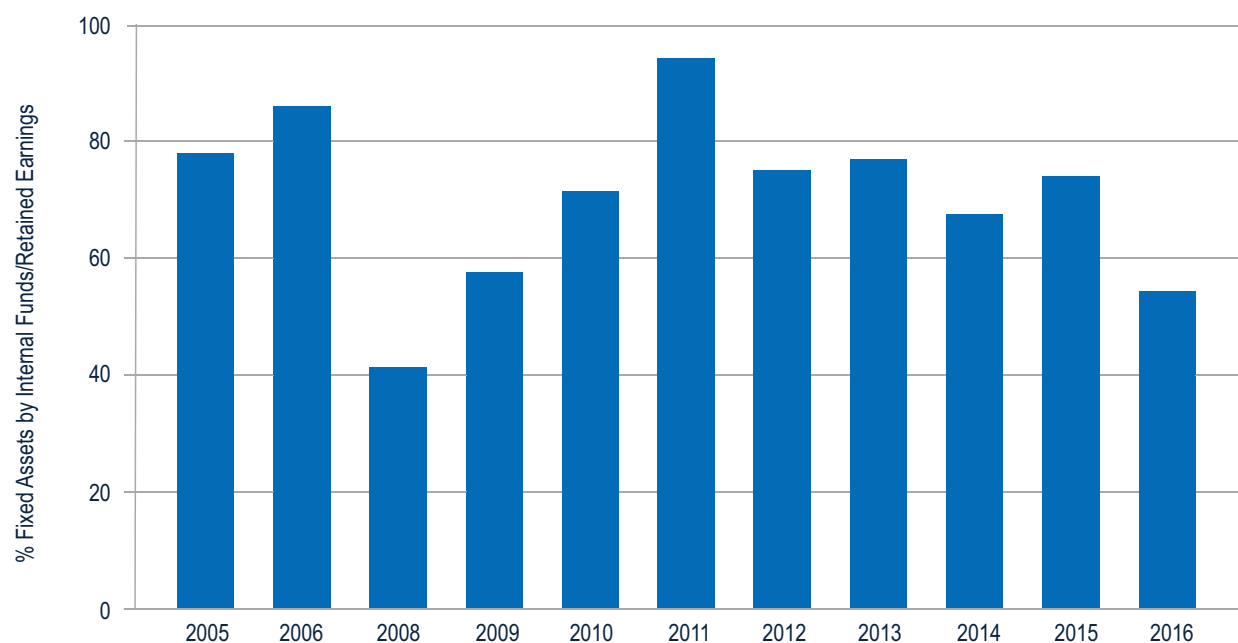
Political risk has been defined as the probability of disruption of the operations of MNEs by political forces or events, whether it occurs in host or home countries or results from changes in the international environment (Luo 2008; MIGA 2009). This broad definition comprises multiple categories of conduct

FIGURE 5. REINVESTED EARNINGS AND THE LEVEL OF DEVELOPMENT



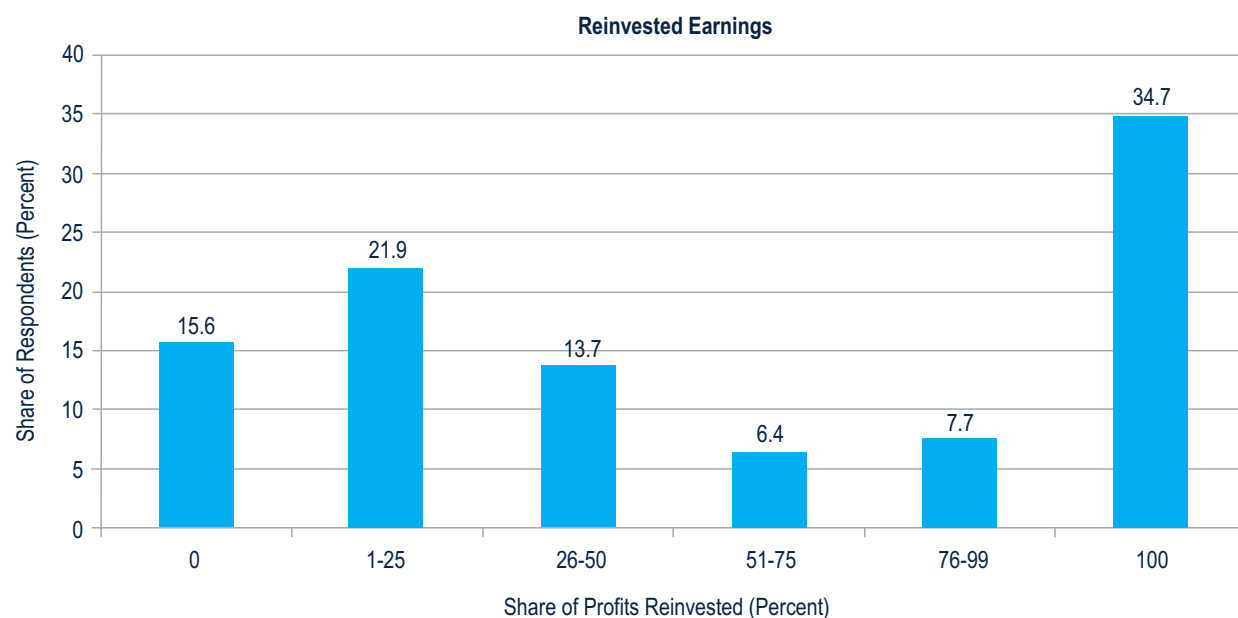
Note: The graph depicts the relationship using binned scatterplots. FDI = foreign direct investment; GDP pc = gross domestic product per capita.

FIGURE 6. AVERAGE SHARE OF FIXED ASSETS FINANCED BY INTERNAL FUNDS OR RETAINED EARNINGS BY FDI FIRMS IN DEVELOPING COUNTRIES



Source: World Bank Enterprise Surveys.
Note: FDI = foreign direct investment.

FIGURE 7. MORE THAN A THIRD OF INVESTORS REINVEST ALL THEIR AFFILIATE-GENERATED PROFITS BACK INTO THE AFFILIATE



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report.

Box 2. Typology of Political Risk

Transfer and convertibility restrictions: risk of losses arising from an investor's inability to convert local currency into foreign exchange for transfer outside the host country. Currency devaluation is not covered.

Expropriation: loss of investment as a result of discriminatory acts by any branch of the government that may reduce or eliminate ownership, control, or rights to the investment as a result of a single action or through an accumulation of acts by the government.

Breach of contract: risk of losses arising from the host government's breach or repudiation of a contractual agreement with the investor, including non-honoring of arbitral awards.

Non-honoring of sovereign financial obligations: risk of losses due to noncompliance of government guarantees securing full and timely repayment of a debt that is being used to finance the development of a new project or enhancement of an existing project.

Terrorism: risk of losses due to politically motivated acts of violence by non-state groups.

War: risk of losses due to destruction, disappearance, or physical damage as a result of organized internal or external conflicts.

Civil disturbance: risk of losses due to social unrest.

Other adverse regulatory changes: risk of losses for foreign investors stemming from arbitrary changes to regulations.

Source: Multilateral Investment Guarantee Agency.

by different actors who may be located in many countries and events that may or may not fall under the control of a single set of actors.

A more specific definition of political risk differentiates between risks in host and home countries. In host countries, political risk is largely determined by uncertainty over the actions of governments and political institutions, but also of other groups in society, such as separatist movements. In home countries, political risk may stem from political actions directly aimed at investment destinations, such as sanctions, or from policies that restrict outward investment (MIGA 2009).

The political risk insurance industry uses a narrower definition of political risk that focuses on actions that take place within host countries only. According to this definition, political risk is divided into: (i) currency convertibility and transfer, (ii) expropriation, (iii) political violence (for example, war or civil unrest), (iv) breach of contract

by a host government, and (v) the non-honoring of sovereign financial obligations (MIGA 2009).

For the purposes of this research, political risk is more specifically defined as the probability of disruption of the operations of foreign investors resulting from government conduct in the form of actions or regulations in host countries.

POLITICAL RISK AND FDI RETENTION AND EXPANSION

As background for this paper, a literature review was undertaken of economic studies addressing the impact of political risk and FDI. The review found that addressing the relationship between political risk and FDI is a complex matter. Arguably, investment retention and expansion are influenced not only by profit opportunities, but also by the level of risks in host countries. However, econometric studies that have examined the link between political risk and

Box 3. Evolution of Political Risk

The risk of expropriation was prominent in the 1960s and 1970s, when nationalism was rife, and many developing countries asserted control over their natural resources. Many foreign investors were affected by nationalizations or direct expropriations during that period (Alvarez 2009). Losses resulted primarily from the outright confiscation of foreign assets. In the 1980s, however, the number of foreign expropriations declined drastically, and political risks related to transfers and currency convertibility transactions became more prominent. During the 1980s, most emerging markets allocated foreign exchange via permits, and current and capital account controls were prevalent. This in turn significantly limited the ability of foreign investors to access and repatriate foreign exchange in a time when international debt crises and devaluations affected most Latin American economies and other developing countries around the world (MIGA 2009).

The 1990s was a decade of market-oriented reform in many developing countries. After the fall of the Iron Curtain, many economies transitioned toward market-oriented policies. With economic liberalization came floating exchange rate regimes and the allocation of foreign exchange via market mechanisms, while capital controls were relaxed. Most countries started to embrace foreign direct investment (FDI) attraction. However, rather than disappearing, political risks derived from government conduct evolved. Ironically, as countries began to dismantle some barriers affecting FDI entry and establishment, regulatory risks affecting FDI in the post-establishment phase became more apparent. Although outright nationalizations had become an exception rather than the norm, after late 1990s, changes in regulations or contractual agreements that undermined the financial viability of investments started to gain prominence. Investor surveys in the early 2000s indicated that, during that time, an increasing number of investors became concerned about breach of contract, non-honoring of government guarantees, and adverse regulatory changes—all of which can result in huge investment losses—rather than outright expropriations (MIGA 2009).

During the first decade of the 2000s in a global environment of rising commodity prices, some governments attempted to renegotiate the concession and royalty agreements they had struck with foreign investors a decade earlier, when commodity markets were depressed. Other governments, sought to reclaim ownership of the mining sector by taking control of foreign-owned assets. Thus, by the end of the first decade of the new millennium, an apparent resurgence of “resource nationalism” heightened perceptions of political risks derived from government conduct (MIGA 2011).

Another key development that has shaped the predominant patterns of political risks derived from government conduct over the past decade has been administrative decentralization. As developing economies have embraced “regional power devolution” programs away from central national administrations, local authorities, such as provincial or municipal governments, have taken a more active role in providing and regulating many public services, including power and transportation infrastructure. Research shows that subnational authorities have become an increasing source of regulatory risk for foreign investors, especially due to risks associated with breach of contract, adverse regulatory changes, and indirect expropriations.

FDI over the last four decades show a degree of ambiguity.⁷ Although some find a clearly negative co-relation between FDI and higher degrees of political risk, others focusing on case studies have not found political risk to be a clearly significant determinant of FDI.

When investors incur fixed and irreversible costs to invest, uncertainty about the local conditions—including the political and regulatory frameworks—will have a dampening effect that reduces investors' response to new investment opportunities (Bloom 2009). Post-entry, existing investors can choose to delay or outsource operations in situations with heightened risks.

Recent studies have suggested that political risk may have an impact on the financing mode of FDI, which can affect reinvestment potential. For example, Kesternich and Schnitzer (2010) show that high political risks clearly favor joint ventures to mitigate political uncertainty. Other literature suggests that partial ownership of foreign affiliates has a negative effect on internal lending from related firms in the multinational group and engagement in integrated global operations (for example, Desai et al. 2004). The intuition is that monitoring activity abroad by the parent investor is more critical in settings where investor protections are weaker. Thus, overall, theory indicates that reinvestment using internal funds (for example, internal borrowing from the parent company and retained earnings) can be lower in environments with high levels of regulatory and political risks, conditional on FDI entry and despite growth opportunities. More recently, Hebous and Lipatov (2014) show that firms have strong incentives to shift profits generated in countries with high corruption to other countries, especially low-tax jurisdictions. The intuition is that the bribe rate is an increasing function of reported profits, and hence there are disincentives for firms to retain profits in countries with a low level of transparency.

The impact of political risk on FDI retention and expansion can also be examined by reviewing recent literature on how political risks affect certain types of operations of MNEs in host countries. FDI

flow data measure the net value of cross-border capital movements between MNEs and their foreign affiliates. In essence, they measure the impact that MNEs have on the host country's capital account (Kerner 2014). However, FDI involves more than finance. The operations of MNEs entail a variety of activities reflecting complex decision-making processes. MNEs raise capital from diverse foreign and domestic sources and invest in various kinds of assets, hire employees, and sell products and services to various destinations (Kerner 2014). As noted by Hausmann and Fernandez-Arias (2000), "FDI is not the firm and its assets. Instead, it is just one of the sources of financing for the firm." Therefore, recent research has increasingly analyzed firm-level operational data to understand the impact of FDI on host economies (Alfaro and Chauvin 2017; Sauvart 2017). For instance, Antras et al. (2009) finds that the scale of MNE activity—as measured by sales—will be larger in countries with stronger investor protection guarantees.

In sum, although the studies show some degree of ambiguity, empirical analyses based on surveys have consistently shown that foreign investors have serious concerns about political risk when venturing abroad (MIGA 2009). The nature of political risk makes it difficult to predict and quantify, and the concerns are primarily based on perceptions influenced by broad geopolitical and economic trends, as well as local conditions. Thus, by definition, the study of political risks and their potential impact on investors' FDI locational decisions cannot be static, but rather it should be a dynamic exercise, observing how corporate perceptions have evolved as a result of political risk variables over a particular period. That is why this research focuses not only on one but a set of various surveys conducted over nine years, which are analyzed in section 3.

The literature on the empirical evidence on the relationship between investment retention and expansion and political risk is more limited. As background research for this paper, the empirical relationship between reinvestments and a country's political risk profile was explored. It was found that there is a negative relationship between

reinvestments by foreign affiliates and host country risk (figure 8). Reinvested earnings using Balance of Payments data as a share of GDP were compared with three distinct indexes measuring political risks in host countries.⁸ After controlling for economic fundamentals, such as GDP per capita and GDP growth, and controlling for country fixed effects, their cross-country analysis shows that reinvested earnings by foreign investors decrease with the increase in regulatory risk.

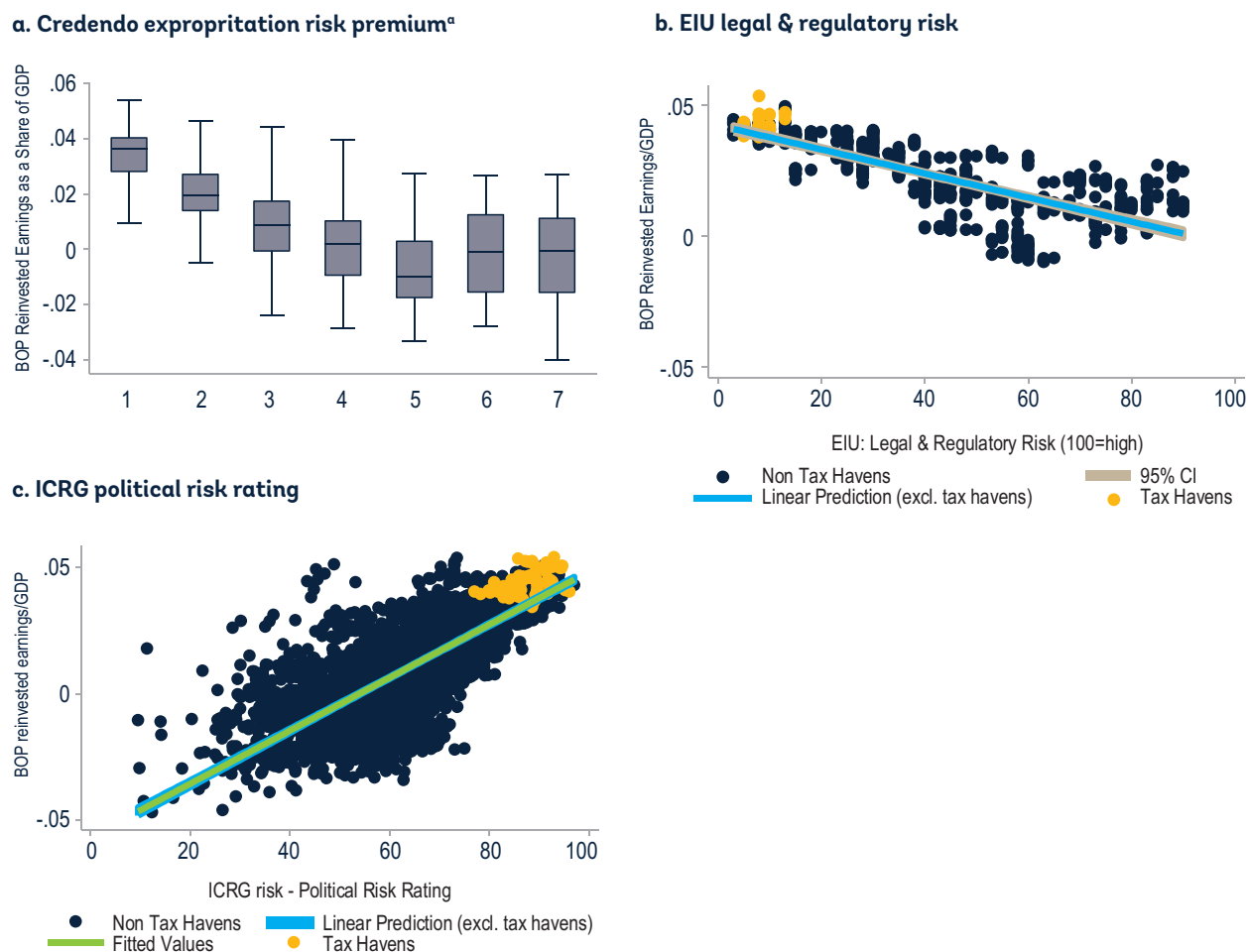
To enrich the empirical exploration of the relationship between investment retention and expansion and political risks, available firm-level data on U.S. MNEs abroad was studied. As shown in figure 9, it was found that, on average, U.S. MNE affiliates spend more on capital expenditures in countries with lower levels of political risks. This relationship holds using different risk indexes used in the research (OECD 2018).

It shows a similar negative relationship between country risk and affiliates' research and development expenditure as a share of total assets and employment. Figure 10 shows the correlation between affiliates' activity and the EIU index of

legal and regulatory risk, after taking into account income, GDP growth, and country fixed effects. Further, the results are qualitatively similar for other risk indexes.

The results of the negative relationship between MNE reinvestments and operational activity with a range of measures of political and regulatory risks suggest that one of the key mechanisms for improving investment retention and expansion is the host country's ability to manage real and/or perceived risks facing investors. Governments in developing countries can do so through a mix of policy tools, including improving the de jure legal and regulatory framework for investment protection, providing effective means to manage and resolve investor grievances, and improving the overall predictability of policy making and implementation. However, to design concrete policies that can lead to measurable results, a further level of specificity is required to identify the concrete types of problems perceived as risks by investors, identify their causes, and thereby be able to devise effective means of risk mitigation at the source.

FIGURE 8. CORRELATION BETWEEN BALANCE OF PAYMENTS REINVESTMENT AS A SHARE OF GDP AND DIFFERENT MEASURES OF RISK

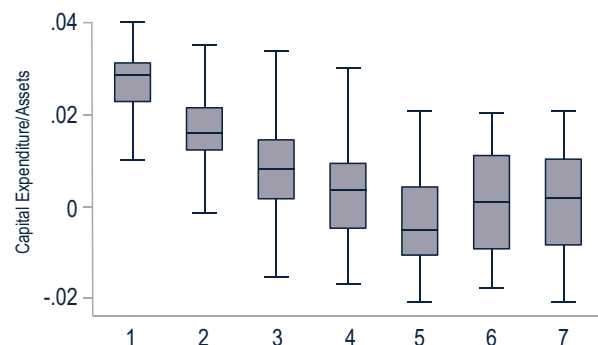


Note: All the figures present results from the correlation between risk indexes and the residuals from regressing reinvestment/GDP on GDP per capita, GDP growth, and country fixed effects. Panel a covers 2002–16, and a higher premium indicates higher risk. Panel b covers 2006–16, and a higher score indicates higher risk. Panel c covers 1984–2016, and a higher score indicates lower risk. BOP = Balance of Payments; CI = confidence interval; EIU = Economist Intelligence Unit; FE = fixed effects; GDP = gross domestic product; ICRG = International Country Risk Guide; pc = per capita.

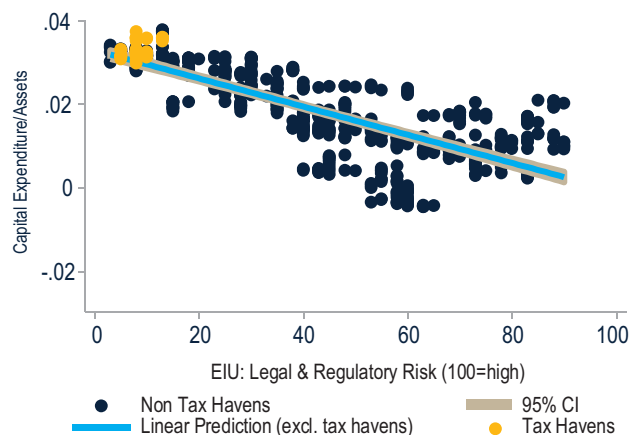
a. Since this is a categorical variable, the relationship is depicted using a box plot. Box plots show the median value of the outcome variable for categories of the independent variable, as well as the 25th and 75th percentiles and the upper and lower adjacent values. Outside values are not depicted here.

FIGURE 9. CAPITAL EXPENDITURE OF U.S. FOREIGN AFFILIATES AND COUNTRY RISK

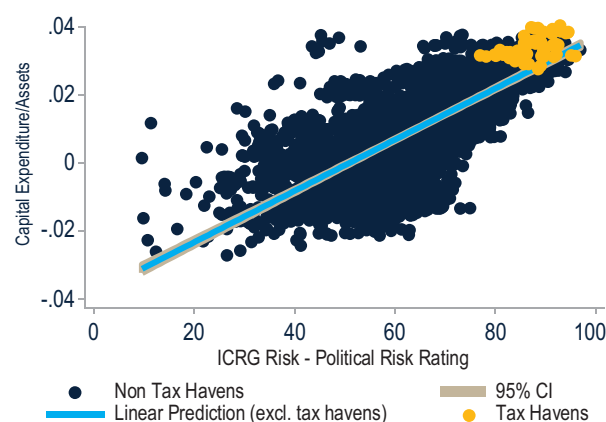
a. Credendo expropriation risk premium



b. EIU legal and regulatory risk



c. ICRG political risk rating



Note: All figures present results from the correlation between risk indexes and the residuals from regressing capital expenditures of U.S. foreign affiliates on GDP per capita, GDP growth, and country fixed effects. CI = confidence interval; EIU = Economist Intelligence Unit; GDP = gross domestic product; ICRG = International Country Risk Guide.

FIGURE 10. R&D EXPENDITURE, EMPLOYMENT GROWTH, AND COUNTRY RISK



Sources: In panel a, R&D expenditures are from the Bureau of Economic Analysis U.S. outward FDI data. In panel b, employment data are from European Union foreign affiliates statistics, summed across the extractives, manufacturing, and service sectors.

Note: The graphs present the results from the correlation between risk indexes and the residuals from regressing reinvestment/GDP on GDPPC, GDP growth and country fixed effects. CI = confidence interval; EIU = Economist Intelligence Unit; FDI = foreign direct investment; GDP = gross domestic product; GDPPC = gross domestic product per capita; R&D = research and development.



INVESTOR SURVEYS ON POLITICAL RISKS AND THEIR IMPACT

To examine how political risk and its impact on investor behavior has evolved over time, this section presents an analysis of two sets of investor surveys that were conducted annually between 2009 and 2013 by MIGA in collaboration with EIU (hereinafter, the 2009–13 MIGA/EIU Surveys). The second set comprises an international survey conducted and published in 2017 by the World Bank Group’s IPP team for the 2017/18 Global Investment Competitiveness Report (hereinafter, the 2017 GIC Survey).

Although different in scope, both sets of surveys target the same profile of investors and include very similar questions on the impact of government conduct on investors’ decisions to withdraw and/or cancel the expansion of FDI projects.⁹ Taken together, these two sets of surveys cover more than 2,500 international investors investing in developing countries and provide a good overview of corporate perceptions of political risk over the past decade.

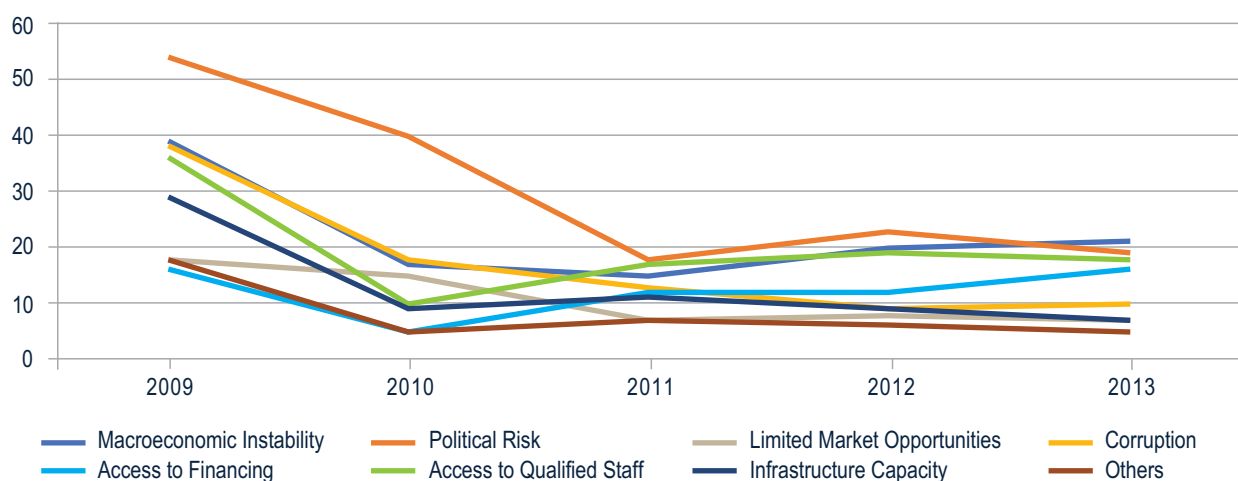
For the period under study, this section examines four questions. (i) To what extent have political risks arising from government conduct influenced investors’ decisions? (ii) What types of government conduct have been most disruptive to FDI over the past decade? (iii) If patterns of disruptive government conduct over FDI can be identified, have they affected different types of FDI in a similar manner? (iv) What means have investors used to deal with grievances arising from government conduct?

INFLUENCE OF POLITICAL RISKS ARISING FROM GOVERNMENT CONDUCT

When asked to rank the most important constraints for FDI when considering investing in developing economies,¹⁰ international investors consistently rank political risk among the top factors affecting their decisions (MIGA 2009).¹¹ Figure 11 shows the evolution of investors’ perceptions over the first part of the past decade, revealing a key finding: political risk is the most consistent and prominent factor constraining FDI in developing countries. Although the rankings of other variables, such as corruption, access to qualified staff, and infrastructure capacity, fluctuate over the period studied, only political risk shows a relatively constant pattern as the top constraint perceived by investors. Only in 2013 did political risk appear to be slightly lower than macroeconomic stability, but still higher than any other factor.

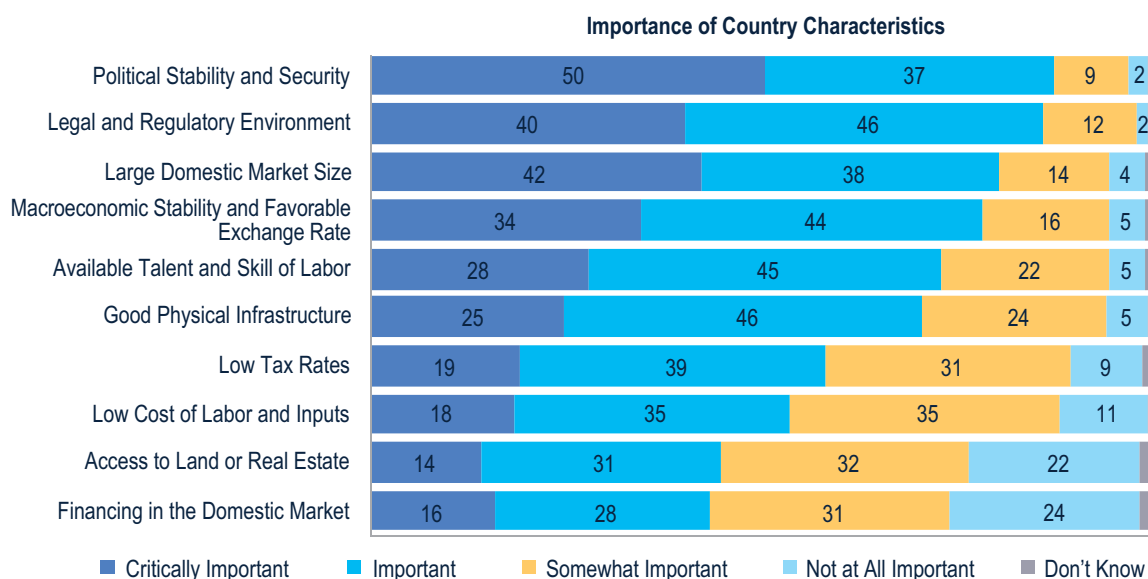
The GIC 2017 survey also supports the conclusions from the 2009/13 MIGA/EIU Surveys on the weight of political risk as a factor affecting investment decisions. Although the 2017 GIC Survey framed the question slightly differently, figure 12 shows that international investors consider a broad range of factors when deciding to invest, the most important being political stability and security, as well as a business-friendly legal and regulatory environment. The latter two factors ranked at the top among the other major variables affecting investment decisions, above macroeconomic stability, the size

FIGURE 11. INVESTORS' PROSPECTS: RANKING THE MOST IMPORTANT CONSTRAINTS TO FDI IN DEVELOPING ECONOMIES, 2009–13 (PERCENT)



Source: Multilateral Investment Guarantee Agency–Economist Intelligence Unit Political Risk Surveys, 2009–13.
Note: Percentages add to more than 100 due to multiple selections. FDI = foreign direct investment.

FIGURE 12. FACTORS AFFECTING INVESTMENT DECISIONS (% OF RESPONDENTS)



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report.

of the domestic market, the state of infrastructure, labor talent and skill, and low costs of labor and inputs.

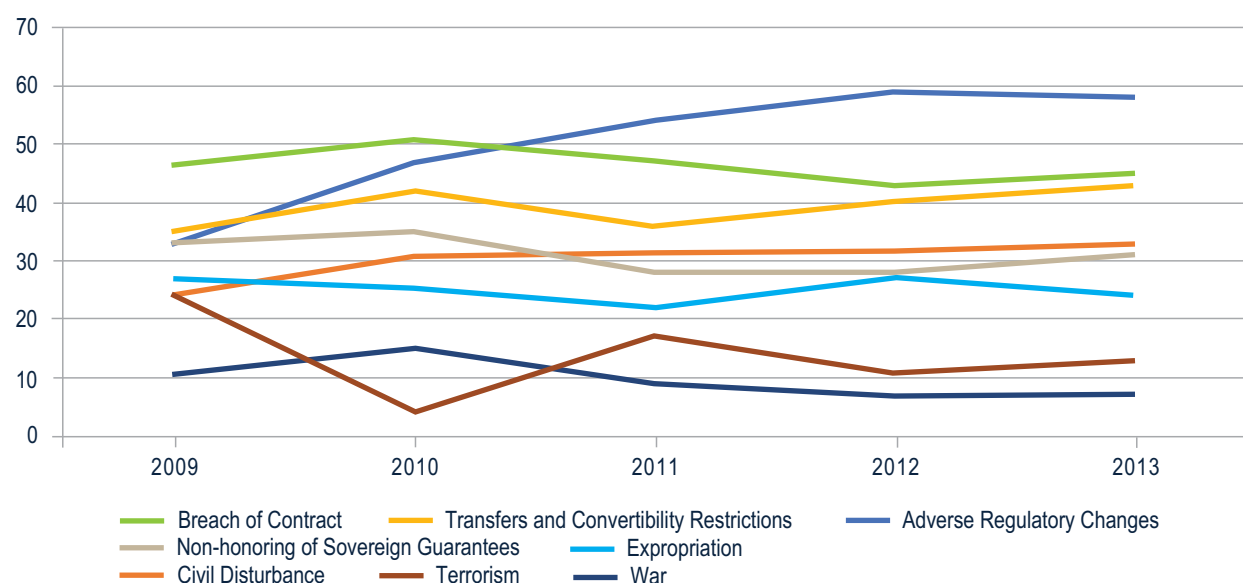
Bearing in mind the definition of “political risk” explained in section 2.3, one can conclude that the importance ascribed by investors to political stability and security, as well as to the legal and regulatory environment, is a proxy for the importance ascribed to political risk when investing in developing countries. Moreover, this finding suggests that political risk derived from government conduct is top in the minds of the investors who were surveyed. Eighty-six percent of the investors surveyed found the legal and regulatory environment to be important or critically important when making investment decisions. Such finding may be easily understood when considering another very revealing trend from the five 2009–13 MIGA/EIU Surveys, which is illustrated in figure 13.

Between 2009 and 2013, when investors were asked to specify the type of political risk about

which they cared most, the investors consistently identified political risks related to government conduct, such as adverse regulatory changes, breach of contract, or transfer and convertibility restrictions. Such finding is critical for investment policy making, as it shows that such risks are the highest concern for international investors. Despite being a concerning trend, on the positive side, these matters are significantly easier for governments to mitigate than those which largely fall beyond their control.

Contrary to the 2009–13 MIGA/EIU Surveys, the 2017 GIC Survey did not include a specific question asking investors to differentiate among the different categories of political risk. Thus, it is not possible to make a direct comparison between the two surveys. However, the 2017 GIC Survey shows patterns that confirm the preponderant weight investors ascribe to instruments to mitigate political risk derived from government conduct.

FIGURE 13. INVESTORS’ PERCEPTIONS: TYPES OF POLITICAL RISKS OF MOST CONCERN TO INVESTORS IN DEVELOPING COUNTRIES, 2009–13 (%)



Source: Multilateral Investment Guarantee Agency–Economist Intelligence Unit Political Surveys, 2009–13.

Note: Percentages add to more than 100 due to multiple selections.

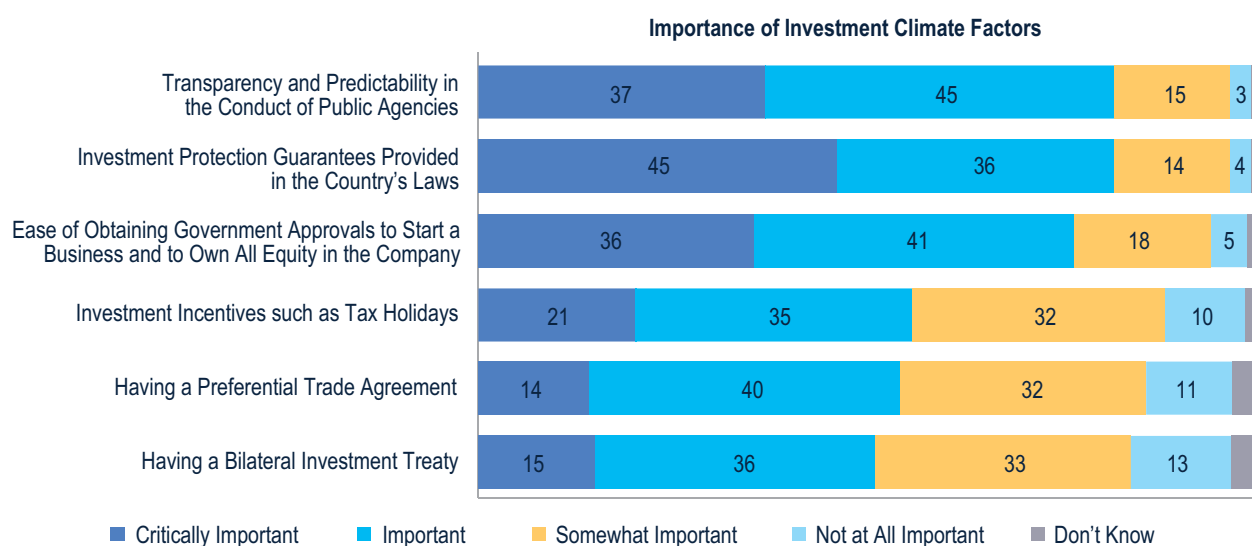
As illustrated in figure 14, the 2017 GIC Survey clearly shows the significant weight investors ascribe to transparency and predictability in their overall interactions with host governments, as well as the effective implementation of legal investment protection guarantees as a means to foster certainty and predictability for business operations. Legal protections against such risks are usually provided by “investor protection guarantees,” which are typically included in a country’s domestic legal framework and its IIAs and include the ability to transfer currency in and out of the country and protections against expropriation, breach of contract, and nontransparent or arbitrary government conduct. Forty-five percent of the respondents rated investment protection guarantees as critically important or deal-breakers, the highest among all investment climate factors. In addition, over 80 percent of the investors rated various types of legal protections as important or critically important. All the investors—regardless of sector, source country, or type of FDI—found these guarantees of greatest value.¹² Further, 51 percent of the investors rated bilateral investment treaties as

important or critically important in their investment decisions.¹³

Another interesting finding from the 2017 GIC Survey is that, compared with those from developed economies, investors from developing countries tend to ascribe higher importance to transparency and predictability in the conduct of public agencies and to investment protection guarantees. As is shown in figure 15, investors from developing countries also seem to value other investment climate factors when investing, including the existence of preferential trade agreements and bilateral investment treaties. Accordingly, it cannot be said that MNEs from industrial countries are the main advocates for the existence of an effective, rule-oriented international investment regime.

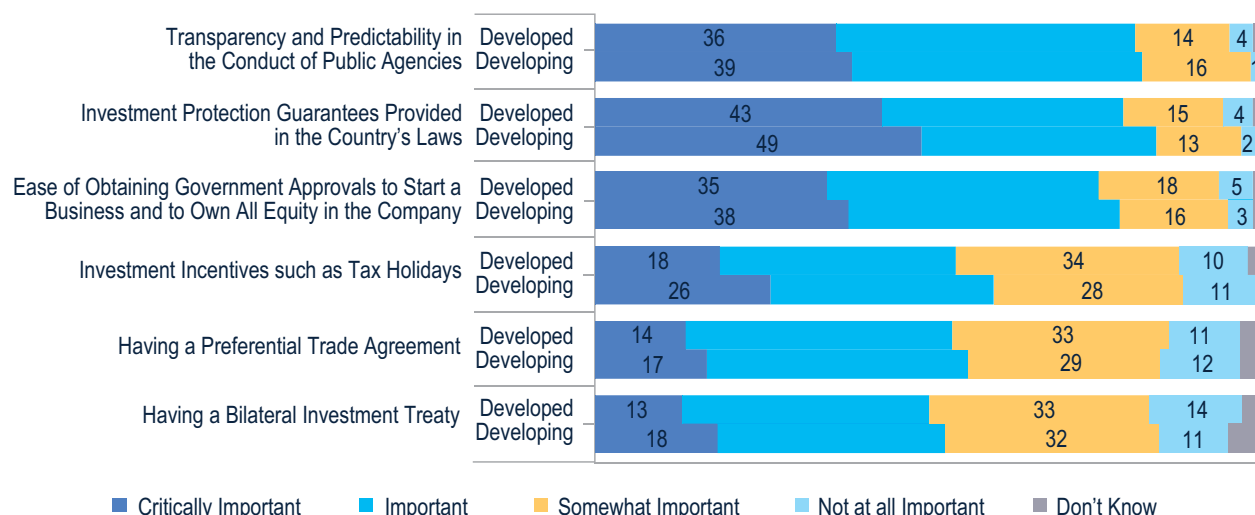
In sum, the comparison of the two sets of surveys shows that, over the past decade, investors engaged in FDI have ascribed a greater weight to government conduct as a source of political risk than to other types of risks that fall beyond direct domestic government control, such as war,

FIGURE 14. IMPORTANCE OF INVESTMENT CLIMATE FACTORS AFFECTING INVESTMENT DECISIONS (% OF RESPONDENTS)



Source: World Bank Group Global Investment Competitiveness Report, 2017.

FIGURE 15. IMPORTANCE OF INVESTMENT CLIMATE FACTORS BY DEVELOPED VERSUS DEVELOPING SOURCE ECONOMIES (% OF RESPONDENTS)



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report.

terrorism, or civil unrest. This pattern explains the high value that investors ascribe to effective compliance with investment protection guarantees included in domestic laws or IIAs as a means to mitigate those risks. This finding also shows the critical importance that host governments should place on investors who are already established in their economies, rather than focusing exclusively on those whom they are still seeking to attract.

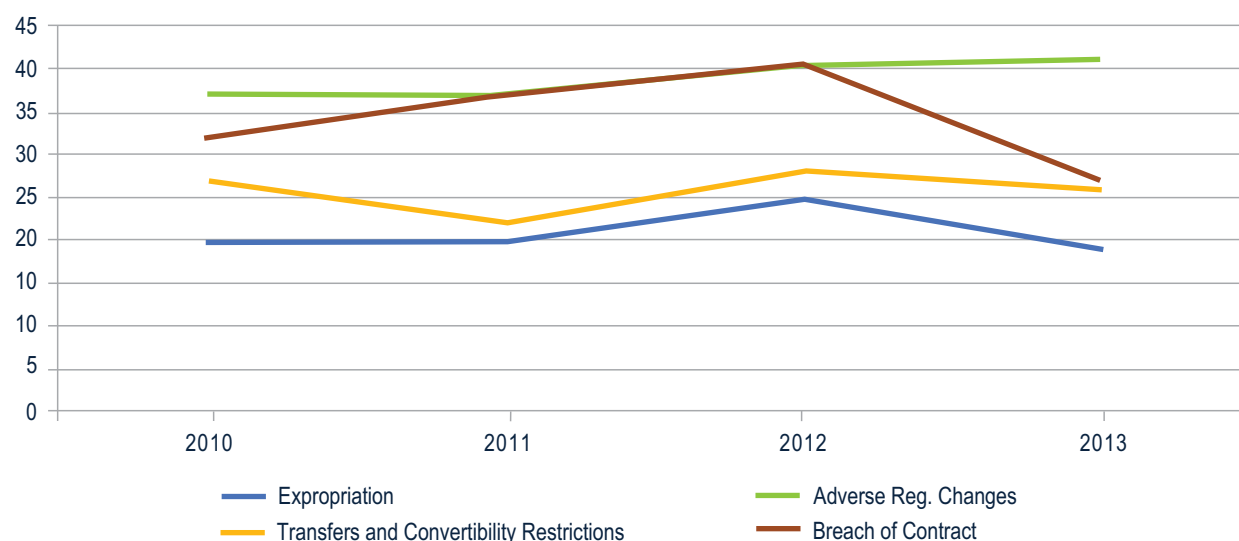
TYPES OF GOVERNMENT CONDUCT CAUSING FDI WITHDRAWAL OR CANCELLATION

There is a clear pattern distinguishing the most common types of government conduct making investors withdraw investment or cancel expansion plans. According to the 2009–13 MIGA/EIU Surveys, investors consistently identified the same types of regulatory risk behind their divestment decisions (figure 16). These include (i) sudden adverse regulatory changes, (ii) breaches of contract, (iii) transfer and convertibility restrictions on payments related to investments, and (iv) expropriation. Adverse regulatory changes

appeared to be the most frequent factor affecting the operations of established investors, followed by breach of contract, transfer and convertibility restrictions, and expropriation.

To get a more accurate view, the 2017 GIC Survey explicitly differentiated between the frequency at which investment operations were disrupted by each particular type of government conduct, and the impact resulting from each type of regulatory risk. The results in figure 17 show about half of the respondents identified a lack of transparency and predictability in dealing with developing country public agencies as the most frequent type of risk affecting their operations. Almost 50 percent encountered adverse regulatory changes and delays in obtaining necessary government permits and approvals to start or operate a business, and over 40 percent encountered restrictions in transferring and converting currency. Interestingly, breach of contract shows a relatively lower frequency of grievances than in 2010–13, although since 2012 its frequency started to decline. Further transfer and convertibility restrictions, which were less common than breach of contract and expropriation between

FIGURE 16. PROPORTION OF COMPANIES THAT HAVE WITHDRAWN AND/OR CANCELED EXPANSION OF FDI PROJECTS DUE TO SPECIFIC TYPES OF REGULATORY RISK, 2010–13 (%)



Source: Multilateral Investment Guarantee Agency–Economist Intelligence Unit Political Surveys, 2010–13.

Note: Percentages add to more than 100 due to multiple selections. FDI = foreign direct investment.

2010 and 2013, escalated in relative frequency in the 2017 GIC Survey. Consistent, with the 2009–13 MIGA/EIU Surveys, the GIC Survey finds sudden regulatory changes to be a common problem for investors.

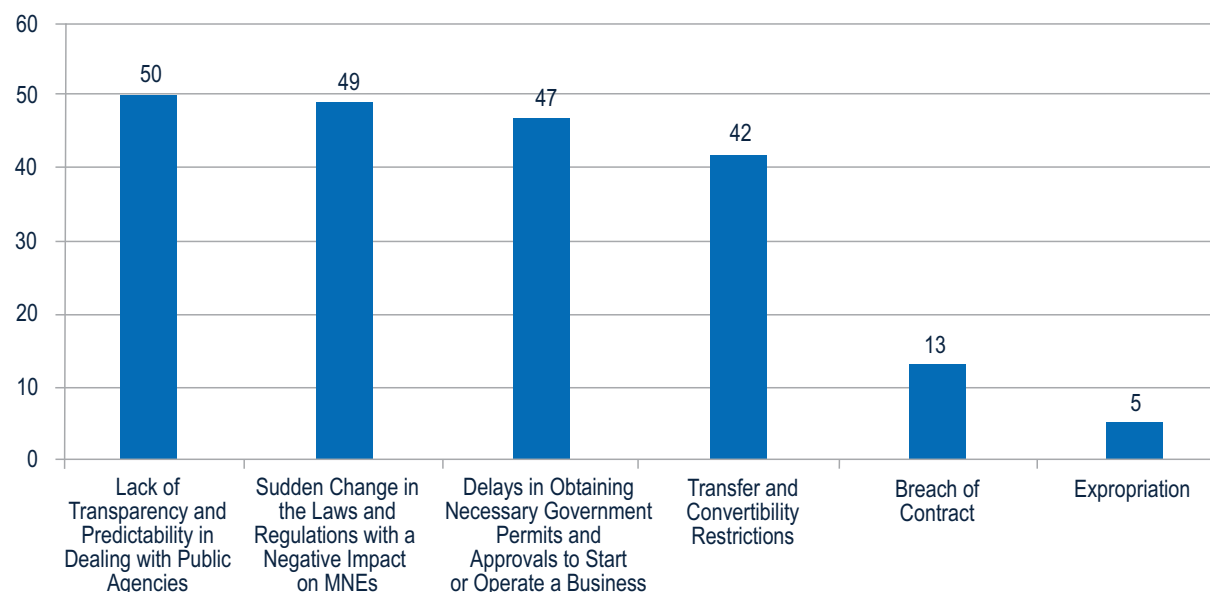
Turning to the question of the impact of the regulatory risk in terms of the investors' reactions, figure 18 shows that, in the case of lack of transparency, sudden regulatory changes, delays in obtaining permits and approvals, and transfer and convertibility restrictions, about one in four investors—that is, 25 percent—totally withdrew an existing FDI project or canceled a planned expansion owing to those particular political risks. Considering the number of FDI projects every year, this impact is of an extremely high magnitude.

Further, the GIC 2017 survey showed that relatively more severe cases of political risks arising from government conduct occur less frequently but have a far greater impact. For instance, although only 13 percent of the respondents in 2017 experienced

breach of contract by the government, the impact of those grievances was much greater—35 percent of those investors canceled a planned investment or withdrew an existing one. Expropriation was even more extreme: although only 5 percent of the respondents experienced it, almost half of them canceled or withdrew an investment.

The surveys conducted by MIGA and the Economist Intelligence Unit during 2009–13 also support this finding. According to findings of the 2013 survey presented in figure 19, of the eight political risks, most respondents singled out adverse regulatory changes and breach of contract as the risks that have caused most cancellations, withdrawals of investments, or both, over the past 12 months. About one in four investors—that is 28 percent (on average) of the respondents—experience adverse regulatory change, breach of contract, transferability and convertibility restriction and expropriation and either withdraw or cancel, or both over the past twelve months.

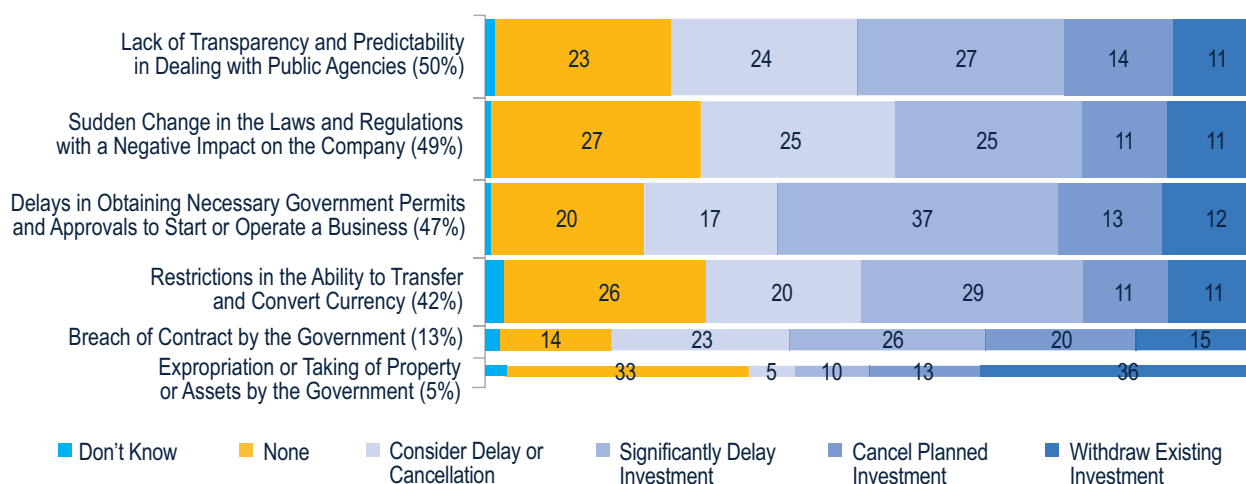
FIGURE 17. MOST FREQUENT POLITICAL RISKS DERIVED FROM GOVERNMENT CONDUCT AFFECTING FDI (% OF RESPONDENTS)



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report.

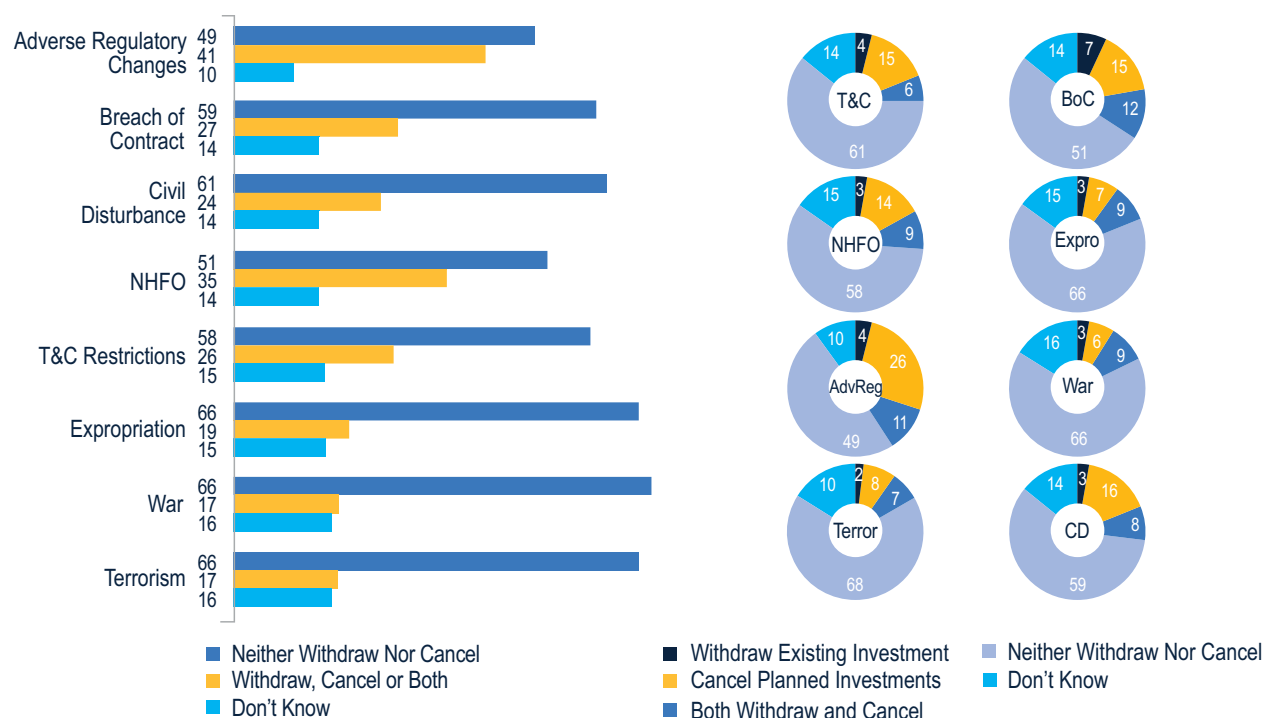
Note: FDI = foreign direct investment; MNEs = multinational enterprises.

FIGURE 18. IMPACT OF POLITICAL RISKS DERIVED FROM GOVERNMENT CONDUCT ON FDI (% OF RESPONDENTS)



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report.

FIGURE 19. WITHDRAWAL OF EXISTING INVESTMENTS OR CANCELATION OF PLANNED INVESTMENTS OVER THE PAST TWELVE MONTHS DUE TO POLITICAL RISKS (% OF RESPONDENTS)



Source: MIGA-EU Political Risk Survey 2013

Note 1: T&C (Transfer and Convertibility), BoC (Breach of Contract), Expro (Expropriation), AdvReg (Adverse Regulatory Changes)

Note 2: 2013 survey is the last one undertaken for the World Investment and Political Risk Report.

A summary of the empirical evidence discussed in this subsection shows certain patterns of political risks derived from government conduct over the past decade. First, grievances related to expropriation, transfer and convertibility restrictions, breach of contract, and adverse regulatory changes have continuously ranked among the types of government conduct leading to FDI withdrawals and expansion cancellations. Second, though they are the most impactful regulatory risks, the frequency of situations related to expropriation and breach of contract has continued to decline. Third, the risks associated with sudden adverse regulatory changes have been consistently prominent in frequency. Fourth, problems related to transfer and convertibility restrictions have constantly remained in the middle of the curve in frequency. Fifth, the 2017 GIC Survey reveals two additional types of government conduct with significant frequency and

impact on FDI retention and expansion: the lack of transparency and predictability in dealing with public agencies, and the delays in obtaining the necessary government permits to start or operate a business. These two types of regulatory risks, together with sudden adverse regulatory changes, relate to the way government agencies perform their routine regulatory functions.

Different types of government conduct affecting FDI retention and expansion can be better understood by also considering how the political economy of FDI has evolved. Two key variables are particularly relevant. On the one hand, investment in services has become the bulk of FDI worldwide. Led by industries such as finance, business activities, trade, telecommunications, and tourism, today services account for about two-thirds of global FDI stock (UNCTAD 2017). On the other hand,

the increasing role of subnational or sector-specific government agencies in regulating the economy means that foreign investors must interact with an increasing number of bureaucracies. Many public officials may not be familiar with or may not fully appreciate the importance of performing their routine regulatory activity according to investment protection parameters mandated by domestic law or IIAs. Indeed, knowledge of the practical application of these legal protections may be typical in the ministry of trade or investment in charge of negotiating IIAs, or in the ministry of justice or the attorney general's office in charge of dealing with investor-state disputes. Beyond those agencies, knowledge of the content and practical impact of investment protection guarantees may be limited or may fall below other legal mandate imperatives. For instance, the sector-specific agencies in charge of regulating a specific sector, such as telecom, financial services, or environmental standards, to name a few, have professionals who logically may perform their daily activities based on their sector-specific regulation and agency mandate.

How to perform their tasks also in conjunction with investment protection guarantees may not be an area where government officials may have been trained. Further, the multiplication of government agencies that deal with foreign investors on a daily

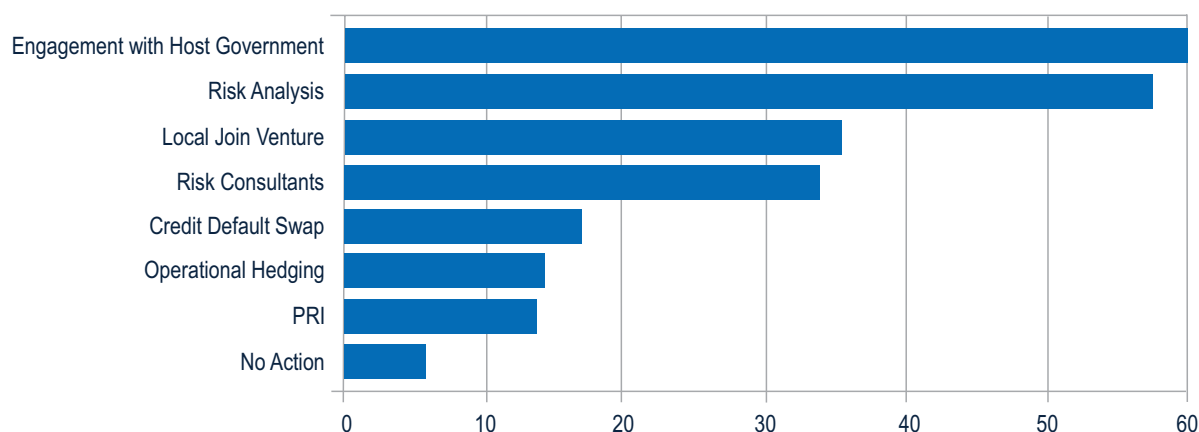
basis increases the possibilities for regulatory capture by powerful interest groups. Thus, the increased complexity of public administrations worldwide has created a need for governments to devise mechanisms to foster a minimum degree of coherence in policy implementation and behavior, at least in the basic standards of conduct, such as transparency, due process, and respect for the rule of law when performing daily regulatory activities.

MECHANISMS TO DEAL WITH GRIEVANCES

According to the MIG-EIU surveys, direct engagement with governments ranks among the most frequently used risk mitigation tools used by foreign investors in developing countries to address political risk derived from disruptive government conduct. However, investors report a high level of dissatisfaction with the effectiveness of this engagement in practice.

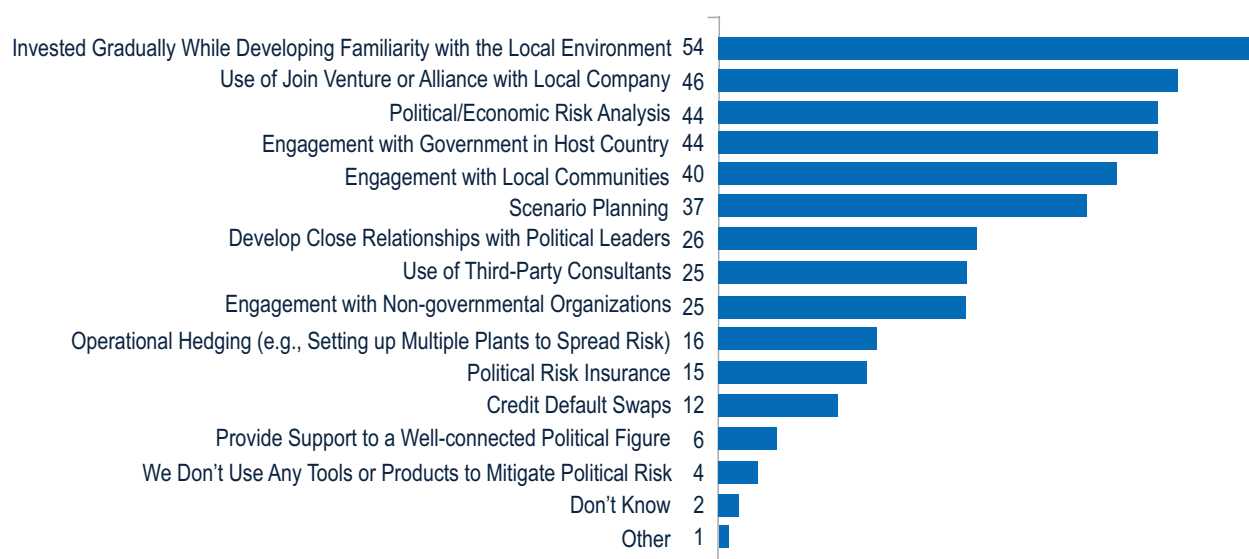
Comparing the MIGA/EIU Survey of 2009 with the last available survey in 2013 reveals a fall in the ranking of direct government engagement as a risk mitigation tool (figures 20 and 21). In 2009, direct engagement with local public authorities was the preferred choice of investors, above other tools such

FIGURE 20. MECHANISMS USED BY INVESTORS TO MITIGATE POLITICAL RISK IN EMERGING MARKETS, 2009 (% OF RESPONDENTS)



Source: Multilateral Investment Guarantee Agency–Economist Intelligence Unit Political Survey, 2009.

FIGURE 21. MECHANISMS USED BY INVESTORS TO MITIGATE POLITICAL RISK IN EMERGING MARKETS, 2013 (% OF RESPONDENTS)



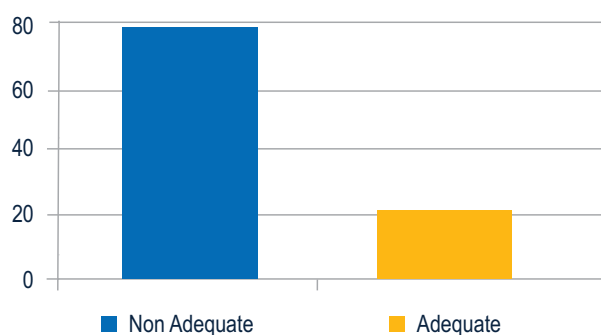
Source: Multilateral Investment Guarantee Agency–Economist Intelligence Unit Political Survey, 2013.

as risk analysis, establishing a joint venture with a local investor, and the use of risk consultants (MIGA 2009). In 2013, direct government engagement was only the fourth most common mechanism used by investors to mitigate political risk. Although further research is needed to understand this outcome in detail, the World Bank Group 2017/2018 GIC Survey helps to determine the cause. When asked about their degree of satisfaction with the way governments address their grievances, 75 percent of the investors responded unfavorably (figure 22). Most of the foreign investors in developing countries said that governments do not effectively address grievances related to political risks. Only about one in five affected investors felt that their grievances were promptly resolved by the government, the process was clear and efficient, or the government introduced a systematic solution to address or prevent such grievances in the future.

The importance of this finding is critical for understanding investor-state relationships. First, it shows that when problems arise, investors' initial step is to engage in consultations with host governments, rather than turning to litigation as a

first reaction. Second, these findings echo previous empirical trends showing that high rates of FDI withdrawals and expansion cancellations result not only from disruptive conduct, but also from the lack of a timely and appropriate response by the authorities involved in resolving the problem.

FIGURE 22. INVESTORS' PERCEPTIONS OF EXISTING MECHANISMS TO ADDRESS GRIEVANCES (%)



Source: World Bank Group 2017/2018 Global Investment Competitiveness Report Survey.



EMPIRICAL EVIDENCE ON ISDS

The empirical evidence discussed in section 3 shows that investors rely on direct government engagement as a key tool to manage their grievances. However, the surveys also suggest that there is a high degree of frustration caused by the low level of responsiveness and efficiency of public authorities in addressing investors' grievances. Considering the high costs in time and capital required to litigate an investor-state dispute, invoking ISDS is often used only as a last resort when other alternative means to address grievances with the state have failed (Dupont, Schultz, and Angin 2016). Further, submitting an international claim against a sovereign state has significant political repercussions, which most governments take seriously. Consequently, there is significant impairment of the relationship between foreign investor and the public authorities of the host country, or the relationship may be totally severed (UNCTAD 2009). It follows that ISDS only occurs when the investor-state relationship has been so negatively affected that, rather than focusing on resolving a problem to enable the

investor to continue operating or expanding its investment, the investor chooses to resort to legal means to seek compensation for the damage caused by government conduct.

Table 2 compares the types of government conduct that empirical evidence has shown leads to greater investment withdrawals and expansion cancellations with the types of government conduct that IIAs aim to prevent. The results show that the types of government conduct affecting FDI withdrawal and cancellation (except delays in obtaining government permits and approvals to start or operate a business) are covered by a specific investment protection clause included in the text of IIAs.

This section aims to clarify three key relevant aspects of investors' grievances and government conduct: (i) whether the types of conduct generating greater impact on FDI withdrawal and cancellation coincide with the types of conduct most frequently contested in ISDS claims; (ii) whether investors' views on

TABLE 2. GOVERNMENT CONDUCT COMPARISON

Major Types of Government Conduct Leading to FDI Withdrawals and Planned Expansion Cancellations	Types of Government Conduct that IIAs Aim to Prevent: Investment Protection Guarantees
Expropriation	Protection against unlawful expropriation
Breach of contract	Umbrella clauses/expropriation
Transfers and currency convertibility	Transfers
Lack of transparency and predictability in dealing with public agencies	Fair and equitable treatment/Transparency
Sudden adverse regulatory changes	Fair and equitable treatment

Note: FDI = Foreign Direct Investment; IIA = International Investment Agreement.

the types of government conduct generating the withdrawal and cancellation of FDI coincide with the types government conduct subject to ISDS awards; (iii) whether the sectors and types of FDI affected by withdrawal of existing investment or cancellation of planned investment coincide with those in which ISDS tends to concentrate.

TYPES OF GOVERNMENT CONDUCT

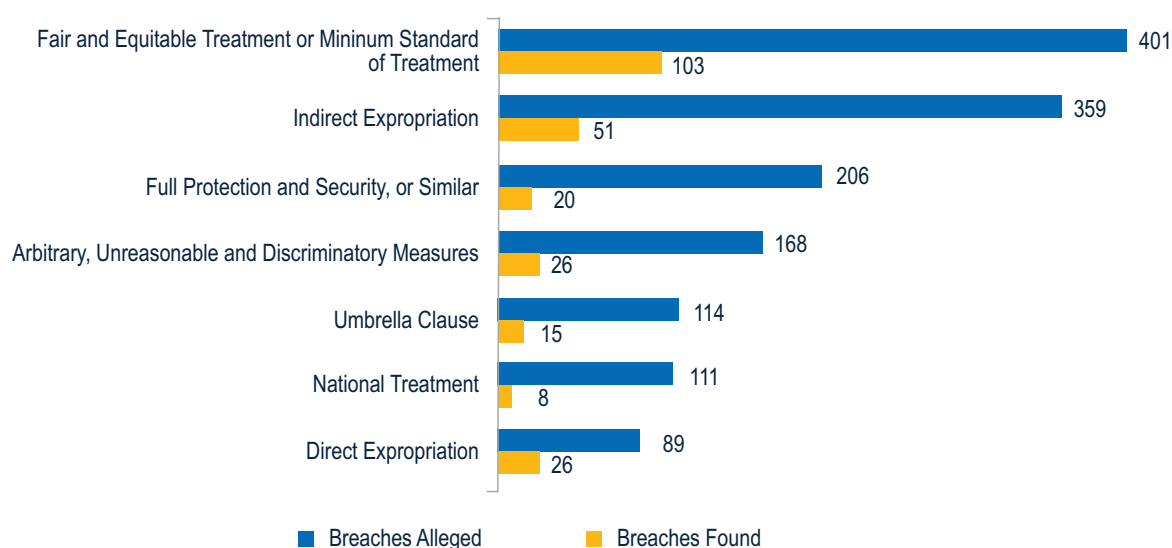
The empirical evidence shows a clear correlation between the specific types of government conduct inducing FDI divestments with those leading to ISDS claims. As figure 23 shows, the most common breaches alleged by investors in ISDS proceedings are those violating fair and equitable treatment (FET); indirect expropriation; full protection and security or similar; and arbitrary, unreasonable, and discriminatory measures. When examining the correlation with the four types of government conduct categories leading to FDI divestments, it turns out that a lack of transparency and predictability of government agencies and

adverse regulatory changes seem to be the main sources of contention between investors and host governments. Thus, this is an area where empirical data on investors' surveys and ISDS data coincide.

On ISDS awards, the most common IIA breaches found are FET and indirect expropriation.¹⁴ Depending on its wording and interpretation, FET has been understood as requiring that government action is transparent, coherent, reasonable, proportionate, or consistent with the expectations of foreign investors, arising from written commitments undertaken by governments through contracts or investment authorizations. This finding corroborates the survey data, which place lack of transparency and predictability in dealing with public agencies and sudden adverse regulatory changes as the most frequent government conduct inducing FDI divestments.

An important empirical finding that complements the data is that around 70 percent of the ISDS claims involved measures adopted by subnational or sector-specific regulatory agencies (Franck 2008;

FIGURE 23. BREACHES MOST FREQUENTLY ALLEGED AND FOUND IN TREATY-BASED ISDS CASES, 1987–2017



Source: UNCTAD.

Note: ISDS = Investor-State Dispute Settlement.

UNCTAD 2010). This finding confirms that one of the key challenges of modern administrative regimes is how to foster coherent policy implementation within a multilayered governance structure.

States are intricate and multilayered structures, comprising many internal factions and stakeholders. Given their broad scope of application, the norms and disciplines of IIAs may touch upon a plethora of policy matters that are handled by multiple governmental agencies operating at different jurisdictional levels, and even in multi-state contexts in countries with federal systems of government. Public agencies do not always have the same policy priorities, and not all agencies are aware of the existence of IIAs or prioritize compliance. However, IIAs operate under the premise that the state is a single entity—regardless of its internal administrative complexity—and is a subject under international law. Therefore, governments as whole are considered to be accountable for compliance with their international obligations.

The empirical evidence from the investor surveys and ISDS cases reveals the tension between the single state paradigm at the core of domestic and international legal systems on the one hand, and the multilayered agency composition of governments on the other. There is a gap between the law “on the books” and reality. In this sense, the evidence suggests that IIAs in general, and ISDS in particular, have been generating pressure for states to behave in accordance with the one-state legal paradigm, an outcome that is not always easy to achieve. That most of the measures generating ISDS disputes have been taken by subnational or autonomous regulatory authorities shows the challenge that many governments face in ensuring this minimum level of policy coherence.

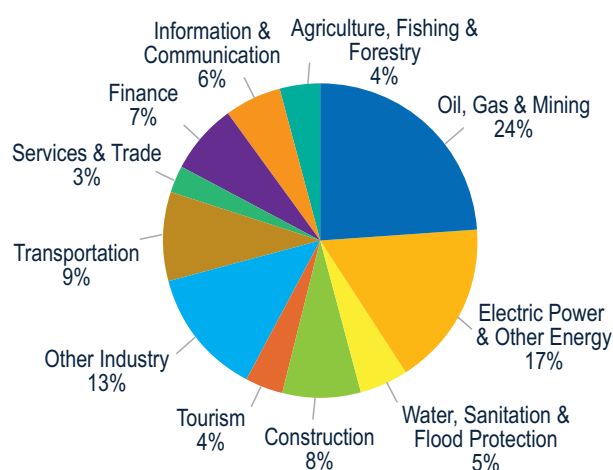
SECTORS

According to International Centre for Settlement of Investment Disputes (ICSID) data, tertiary sectors cumulatively have the highest incidence of ISDS cases (figure 24). The ICSID case load includes, inter alia, electric power and other energy (17 percent),

transportation (9 percent), construction (8 percent), information and communication (6 percent), and water and sanitation (5 percent)¹⁵ (total 45 percent of cases). The second highest incidence of ISDS is in the primary sectors. Here the ICSID caseload data show oil gas and mining make up 24 percent of the cases.¹⁶ This seems to suggest that about 70 percent of ISDS cases are related to sectors that are heavily regulated. Hence, government conduct has a direct impact on investments in those sectors.

Examining the economic sectors where ISDS occurs most frequently shows that although ISDS has taken place in a wide range of areas, many of the disputes tend to arise in economic sectors characterized by high levels of state intervention. The sectors can be categorized into two baskets that are particularly prone to ISDS.¹⁷ The baskets are (i) natural resource industries such as extractives, agriculture, fishing, and forestry; and (ii) the tertiary sector, which many countries consider to be of “public interest” and is thus subject to close state supervision, or where public-private partnerships (PPPs) are typical, such as transport infrastructure and utilities (for example, water and electricity distribution).

FIGURE 24. ICSID CASES, BY ECONOMIC SECTOR, 1987–2017



Source: International Centre for Settlement of Investment Disputes caseload statistics, 2018.

Note: ICSID = International Centre for Settlement of Investment Disputes.

Natural resources FDI has historically been politically sensitive. These factors often raise environmental or social concerns for local communities. This type of investment also tends to raise the thorny political issue of the fair distribution of the rents between the foreign investors exploiting the natural resource and the governments mandated to manage a public asset belonging to the host nation as well as local communities who may be directly affected by the environmental impact of the natural resource exploitation. These already complex dynamics are exacerbated by the investment projects in these sectors entailing significant initial sunk costs, which are only recovered in the long term. Thus, this type of investment tends to outlive governments. In addition, these types of projects often entail exports of commodities with volatile prices, which may in turn affect the share of the rents and expected rate of return of the original investment.

All these factors generate tension between investors' interest in a business environment that is predictable and stable over the long run and the short-term interests of governments or local communities in adjusting—and often renegotiating—concession contracts to maximize rents affected by changing circumstances.

Similar political economy tensions exist with the other economic sectors in which ISDS tends to occur more frequently: highly regulated services and PPP projects. In both cases, the foreign investors' opportunity cost of geographically relocating FDI projects already in operation is extremely high. Further, as in the case of natural resource-seeking FDI, these types of investments often entail significant initial sunk costs, leading to profitability only in the long term, and thus clashing with the relatively short-term agenda of publicly elected administrations. And because these sectors are highly regulated, the regulatory authorities' actions will likely affect the economic profitability of private investments. Further, in all these sectors, the final prices of the goods produced or services rendered may change over time. Such price changes may become political liabilities for publicly elected governments. Politicians clearly understand that price increases for utilities or tolls for the use of

public infrastructure often affect electoral polls. Thus, public agencies may be pressured to adjust the terms of service delivery originally agreed with or notified to investors. Since PPPs are often subject to bidding, investors may artificially lower the estimation of the cost of their services to win the bidding and then attempt to renegotiate the terms of the original contract, arguing that circumstances have changed.

In sum, all sectors with higher incidence of ISDS are affected by factors that in the short term may pressure governments to undertake opportunistic behavior, clashing with the need for stability and predictability of investors in the long term. The opposite may also happen. Investors may attempt to readjust the original economic balance of a contract, because of an actual change in the regulatory or economic context in which the project was originally negotiated, or because they may be keen to adjust the economic balance of a bidding originally won due to artificially lower estimations. In the latter case, it may be that investors are assuming opportunistic behavior.

PATTERNS OF INVESTORS' REACTIONS

The empirical evidence suggests that not all the investors who are forced to withdraw or cancel planned expansion opt to invoke ISDS, nor are all countries that are frequently affected by ISDS the ones most frequently affected by divestment. First, the data show that only a minor fraction of foreign investors tends to invoke ISDS. During the first 30 years of treaty-based ISDS (1987–2017), there have been 855 claims submitted to international investor-state arbitration, representing an annual average of less than 30 claims per year (UNCTAD 2018). Looking at just the past decade, as the level of litigation activity has increased, the annual average number of claims has increased to 55. Comparing the number of new greenfield FDI projects announced with the new ISDS cases over the same period shows that the number of investors invoking ISDS may represent around 0.4 percent of the total (Echandi 2019).

Second, the empirical evidence discussed in this paper shows that only a very minor share of investors withdrawing or canceling FDI expansion plans opt to invoke ISDS. In all the surveys, the rate of investors divesting from developing countries due to irregular government conduct was consistently around 25 percent of the total interviewed investors. Even back-of-the-envelope calculations show that investors invoking ISDS are just a minor fraction compared with those who divest. Indeed, considering that today there are more than 100,000 foreign affiliates undertaking multiple investment projects worldwide, and assuming that only half of them invested in developing countries, a 25 percent rate of FDI divestments would represent roughly 12,500 potential ISDS claims against developing countries. Even cutting such rough estimate by half—or even by 10 times—would lead to a figure that would still be significantly higher than the actual number of cases of ISDS submitted against developing countries over the past 30 years.

The finding that most foreign investors may be canceling investment plans or withdrawing their investments and yet abstaining from invoking ISDS has practical policy implications. Investment retention and expansion and dispute prevention are distinct, and one may not necessarily entail the other. Governments should therefore avoid confusing mechanisms to prevent ISDS disputes (dispute prevention) with mechanisms to prevent investors from withdrawing or canceling FDI projects. Accordingly, this paper outlines key implications for investment policy making.

For instance, empirical studies have shown that governments may succeed in reaching settlements with foreign investors to prevent or terminate an ISDS proceeding. Around one-third of all known ISDS claims submitted to arbitration are settled before the arbitration tribunal renders an award (Echandi and Kher 2014). However, such finding does not explain whether the recovery of damages incentivizes the investors to remain in the host country or keep the original investment expansion plans.

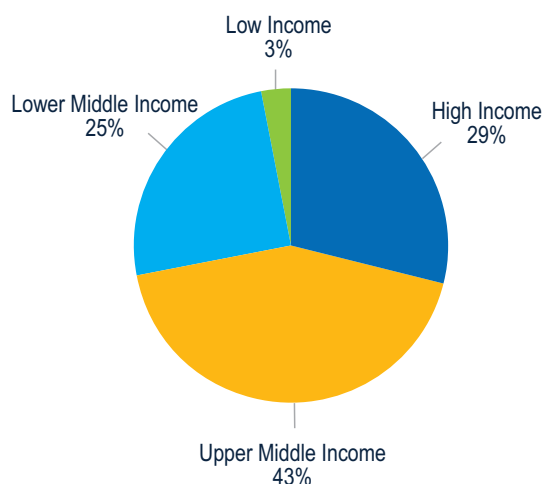
Further research would be needed to verify whether every investor that has submitted an ISDS claim against the host government has in fact divested. It may be possible that in certain types of FDI (for example, natural resources), investors may be forced to remain in the host country despite the high political cost of seeking compensation for damages through ISDS. Anecdotal evidence suggests that even in those cases, due to the severance of the investor-state relationship, many investors opt to sell their assets to other investors who may be able to take over the original FDI project and reset it under a new, context (UNCTAD 2009).

The sharp contrast between the number of investors withdrawing or canceling FDI projects and those seeking compensation through ISDS raises many questions. The empirical data already show that ISDS proceedings are neither cheap nor fast, and in the majority of the cases, arbitration tribunals tend not to support the arguments or amounts for compensation sought by foreign investors (Echandi 2019). These factors may explain to a great extent why so few ISDS cases are brought against developing countries relative to the potential number of episodes.

Comparing the data on FDI withdrawals and cancellations with the data on ISDS also shows another trend worth noting. Although ISDS has been a geographically widespread phenomenon, very few disputes have been brought against low-income countries—only 3 percent of all cases (figure 25).¹⁸ This can be explained by the relatively low amounts of FDI they receive. Comprising 72 percent of the total disputes submitted to arbitration, the evidence shows that ISDS is really a story about upper-middle-income and high-income economies.

Such trend contrasts with the picture depicted by investors' surveys, which do not seem to show any statistically significant deviation among developing countries as far as FDI withdrawals and cancellations are concerned. Such trend raises the concern that many low-income countries, not having been impacted by ISDS, may not comprehend the potential impact of investment protection

**FIGURE 25. TREATY-BASED ISDS CASES:
RESPONDENTS CLASSIFIED BY
INCOME LEVEL, 1987–2017**



Source: Own calculations based on UNCTAD data, 2019.

guarantees included in national legislation or IIAs. Indeed, as a series of pilot projects conducted by the World Bank Group over the past four years has shown, ISDS has led many governments to realize the importance of preventing investor-state disputes, and thus has forced a discussion within governments and between the latter and other stakeholders to improve understanding of the causes of differences between foreign investors and public authorities, the consequences of their escalation into grievances and legal disputes, and mechanisms to prevent those outcomes. Conversely, this may mean that, for many countries, FDI withdrawals and project cancellations, regardless of their amounts, may remain undetected even at higher spheres of government.



CONCLUSIONS AND POLICY IMPLICATIONS

Comparing the results of investor perception surveys with empirical data on ISDS shows a close convergence among the types of government conduct generate FDI divestments more frequently, and that escalate into international investor-state legal adjudication. Further, this research provides key insights on its most common patterns.

First, ISDS is not a sufficient mechanism to ensure proper enforcement of IIAs or prevent investors' grievances. Traditionally, IIAs have relied exclusively on ISDS to ensure the implementation of the investment protection obligations. However, ISDS is not a mechanism for promoting enforcement of IIAs on the ground. Instead, it is a mechanism for seeking redress for damages caused for treaty violations, that is, for situations when IIAs have not been implemented. International investment law has a social function, and it entails much more than investor-state disputes. In other areas of international economic regulation, such as trade in goods, policy makers have included within the treaties a set of mechanisms to ensure that the agreements are fully implemented at the international and domestic levels.

Second, the types of government conduct generating FDI divestments as well as ISDS cases have evolved over time and may need a more response. Although in the past regulatory risks were mostly related to expropriations, today most FDI divestments and ISDS cases raise issues of transparency, due process of law, proportionality, coherence, and adherence to commitments. In IIAs, such issues have been traditionally covered by standards such as FET; however, this has had mixed results in practice, often due to the divergent

ways in which the standards have been interpreted and applied in ISDS cases.¹⁹ Addressing the needs of the investors in a more targeted manner may require dedicated, detailed, and precise provisions on each of these aspects.

Third, there is growing tension between the single-state paradigm at the core of domestic and international legal systems, and the multilayered agency composition of governments. Foreign investors and IIAs and ISDS in particular have been generating pressure on states to behave in consistent manner, in accordance with the one-state legal paradigm. This is an outcome that is not always easy to achieve. Knowledge about the content and implications of protection standards included in IIAs is often found in certain agencies at the national level, and familiarity with those investment protection guarantees among subnational and/or specialized agencies is often missing. This leads to a gap between the law "on the books" and in practice.

Fourth, the lack of tracking mechanisms enabling the early detection of investor-state grievances exacerbates an already complex challenge for governments to articulate a timely and coherent response to those problems. Many developing countries lack mechanisms to enable them to articulate a coherent and timely response to grievances arising from government conduct. As opposed to the dispute resolution phase of the investor-state conflict continuum, in the conflict management phase, governments rarely track or have complete data on the number of grievances arising between foreign investors and public authorities of host states. The lack of a tracking

mechanisms also explains why those government agencies that are familiar with the importance of enforcing investment protection guarantees often learn about the existence of an investor-state grievance at a very late stage, once the grievance has escalated into a legal dispute (Echandi 2013). This conclusion is also coherent with an empirical study that found that a significant number of investor-state disputes could have been prevented, if competent authorities had the chance to address the grievance well before it escalated into the dispute resolution stage (Echandi and Kher 2014). It is crucial to enable more coherent coordination and collaboration between national central authorities and subnational and specialized regulatory bodies, to foster greater FDI retention and expansion.

Fifth, host governments should do more when it comes to offering investors domestic tools to mitigate political risk. There is a sharp contrast between the investors' preference to engage with host governments and their high degree of dissatisfaction with such engagement in practice. Thus, there is a need for governments to establish new or more efficient ways to respond to investors' grievances. This would avoid the translation of frustration among investors into the high rate of FDI withdrawals and expansion of cancellations as unveiled by this study.

In a globalized world where patterns of international production are leading every day to a higher level of interaction among foreign and local investors, governments, and civil society, there is an evident need for an international investment regime to promote and maximize the positive impact of foreign investments in host countries and mitigate any potential negative effect. In particular, IIAs should be used as an effective risk management tool to respond to the need for assisting investors and host states to address their problems—the number of which may naturally arise from their increasing interaction—in an efficient manner, well before investors are induced to withdraw or cancel their FDI projects, and certainly without making the parties incur the costs associated with litigation. Currently, this type of institutional infrastructure does not exist in many countries. However, it is encouraging to see good practices gradually being developed by several countries. With the support of the World Bank Group and other institutions, these practices are being used to develop coherent protocols for investor-state conflict management that may be implemented on a wider scale, as is detailed in the next part of this paper.



PART II

Proof of Concept: Fostering Retention and Expansion of FDI by Enabling Governments to Address Investor-State Grievances



INTRODUCTION

The empirical research in part I of this paper shows that many developing countries dedicating significant amounts of resources to attract foreign direct investment (FDI) are, paradoxically, simultaneously pushing foreign investors away by not resolving investors' grievances as they arise. Studies have consistently shown that each year, around 25 percent of foreign investors investing in developing countries totally withdraw or cancel planned expansion plans of their FDI projects due to political risks. Contrary to other political risks, such as terrorism, civil strife, or war, the types of problems leading to FDI divestments relate to patterns of government conduct that can easily be prevented. Expropriation, breach of contract, transfer and convertibility restrictions, and arbitrary or sudden regulatory changes and actions are the main types of regulatory risks generating FDI loss in developing countries. These same types of regulatory risks are also generating an increasing number of international investor-state dispute settlement (ISDS) cases that have significant monetary costs and political and economic implications derived from reputational damage and loss of jobs and FDI, among others.

By looking at the types of government conduct that most often lead to FDI divestments, it is clear that frequently, the political economy behind this phenomenon is related to the multilayered governance structure of public administrations that operate in highly regulated environments, thereby increasing the risk of uncoordinated priorities and actions and regulatory capture by interest groups. In many developing countries with relatively weaker institutions, economic regulation and administrative

decentralization are the cornerstone of the problem affecting FDI retention and expansion.

Within this context, there is an urgent need to provide governments a minimum institutional infrastructure that enables them to identify, track, and manage conflicts arising between investors and public agencies as early as possible. Through the intervention of a lead agency that is well connected to existing top political decision makers, governments need to be able to react to conflicts as they arise, in a coordinated manner well before the aggrieved investor opts to divest. This situation led the World Bank Group's Investment Policy and Promotion (IPP) team to develop a solution package, known as the Systemic Investment Response Mechanism (SIRM), to respond to these challenges and enable governments to undertake concrete reforms. However, from the outset, it was mandated that such design must comply with two minimal conditions. The first is to be capable of being implemented within real political timeframes—a maximum of three to four years—that correspond to the timeframes of most government administrations. The second is that the SIRM should be designed so that its effectiveness can be measured using objective impact indicators.

This part of the paper focuses on the design of the SIRM as a practical solution package to enable governments to identify, track, and timely resolve investor-state grievances that put FDI projects at risk of divestment and create risks for the host state through potential liability under applicable domestic or international investment rules. This part describes the process leading to the design of the

SIRM concept and summarizes the experiences of eight pilot projects undertaken by the World Bank Group's IPP team in countries in Latin America, Eastern and Southern Europe, Central Asia, the Middle East, North and Southeast Asia, and East Africa.

The rest of this part is laid out as follows. Section 2 focuses on the SIRM concept: its origins, key elements, and how its design is supposed to leverage the political economy dynamics related to investor-

state conflict. Section 3 summarizes the pilots, describing the different components and stages used to customize each of them. Section 4 focuses on the analysis of the preliminary results and lessons learned from the pilots. Section 5 summarizes the main conclusions, focusing on proof of concept extracted through the pilots, the main implications for policy makers, and suggestions on how to move forward the agenda of investment retention and expansion.



SYSTEMIC INVESTMENT RESPONSE MECHANISM

CONCEPT

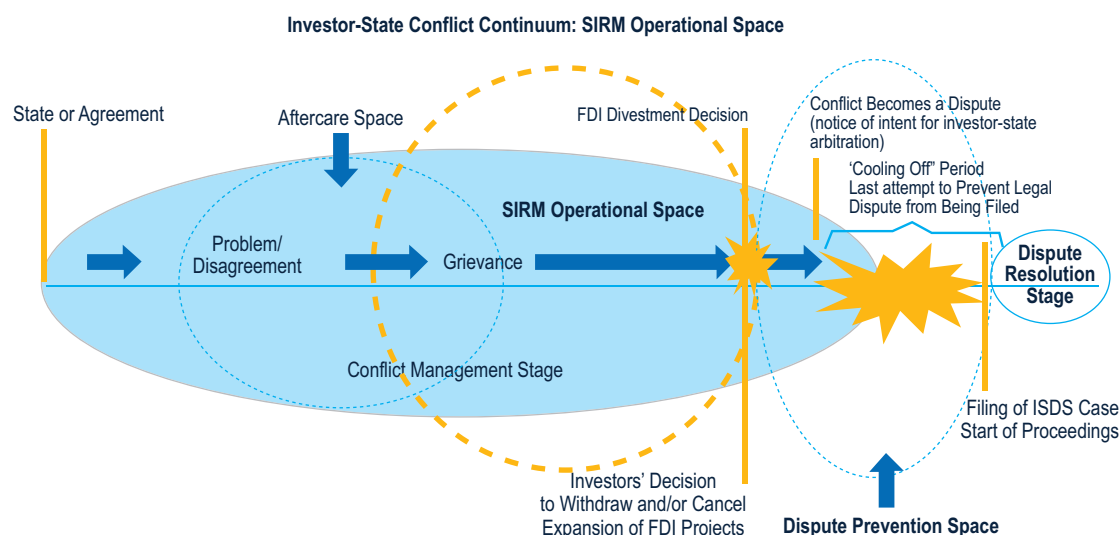
The first step in the design of the SIRM solution package was to undertake comprehensive research on the topic of investor grievances as a result of government conduct. This entailed a literature review and a series of case studies looking at different experiences and good practices in addressing risks derived from government conduct. The research found that although most policy makers had not yet connected between investment retention and expansion and political risk derived from government conduct, several governments had begun to work on this topic. From this background research, two patterns emerged.

First, those countries focusing on investment retention and expansion had deployed aftercare programs. For example, the Republic of Korea developed the Foreign Investment Ombudsman Office (OFIO),²⁰ which is considered one of the most sophisticated aftercare programs in the world. Second, several governments have prioritized addressing political risk but not investment retention or expansion. This has been the experience of various Latin American countries, which over the past two decades have been the most frequently hit by claims submitted by foreign investors to international investment arbitration under international investment agreements (IIAs). Within this context, it is not surprising that, over the past decade, the issue of ISDS dispute prevention started to resonate strongly among Latin American countries, which have begun taking pioneering steps in this field.²¹

These two sets of experiences show that although some countries have started to focus their attention on the beginning of the investor-state conflict continuum, focusing on addressing problems affecting investors at an early stage before they have escalated to grievances and placing the FDI at risk of withdrawal or expansion cancellation, efforts by other countries have focused on the opposite side of the spectrum. In the latter cases, governments that are frequently hit by ISDS have focused on using coordinated, inter-institutional efforts to manage and respond to ISDS disputes.

However, as illustrated by figure 26, the problem with these approaches is that neither one fully connects the dots between the two ends of the continuum. Although aftercare may focus on investment retention, it will likely also have to deal with issues that go beyond government conduct placing FDI at risk of withdrawal or cancellation of expansion. It is very difficult for investment promotion agencies (IPAs) to learn about grievances arising with investors who usually do not interact with those agencies in the first place. Investors in natural resources, particularly in extractives, often interact directly with the ministries in charge of mining, energy, and/or the environment. In those cases, investors do not usually enter the host economy with the support of IPAs; therefore, when dealing with their government counterparts, the investors are unlikely to seek assistance from IPAs. Further, IPAs do not usually have the mandate, legal attributions, or political clout to deal with other government agencies whose conduct is putting FDI at risk.

FIGURE 26. SIRM WITHIN THE INVESTOR-STATE CONFLICT CONTINUUM



Source: World Bank research based on Echandi (2013).

By contrast, as their name suggests, dispute prevention policies focus on preventing the escalation of grievances into international legal disputes. The agencies that are interested in preventing investor-state arbitration are often those in charge of implementing IIAs and representing the host state in international arbitration proceedings (for example, the ministry of trade and investment and/or the ministry of justice or the attorney general's office, hereinafter "competent agencies"). These competent agencies often have staff with technical skills and, in some circumstances, may even have enough political clout to settle certain ISDS disputes. However, because the mandate of these competent agencies is focused on negotiating, implementing, or enforcing IIAs, they traditionally get involved in investor-state grievances only once the grievance has escalated to a legal dispute.

Under most IIAs, investors who intend to submit a claim to international arbitration must submit a notice of intent to the competent agencies at least three to six months before the claim is effectively submitted to a dispute resolution body. This "cooling off" period is intended to enable the affected investor and the host government to reach an amicable settlement. Thus, most of the agencies referred to above get involved in attempting to

settle a dispute once the investor has suffered damages and is already seeking compensation due to an alleged IIA violation.

This method presents two problems. First, the overwhelming majority of foreign investors who are induced to withdraw or cancel FDI expansion in developing countries tends to abstain from invoking ISDS and, therefore, may never submit any notice of intent to arbitrate (Echandi 2019). Thus, there is a high risk that competent agencies may never be alerted about a significant number of investors who may be divesting from the host country. Second, even if investors alerted those competent agencies to seek resolution, there is a very high risk that the impact of the grievance may have already induced the investor to withdraw, cancel, or at least postpone the expansion of the FDI project. Once an aggrieved investor has started to visualize the possibility of litigation to seek compensation for a damage inflicted due to government conduct, even if there may be a relatively good prospect to avoid the litigation process, the chances for retaining or expanding the investment may be lost.

As a result, within the investor-state conflict continuum in figure 26, there is a need for a mechanism to fill the gap and connect the area or

work currently performed by two types of agencies. At the beginning of the continuum, the IPAs in charge of aftercare deal with many problems or incipient grievances. At the opposite end of the spectrum are conflicts that have already escalated into disputes. The SIRM was conceived precisely to fill this gap and address this challenge.

The SIRM is an early warning and tracking mechanism to identify complaints and issues that arise from government conduct. It collects data and identifies patterns in the sources of government-generated political risks affecting investments and quantifies investments that are retained, expanded, or lost as a consequence of addressing or not those political risks. The SIRM entails the empowerment of a reform-oriented government agency and the establishment of an intergovernmental mechanism for systematically addressing grievances arising from government conduct, thereby reducing these types of political risks at their source. The lead government agency is responsible for bringing grievances to the attention of high-level government bodies to address the issues before they escalate further. The operation of the SIRM includes the following:

- Identifying specific patterns and main origins of government conduct generating political risks
- Measuring affected investment as evidence to advocate for timely changes
- Strengthening capacity in the offending institutions to minimize the recurrence of these events.

KEY ELEMENTS

The concrete features of the mechanism must be customized to correspond to the specific political economy and idiosyncrasy of each country. Despite their differences, the design and implementation of the pilot projects—which are explained in more detail in section 3 of this part—highlight four fundamental core elements to enable the SIRM to function properly:

- *Empowerment of a lead agency.* There should be a recognized government agency with power and attributions conferred by regulation or law that is responsible for implementing the SIRM.

- *Early alert mechanism and tracking tool.* An early alert mechanism would enable the lead agency to learn about the existence of grievances as soon as they arise. The response could be proactive (for example, the lead agency visits the private sector) or reactive (for example, the private sector communicates with the lead agency). Once a grievance is identified, it is “filtered” and assessed from a legal and economic point of view and captured by a tracking tool that monitors the investment at risk. The tracking tool also monitors whether the grievance is resolved and how much investment is retained and expanded as a result of the resolution of the issue.²²
- *Problem-solving methods.* Based on the specific political economy of the country, the SIRM would empower the lead agency to use different problem-solving methods for directly addressing and negotiating a solution with the other public agencies involved in the problem. The problem-solving methods range from simple exchanges of information to mechanisms of peer pressure or legal advisory opinions. In case a solution cannot be reached at a technical level, the issue would be elevated to a political decision-making level.
- *Political decision making.* Often the lead agency may not have the political authority to discipline another peer agency. In this case, the problem is elevated to higher political levels, such as the ministerial cabinet and in some countries special ministerial councils chaired by the president or prime minister. Once a decision is taken at this higher instance, the lead agency tracks the resolution, positive or negative, and the impact on investments.

The SIRM is a tool to identify case-specific grievances arising with particular investors. Within this logic, investment retention and expansion are promoted one case at a time. This firm-level approach has two purposes. First, it allows a country to identify specific FDI projects that are at risk and measure the impact of the success or failure of the intervention by the lead agency. Many investors may be affected by the same government measure, and the SIRM may address them in a

consolidated manner. However, to measure the impact and causality, the mechanism is designed to track the impact of government conduct on specific FDI projects. Second, despite following a firm-level approach, the tracking of grievances over time will enable the SIRM to identify and address “systemic” issues that may be impacting a broad group of investors. In this sense, the SIRM is intended to identify patterns of conduct across institutions, the multiple incidences by “offending” institutions, or any other recurring problem placing FDI at risk, and develop an evidence-based systemic approach to develop a reform agenda with different investment stakeholders.

Further, the SIRM has been designed to deal with actions of public agencies. The SIRM concept is based on the premise that most of the grievances arise from the conduct of agencies within the executive branch of government, at the national or subnational level. The highest authority within the executive branch may be legally or politically capable of implementing creative means for disciplining agencies under its command. Thus, the SIRM is not intended to address grievances stemming from the conduct of other branches of government, like the legislative or judiciary branch. Investor-state grievances may arise from new pieces of legislation enacted by parliaments or by court decisions. However, for those type of grievances, other alternative mechanisms may be more effective.

OPERATION

In fostering economic development, very often the problem in implementing well-informed and sound policy making is not the lack of clarity about what policy makers should do, but rather how to make reforms politically viable. Recognizing how important it may be for governments to address political risks at the source to enable FDI to remain and expand in host countries is one thing. Making it possible for reform-oriented policy makers to do something about it is another issue altogether. The SIRM design must therefore consider this reality and make it politically feasible—and even attractive—for reform champions sitting within governments to implement this type of mechanism.

The SIRM design is based on the recognition that one of the most important demands of constituents is for governments to show real results in generating more and better jobs. The SIRM is meant to leverage firm-level data to demonstrate how greater FDI retention and expansion contributes to achieving those objectives.

Of all the actors involved in investor-state grievances, investors are the most likely to want to adopt the SIRM provided that: (i) they know that the system is being put in place, (ii) they trust that the government will use it to help them and not to seek retaliation for submitting a grievance, and (iii) the system delivers and gets problems solved. Investors’ key interest is to be able to do business. If such objective is being disrupted by a government measure, logically it follows that investors’ core goal in the SIRM context will be to have their grievances resolved as swiftly and thriftily as possible. Thus, the SIRM pilots entail a key component of information sharing and diffusion, aimed at informing investors about how the system will work—which should entail no cost for the investor—but also to convey the political commitment of the government to make it work properly.

As far as civil society actors are concerned, with the exception of local communities that are affected by environmental concerns, or natural resource-seeking FDI, which may have more specific demands,²³ they will expect that investors and governments resolve their grievances according to domestic laws, avoiding any nontransparent and illegal transactions. The SIRM is expected to operate within and never at the margins of the existing legal frameworks of host countries. To deal with this challenge, the SIRM pilots entail a key component of information sharing and diffusion, in this case aimed at interested civil society stakeholders, to inform them about how the system will work within the applicable laws and regulations and convey the political commitment of the government to make it work properly.

The most difficult part of the political economy equation of the SIRM is how the lead agency entrusted with coordinating the mechanism will generate an

atmosphere of cooperation and collaboration with other peer agencies that are causing the grievance. World Bank Group research and experience has shown that most of the investor-state friction is generated by regulatory conduct by subnational agencies and/or sector-specific regulatory bodies that operate with a certain degree of autonomy from the central national administration. This complex political operational space is precisely where the SIRM is supposed to operate.

In a nutshell, to deal with the intergovernmental collaboration challenge, the lead agency will be empowered through a legal instrument giving it a mandate and authority to carry out its work. The lead agency will also be able to leverage data and IIAs to empower it to assume a coordinating role over agencies that are supposed to have a certain degree of autonomy and specialization.

First, to resolve grievances, the lead agency could offer the opportunity for those in charge of the agency causing the grievance to make a contribution to the political rewards associated with the safeguarding an important amount of FDI and number of jobs. However, this incentive system may not work in every circumstance. As shown by World Bank Group research, many grievances arise with specialized regulatory agencies such as those in charge of taxation, customs procedures, incentives, and telecommunications. Very often such specialized matters or sectors are regulated by specific legislation, the expertise of which resides within the specialized agency. Within this context, anytime a grievance arises, the specialized agency will tend to claim that it is acting within its prerogatives under the applicable specialized law, the content and interpretation of which should not be challenged by anybody without the specific expertise. It would be unrealistic to expect the lead agency of the SIRM to challenge the interpretation or application of any piece of legislation regulating a technical field falling beyond its area of expertise.

In this case, the lead agency could rely on a variety of political pressures. For example, the offending agency may be held accountable to the head of the government or to the public for the economic impact of the grievance (that is, the amount of FDI

and number of jobs lost as a result of the conflict). Under a different scenario, the lack of collaboration by the offending agency could entail legal, economic, and political consequences for the state as a whole in cases where the grievance escalated into an international investor-state dispute. Rather, the SIRM aims to enable the lead agency to negotiate with its peers considering likely potential scenarios in case the grievance was not solved and escalated into a legal dispute. Another possibility is the provisions of potential sanctions for bureaucrats or economic consequences for the non-collaborating agency. For instance, some countries, like Peru, have included in their legislation clauses for dealing with ISDS, mandating that the budget of noncollaborative agencies causing a grievance bears the burden of the economic costs of the damages caused by the grievance if it escalates to a legal dispute (UNCTAD 2011).

For this role, the lead agency should be empowered by the head of the government asking it to assume the role of addressing investor-state grievances arising from the conduct of public agencies, and the need to ensure the proper implementation of a statewide commitment under an international agreement. With this mandate, it would be crucial that the grievance is analyzed from economic and legal perspectives. From an economic point of view, the potential impact of the grievance should be assessed in the amount of investment and number of jobs at risk.²⁴ Such analysis should be complemented with a legal analysis using IIAs and legal protection clauses incorporated in domestic laws as points of reference to assess the potential accountability of the state in case the grievance escalated into a legal dispute. Although the lead agency could never claim legal expertise on sector- or matter-specific legislation, it could and should be able to claim expertise in international investment law. Under international law, no state can invoke domestic legislation to refrain from complying with an international obligation. Thus, the discussion with the specialized agency should not be about whether it has acted consistently with the relevant domestic legislation, but rather, whether the grievance could entail liability for the state under IIAs or domestic laws.



SIRM PILOT PROJECTS

SELECTION OF PILOTS

After the initial research, the World Bank Group's IPP team prepared a series of tools to test the SIRM concept in practice, including diagnostic checklists; guidelines for legal, economic, and political economy diagnostics on the ground; how to leverage existing technology to design tracking tools; the best practices for problem-solving techniques; and design of monitoring and evaluation frameworks. On that basis, the IPP team can offer interested governments that are keen on fostering greater FDI retention and expansion tools customized to the specific realities of their respective countries. Each pilot has four fundamental components: (i) initial diagnostics, (ii) country-specific customization of SIRM tools, (iii) validation and reform, and (iv) monitoring and evaluation. Each of these components is explained in further detail in the following section.

Selection of the SIRM pilots was based on client demand. Between 2015 and 2018, the World Bank Group's IPP team responded to requests for support by eight countries in different regions of the world.²⁵

Not all the pilots were able to begin right away, and the unique political environment of each country meant that progress in implementation varied among the pilot countries. Thus, by the end of 2018, only one pilot project had been fully completed; the other seven are still under implementation. However, based on the level of progress achieved, the eight SIRM pilots have been categorized into two broad baskets:

- *Advanced pilots.* These are cases where implementation of the SIRM tools has already reached a basic functional level, that is, the institutional configuration and legal basis for the SIRM is in place, lead agencies have been established, and they have started to address and track grievances. Pilots in Bosnia and Herzegovina (at a subnational level), Georgia, Mongolia and Colombia fall in this basket.
- *Pilots in progress.* These are cases where the diagnostic phase has been completed and the SIRM customization is in the process of being validated. The pilots include projects in Vietnam, Rwanda, Ethiopia, and a subnational pilot in Iraq.

TABLE 3. SIRM PILOTS

Advanced	Recent
Bosnia & Herzegovina (subnational)	Ethiopia
Georgia	Rwanda
Mongolia	Vietnam
Colombia	Iraq (subnational)

PROJECT COMPONENTS

As part of the development of the SIRM tool, the IPP team developed a tool kit that structures the different components, activities, and steps to be followed in each pilot. Each component is further explained in the following subsections.

- *Diagnostic phase.* This phase provides a review of basic indicators and existing FDI regulatory frameworks and examines the type of FDI-related grievances, actors involved, and particular political economy dynamics of the host country.
- *Country-specific customization of SIRM tools.* This component entails four types of activities: (i) customization of tracking tools and capacity building to enable the lead agency to follow up on grievances and collect data to measure the amount of investment and number of jobs at risk, retained, and expanded; (ii) capacity building of the lead agency to enable it to filter and assess the submitted grievances; (iii) customization of protocols for interagency coordination and problem-solving methods needed to manage grievances well before the investor takes the decision to withdraw or cancel an expansion plan—and as a result also preventing potential dispute escalation; and (iv) institutionalization of high-level political decision making if the lead agency cannot reach a solution with peer agencies on an investment grievance.
- *Validation of the solution package proposal with key stakeholders,* and the enactment of any necessary regulatory instrument to set up the SIRM.
- *Execution of the mechanism and monitoring and evaluation of its functioning and impact,* based on the previously designed impact indicators.

INITIAL DIAGNOSTICS

The SIRM initial diagnostic component includes six steps: (i) preliminary desk research; (ii) private sector perceptions of risks of regulatory conduct; (iii) public stakeholder mapping; (iv) assessment of legal mandates, powers, and attributions of agencies

involved in investment grievances; (v) tracking tool assessment; and (vi) diagnostic report.

Preliminary desk research is the first step in the diagnostic stage, and it is carried out before the first meeting with government counterparts and relevant stakeholders takes place. The objective of this step is to get a first picture of the existing regulatory environment and political-economic factors that may be impacting foreign investors operating in the host country. This information should be used to provide a context for the following diagnostic steps that are carried out in the field. Among the main tools available to complete this step are databases on regulatory risk ratings, IIAs, ISDS, and rule of law and transparency indexes.

Examination of private sector perceptions on the risks arising from regulatory conduct in the host country is the second step of the SIRM initial diagnostic component. This step is designed to help better understand what types of grievances exist in the economy, whether there is any existing mechanism that deals with grievances, and what agencies or ministries are involved in generating and handling conflicts. Through a series of interviews, this step entails mapping the main private sector actors to determine who are the major foreign investors present in the domestic economy, their sectoral coverage, and the sizes of investment and employment. Past and present grievances should also be documented through an initial inventory to get an idea of the types of conflicts that are occurring and the impact on FDI, reinvestment, jobs, and other relevant factors. Among the tools developed by the IPP team to undertake this step are (i) the checklist for identifying key private sector stakeholders; (ii) the list of questions for interviews; and (iii) templates for presenting, comparing, and processing inputs from the interviewed investors.

Public sector mapping is undertaken to identify the main government agencies that most frequently affect investors; any existing processes or procedures set up to deal with investor grievances; and, if so, which ministries, agencies, and bodies are involved. Gathering this information should provide a picture of the political economy dynamics

of investor-state conflict. Identifying the interests of the ministries or agencies involved, their mandates, and the political incentives for their operation are also part of the aspects to examine in this step. This mapping can also be used to identify potential champions and challengers of reform and their interests and priorities.

In addition to mapping the relevant stakeholders, all the available data and evidence on the handling of investor grievances should be collected and analyzed. For example, are investor grievances recorded? If so, is there a detailed account of the types of grievances and investors (for example, the sector, type of problem, size of the investor, number of people employed by the investor, and so forth). Is there a record of the average number of days it takes for the grievances to be passed along to the relevant body? How many days does it take for a grievance to be resolved? Is this information centralized in one place? Among the tools developed by the IPP team to undertake this step are (i) a checklist for identifying key public sector stakeholders, (ii) a model questionnaire for public consultations, (iii) a checklist for mining available data, and (iv) a guidance note on how to complete political economy analysis.

Assessment of legal mandates, powers, and attributions of the agencies involved in investment-related grievances is the fourth step in the initial diagnostic. The objective of this step is to understand the legal underpinnings of the host country's existing investor grievance system, regardless of its effectiveness. Based on the comprehensive mapping of actors involved in FDI-related grievances done in previous steps, it is possible to determine whether and the extent of the legal authority and mandates that each agency involved has in those dynamics. Among the tools developed by the IPP team to undertake this step are (i) a model questionnaire to determine the institutional competences of agencies involved in investment grievances, and (ii) a process map on existing mechanisms for handling investment grievances.

The tracking tool assessment is undertaken next to identify any existing information and

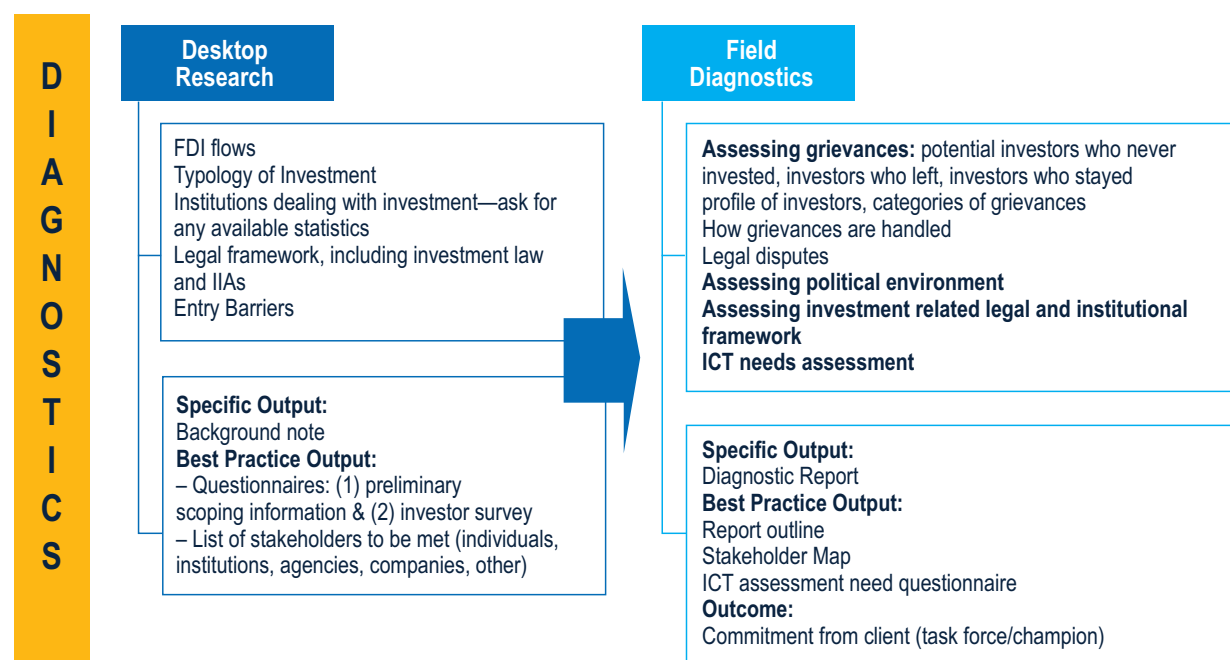
communication technology (ICT) tools currently being used to track and record investment problems. The tracking tool is a customized software application, as sophisticated or simple as the reality of the lead agency permits and is meant to help governments monitor and track investor grievances and the associated amount of investment and number of jobs at risk due to those grievances. The ICT tool is used to centralize data on investors throughout the different stages of the investment lifecycle, for example, investment establishment and operations, investment inconveniences or problems (“warm issues” that can be easily diffused through prompt action), investment grievances (“hot issues” that if left unattended could lead to a dispute), disputes, and investment and jobs retention, expansion, or loss. The IPP team worked in close cooperation with World Bank Group ICT experts to design the following tools: (i) a template for mapping the existing grievances tools, (ii) a list of ICT needs assessment questions, and (iii) a way to check for ICT staff capacity building.

The diagnostic phase is concluded by the preparation of a diagnostic report that summarizes the information obtained in steps one through five (figure 27). The diagnostic report gives the government a clear overview of the legal and political-economic situation on investor-state grievances, including political risk issues, the network of public and private sector actors involved, the patterns in how such grievances are handled, the impact they may be having, and the state of existing tools to collect data on those grievances. The diagnostic report is used as an input in the design of a country-specific, customized SIRM proposal that may respond to the political and economic realities of the relevant country.

COUNTRY-SPECIFIC CUSTOMIZATION

The next step for each pilot was to design a pragmatic proposal for minimal institutional infrastructure allowing governments to address systematically these grievances at an early stage to foster FDI retention and expansion. Such infrastructure had three fundamental elements.

FIGURE 27. SIRM DIAGNOSTIC PHASE



Source: World Bank Group 2019.

Note: SIRM = Systematic Investment Response Mechanism.

The first element was to identify the lead agency that would coordinate the SIRM within the government. The second element was to design a tracking tool based on indicators to measure the amount of investment and/or number of jobs at risk, which would serve as the estimate to measure investment and jobs retained or generated as a result of a subsequent expansion of an investment project, or to measure the investment and jobs lost in case the grievance is not solved. The third element of the SIRM customization entailed the development of procedures and protocols for the lead agency to: (i) receive, assess, and filter investors' grievances; (ii) undertake interagency consultation and explore different problem-solving techniques with peer regulatory agencies; and (iii) set up a high-level political decision-making mechanism or protocol to escalate, when necessary, grievances that the lead agency is not able to resolve mutually with its peers.

LEAD AGENCY

The SIRM concept is based on having a single agency in charge of leading or coordinating the proper functioning of the mechanism. However, by its nature, the SIRM entails the involvement of many government agencies, some of which may be entrusted to fulfill particular functions within the SIRM. Thus, although in some countries all the steps of the process workflow may be conducted by the lead agency, in other countries, it may well be the case that the intake of inquiries and grievances may be done by one agency, and the filtering and analysis by another, while yet another agency takes care of the problem solving and political decision-making stages. The particular configuration will depend on the political economy and institutional reality of each country, as discussed in table 4.

TABLE 4. TYPES OF SIRM LEAD AGENCIES

Models	Model 1: New Lead Agency	Model 2: IPA (with Aftercare)	Model 3: IPA (without Aftercare)
Description	Independent/new lead agency	SIRM lead agency within IPA (Aftercare unit in place)	SIRM lead agency within IPA (no aftercare unit)
Lead agency empowerment	Law or regulation	Law/regulation/instruction	Law/regulation/instruction
Escalation mechanism	Independent platform prime minister or ministerial council	Discussion in IPA units high level management prime minister or ministerial council	Discussion in IPA units high level management prime minister or ministerial council
Pros	Strong authority (including issues outside the scope of IPA) No confusion between SIRM and aftercare issues	Easy access to investors Easy collection of cases	Easy access to investors
Cons	New resources No ongoing relationship with investors Slow progress of projects Limited capacity	Limited legal or sectoral scope (within IPA) Confusion between SIRM and aftercare issues IPA may not have the required political clout	No ongoing relationship with current investors Limited legal or sectoral scope and authority (within IPA) IPA may not have the required political clout
Conditions for success of lead agency	Strong political support from the top to create a new agency Clear distinction of mandate with IPA, if any	Strong IPA for regulatory function and coordination role Working filtering/escalation mechanism	Working escalation mechanism Proactive collection of issues Need for complementary Aftercare unit

Note: IPA = Investment Promotion Agency.

Often, the lead/coordinating agency may not be the IPA in the traditional sense. In most countries, many of the sources of political risks derived from government conduct are sector-specific or subnational agencies regulating sectors that fall beyond the normal scope of the IPA. Further, IPAs often lack the legal mandate and political clout to discipline those agencies at the root of the investor-state grievance. IPAs may be extremely useful in receiving submissions by investors interested in invoking the SIRM. However, their mandates, staff profiles, and positioning within the administration do not enable most IPAs to solve those grievances properly. In some countries, however, the lead/coordinating agency may be a regulatory body that also has promotion functions. However, these are not IPAs in the traditional sense.

A lead/coordinating agency can be established at the national level, or at the sectoral or subnational level. Bosnia and Herzegovina has a strong federal structure with subnational entities functioning fairly independently. Rather than pursuing a national to subnational top-down approach, a more organic approach was taken with the lead agency positioned under a subnational “collaborative network” comprising representatives of the private sector and agencies operating at the municipal level.

Regardless of the various potential configurations of the SIRM, the key role of the lead agency is its coordinating function, which at least involves overseeing the interagency collaboration process to solve the grievance. Its other key role is to decide when and whether to escalate the issue to

a higher-level political authority. In this sense, the lead agency is the SIRM Secretariat, centralizing oversight and providing a key point of contact for investors and other public agencies involved in the grievance.

Additionally, as part of its coordinating role, the lead agency is responsible for undertaking effective information sharing, diffusion, and advocacy vis-à-vis all investment stakeholders on the existence of the SIRM, and the importance and impact of investment retention and expansion as well as the key role that investment protection guarantees included in IIAs and domestic laws play in achieving that role. The lead agency should also be the central depository of data.

TRACKING AND MONITORING TOOLS

The tracking tool is a customized technology application, as sophisticated or simple as the reality of the host country permits.²⁶ The tracking tool is meant to help governments monitor and track investor grievances and the associated amount of investment and number of jobs at risk due to those conflicts. In some countries, a pre-design Excel sheet is being used to track grievances and their potential impact, and in others, like Georgia, a customized, sophisticated software was set up. Such software entails the establishment of a portal that allows affected investors to interact directly with the Office of the Business Ombudsman of Georgia.

A key factor determining which type of tracking tool to use depends on the number of agencies and people involved. The smaller is the number, the easier it is to use a simple software, while the higher is the number of officials and agencies involved, the more sophisticated and costly the software will be. However, neither the quality of the data nor its update is affected by the software used. World Bank Group experience has shown that any tracking system requires people to input the data and follow up each case. No software can substitute a diligent and dedicated staff.

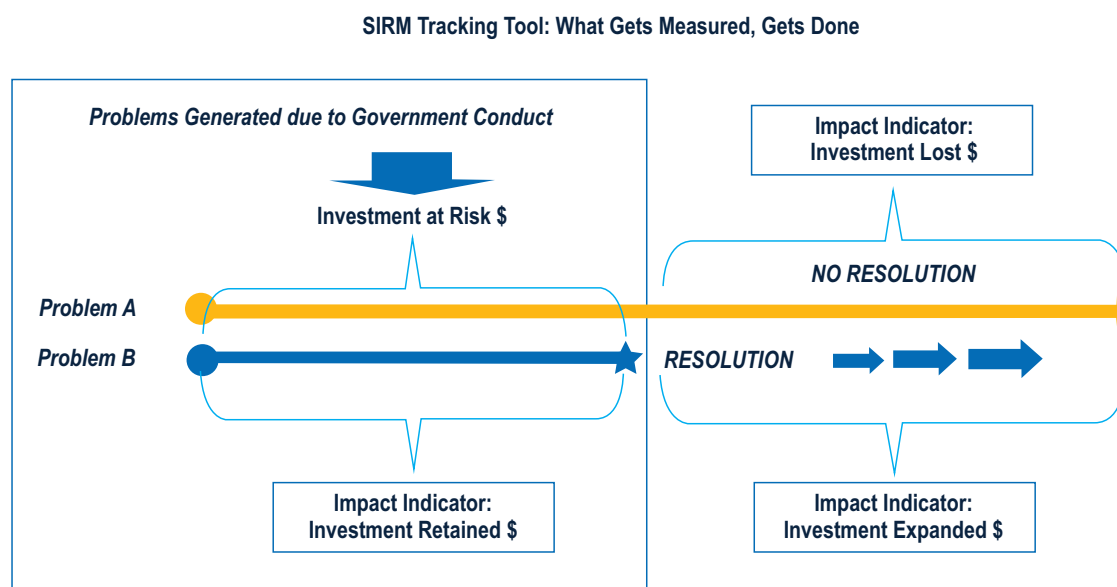
Typically, the tracking tool is populated by the lead/coordinating agency and focuses only on investment at risk of withdrawal or the cancellation of planned expansion (figure 28). However, some countries are already in the process or planning to develop a more sophisticated tracking software and collaborating with the departments in charge of investment promotion and aftercare to make the tracking system part of a customer relationship management system that allows tracking along the different stages of the investment lifecycle, covering establishment, aftercare, investment at risk, and subsequent expansion.²⁷

Each grievance is registered individually in the tracking tool, and the information is used to determine the amount of investment/number of jobs at risk resulting from the grievance at hand. Establishing the amount of investment/number of jobs at risk is critical, as it provides the point of reference to calculate the amount of the investment/number of jobs retained or generated, which are the main impact indicators of the SIRM. Thus, the logic of the impact indicator is that the SIRM can help retain those investment projects that have been previously identified as being at risk of withdrawal or expansion cancellation. Projects that are not yet at this stage should be channeled to aftercare services provided by the IPA. Thus, the key filtering criterion for the SIRM is the determination as to whether an investment project is at imminent risk of withdrawal or expansion cancellation.

FILTERING AND ASSESSMENT OF GRIEVANCES

To address investors' grievances, a two-step methodology has been developed. The first step is to filter and distinguish between grievances placing the investment project at risk and those that are less serious. For the lead/coordinating agency not to be overburdened and to allow it to focus on its purpose, the latter category is usually dealt with by a different agency or unit, in many cases an aftercare program. In the second step, once it has been determined that a grievance is putting investment at risk, the economic impact of the

FIGURE 28. SIRM TRACKING TOOL



Source: World Bank Group 2019.

Note: SIRM = Systematic Investment Response Mechanism.

potential investment withdrawal is estimated and an assessment of the potential legal liability for the state should the investor seek redress through dispute resolution is done.

The initial filtering that determines whether a particular grievance is placing an investment project at risk is done by the affected investor. Thus, it is the investor who must indicate in its submission to the SIRM lead agency whether the severity of the grievance is such that withdrawal or expansion cancellations are being considered. Since such assessment is predominantly a subjective process that can be affected by the investor, the lead agency should verify the severity with additional objective criteria to determine whether the investment may effectively be at imminent risk of withdrawal/cancellation. For this purpose, three factual variables should be considered: (i) time: how long has the conflict remained unresolved? (ii) nature of grievance: whether it relates to protection guarantee (e.g. potential expropriation) or other topics, and (iii) verification as to whether the investor has taken any other parallel step to seek resolution

(for example, legal assistance being sought, diplomatic intervention, or submission of grievances to any domestic or international legal proceeding). It will be difficult to respond fully to each of these questions with complete certainty. However, this initial filtering is not intended to be a long or extremely burdensome process. Its rationale is just to distinguish whether a particular grievance should be handled through aftercare services or requires the swift intervention of the SIRM and to verify investment that is reported by the investor to be “at risk” of cancellation or withdrawal. This filtering practice would be helpful to distinguish a case where the investors’ grievance was opportunistic or frivolous and the level of “seriousness” of a grievance.

In case a grievance does not pass this initial filter, the lead agency will inform the investor that the problem is being channeled to another agency for its resolution. In most cases, it could be the IPA, which would in turn take it over as part of its aftercare and/or advocacy services.

Once the grievance has passed the initial filter and the lead agency has determined that the investment is at risk, a grievance assessment is undertaken. This evaluation is similar in all the SIRM pilots and entails an economic and legal assessment. The economic assessment estimates the amount of investment and number of jobs at risk. It can also estimate the potential cost for the host state of the investment lost in terms of potential tax losses or even fiscal costs should the grievance escalate to ISDS. In this initial phase of the pilots, for the sake of simplicity, the economic assessment has tended to focus on the estimation of investment at risk, based on the information supplied by the investor, and verified by objective criteria.

The economic assessment is complemented by a legal risk assessment to determine the likelihood of the liability the host state would bear should the grievance escalate into a full-blown investor-state dispute. The World Bank Group's IPP team developed a methodology to facilitate the lead agency undertaking such legal analysis in a relatively easy and swift manner. Based on the empirical research undertaken by the World Bank Group's IPP team during the SIRM concept design stage, a classification of the most common types of regulatory conduct leading to FDI divestments was paired with the classification of the corresponding legal protection guarantees included in IIAs and most domestic laws. This helps the lead agency not only to classify the type of conduct placing the investment project at risk, but also to determine quickly whether such conduct is regulated under an IIA and, consequently, the likelihood of the state facing liability should the grievance escalate into a legal dispute. The classification facilitates a legal categorization of the conduct at stake.

It should be stressed that the economic and legal analysis is not intended to be a rigorous academic exercise but rather provide the evidence to the lead agency when attempting to seek the collaboration of peer agencies to resolve a grievance. In a way, the SIRM is intended then to address the problem of information asymmetry that the agency causing the grievance may have. It could be expected that by realizing the impact of the measure or action

being taken, the “offending” agency may be more prone to collaborate with the lead agency in solving the grievance. In sum, the data resulting from the legal and economic analysis would be the basis for the reward and pressure the lead agency would use in the problem-solving phase.

INTERAGENCY PROBLEM-SOLVING

The lead agency should have skilled staff who are well-versed in problem-solving methods. The staff should be trained on how to leverage the power of the information generated by the SIRM to induce the “offending” agency to collaborate. This, together with the legitimacy derived from a clear and public empowerment by the head of the government, should provide the lead agency enough political clout to carry out its functions.

From this perspective, the SIRM has been designed as an internal administrative process, not intended to replace administrative tribunals, but rather to attempt to induce an offending agency to rethink its behavior and conduct its tasks in accordance with the rule of law principles embodied in IIAs and domestic legislation. In this sense, the problem-solving process will always deal with direct interaction between the lead agency and its peers, instead of having an external third party—like a mediator from outside the government—participating in the process. Keeping the process within the administration should enable the government to act swiftly and allow the internal political dynamics operating within a particular government to operate with a degree of discretion that allows the offending party to “save face” and rethink its conduct. If this approach does not work, then there will be a more open phase of the management of the grievance where the offending institution may be publicly exposed if the undesired pattern of behavior continues.

There are many problem-solving techniques that the lead agency can use in its direct interaction with its peers. From simply leveraging the good atmosphere that may already exist between officials from different agencies—derived from professional network connections—the lead agency could also

exert different levels of pressure over the peers with which it is seeking collaboration. Among others, the initial pilot SIRM experience has shown at least four main problem-solving techniques at the base of the direct interaction of the lead agency and its peers: (i) peer pressure, (ii) power-based negotiation, (iii) rule-based negotiation, and (iv) early neutral evaluation.

The most commonly used problem-solving technique was peer pressure. For instance, in the subnational pilot in Bosnia and Herzegovina, the SIRM was organized around a “collaborative network” of public agencies and private associations. The collaborative network regularly organized open private-public meetings to identify and follow up on solutions to problems. The visibility and popularity that the network got from the private sector ensured that all relevant agencies had not only to participate in each meeting, but also to be ready to collaborate and show results in complying with their commitments agreed in previous meetings.

Another common problem-solving technique is power-based negotiation. For instance, in the case of Georgia, during the initial part of the pilot, the business ombudsman participated in regular meetings with the Cabinet and the prime minister. This direct access to the highest authority of the administration became known among all agencies of the executive. This strengthened the bargaining position of the Business Ombudsman Office significantly, inducing other peer agencies to take its recommendations to address grievances very seriously. The prospect of having a grievance elevated to the prime minister was a factor of dissuasion that was strong enough to resolve a good number of grievances relatively quickly. Thus, the mere expectation of being directly exposed to the disciplinary power of the highest authority of government became a lubricant for collaboration.

The SIRM is also based on the notion of fostering “rules-based” negotiation between the lead agency and its peers involved in grievances. Under this approach, legal obligations are used as a reference point and, if necessary, as means of exerting pressure

on offending agencies to modify their behavior according to the rule invoked. In many countries, however, respect for the rule of law itself is not always very strong, and the prospect of the effects of lack of compliance is often the factor of dissuasion. Indeed, the prospect of losing investment and jobs due to conduct subject to liability by the state is the main purpose of the economic and legal analysis of the SIRM. Thus, the role of potential international liability under IIAs becomes particularly useful.

IIAs make it a realistic possibility that a host state can be sued and forced to act as defendant in an international tribunal. Indeed, one of the impacts of ISDS is to increase the cost of noncompliance with IIA investment protection clauses. IIAs also become a reference point for framing state-to-state diplomatic pressure on investor-state grievances. Pilot experiences have shown the key role that the intervention of the embassy of the affected investor’s home state can play in the political economy of addressing grievances before dispute escalation. In the case of one pilot country, the prospect of facing an ISDS case was critical in taking an offending agency to the negotiation table, and it enabled the lead agency to resolve a grievance entailing many hundreds of millions of dollars.

Some pilots also show that early neutral evaluation²⁸ is another useful tool. An early neutral evaluation plays a similar role to the legal analysis done by the lead agency. However, it may be particularly useful when the lead agency needs a “political shield” to distance itself from the legal assessment. The lead agency can simply invoke the prospect of the costs of litigation on the basis of the legitimacy of a legal assessment done by an international legal authority. The pilots showed that for this problem-solving technique to work, the early neutral evaluation must be (i) confidential, to avoid any complications in case the grievance escalates into ISDS; (ii) swift, taking no more than one or two months at the most, as the whole point of the SIRM is to enable the administration to react before the investor opts to cancel or withdraw its investment; and (iii) low cost, so that the services of the expert do not entail a significant budget going beyond any amount already included in an “extraordinary expense”

budget line of the lead agency, which by definition would have a very limited amount, if any at all.

POLITICAL DECISION MAKING

Some grievances can only be solved at the political level and, sometimes, even if the lead agency has succeeded in problem solving at a technical level, it may still be necessary that such solution receives the approval of the adequate political authority of host state to ensure effective implementation. Without a political decision, there may be the risk that a consensual solution solving the grievance at first instance may subsequently not be effectively implemented or complied with, thereby exacerbating the original investor-state conflict.

Based on good practices, political decision making in the SIRM has been conceived to entail a collegial political relationship where the lead agency acts as a secretariat to a body in which relevant ministries are represented, and it is chaired by the head of government. Such political decision-making body may already exist (for example the Cabinet) or a special inter-ministerial commission can also be set up. A key point, however, is that such political decision making should be designed recognizing that high-level officials have very busy and overburdened agendas. Further, to gather multiple ministers together with the prime minister or president is often a very difficult endeavor, unnecessarily delaying pending decisions. To deal with this challenge, political decision making should be used as sparingly as possible, considered to be comprised by proxies—provided that they are empowered and keep constant communication with their principal—and even considered to be mechanisms by which the lead agency would make recommendations to which the representatives could simply approve or reject, even enabling a virtual review meeting to take place.

VALIDATION AND CAPACITY BUILDING

Once the customization of the SIRM design is done, the concept is validated by the highest government

authorities and private sector and other civil society actors. For such purpose, each pilot entailed the preparation of a proposal explaining the key SIRM elements, including the budget, which tended to be relatively low, given that most actors are already government officials. The proposal also includes detailed workflow roadmaps, indicating each step of the process and which unit/department will undertake it.

Once the proposed SIRM has been validated, a capacity-building program is developed for personnel of the lead agency, as well as other stakeholders who would be involved in the SIRM process (that is, subnational and sector-level agencies, other ministries, private sector, civil society, and press). The capacity-building activities are tailored according to the needs of each stakeholder group, as detailed in table 5.

The SIRM entails setting up the tracking system and establishing protocols for interagency coordination and collaboration to address and resolve grievances. Such outcomes often entail the enactment of some sort of regulation to provide a legal anchor for the SIRM. In some countries, this legal anchor may be a law, while in others a regulation may suffice as the SIRM may be hosted within an existent agency appointed as lead/coordinator, the authority of which has already been granted by preexisting legislation. Further, in some countries, the main anchor of the SIRM may be an International Investment treaty that already provides mechanisms to enable a point of contact within the host government that is responsible for administering and implementing the international agreement.

MONITORING AND EVALUATION

Each SIRM pilot has been implemented on the basis of a theory of change, undertaking support activities that lead to concrete outcomes, the impact of which is measured on the basis of key indicators. In the case of the SIRM, the outcome indicators reflect the specific steps that governments should undertake to effectively establish SIRM, incorporating the good practice elements discussed in this report. The key

TABLE 5. SIRM CAPACITY-BUILDING ACTIVITIES

Type of Capacity-building Modules	Target Audience
SIRM objectives, elements, and processes	Lead agency, peer agencies, private sector
ICT tracking tools	Lead agency
Monitoring and Evaluation: Indicators and Data Gathering	Lead agency
IAs substantive investment protection guarantees	Lead agency, peer agencies, private sector
International investor-State arbitration	Lead agency, peer agencies
Non-litigious problem-solving techniques	Lead agency
Information sharing and diffusion techniques	Lead agency

Note: ICT = Information and Communications Technology; IIA = International Investment Agreement; SIRM = Systematic Investment Response Mechanism.

impact indicator specially developed for the SIRM is “investment retained.”

The calculation of the investment and jobs retained as a result of the SIRM is done as follows. Investors using the SIRM mechanism identify the amount of investment and jobs at risk due to the grievance (i.e. feasibility of which is at risk). In other words, the investor would be considering the following investment actions: withdrawal, no expansion, on hold. An investor might identify a certain share of their investment as being at risk, or their entire investment. Since the information is largely based on the subjective assessment of the investor (in terms of what they consider ‘at risk’), certain objective criterion (i.e. time, impact and actions taken) should be used to validate the data and determine the final amount of investment at risk.

Once the grievance is resolved, it is determined how much of investment originally identified as at risk is now saved or retained as a result of resolution of the grievance.

Thus, the formula to calculate the actual amount of investment retained is the following:

Investment retained = investment at risk when the grievance is registered in the SIRM (ex ante)—investment withdrawn (that is, existing investment withdrawn or expansion plans put on hold or canceled)

Investment can be counted as “retained” if the following conditions are met:

- Value of investment at risk ex ante > value of investment that was withdrawn or expansion plans canceled or put on hold by the year of the project close date.
- Investor acknowledges that the SIRM helped resolve their grievance.
- SIRM data show the status of the grievance as closed (resolved, escalated to legal dispute, or withdrawn).

It is important to ensure that the SIRM tracking tool has captured all the necessary data. If the SIRM tracking tool has not captured all the needed data points, ex ante and ex post surveys may be necessary. Estimating jobs retained uses the same methodology as investment retained, but it uses the number of jobs as the indicator rather than the value of investment. As part of this component, the World Bank Group’s IPP team developed impact indicator guidelines specifying in detail data, the sources and variables to be collected, units of observation, data collection method, and methodology for setting the baseline and step-by-step calculation for the indicator.



PILOT FINDINGS

As of the writing of this paper, all the SIRM pilots other than the subnational one in Bosnia and Herzegovina are still in the implementation phase. However, every six months, a project supervision review has been conducted in which the progress of each pilot is evaluated and discussed on the basis of the monitoring and evaluation methodology. Thus, for the few pilots that have reached an advanced stage, they provide a significant wealth of findings. Such preliminary results can be analyzed by focusing on three types of questions. (i) To what extent do the pilots confirm empirical research findings on the relationship between political risk arising from government conduct and FDI investment retention and expansion? Further, on the basis of the pilots, what practical lessons can be learned on (ii) the operation of the different SIRM components and (iii) the political economy perspective of the SIRM? Each of these categories of findings are further discussed in the following subsections.

KEY FINDINGS

Although it may be early for a sample big enough to generate statistically relevant data, the pilots provide some preliminary, firm-level anecdotal evidence on the types of grievances impacting the investors, the most frequent issues generating conflicts, the most commonly affected sectors, and some—albeit very initial—estimates of the magnitude of investments at risk that have already been retained and expanded in selected cases (box 4).

BOX 4. SIRM PILOTS: PRELIMINARY ESTIMATES OF INVESTMENT RETAINED AND EXPANDED

Three FDI projects where the amount of investment effectively retained/expanded has been properly verified according to the World Bank Group monitoring and evaluation methodology, resulted in US\$ 200 million in investment retained, US\$20 million in reinvestments, and a conservative estimate of US\$ 10 million in public cost savings derived from verified prevention of three ISDS cases.

A trend that is evident from the data collected so far is that the number of grievances that are serious enough to place investment at risk (39 in total, counting all the pilots) tends to be significantly lower than the number of minor issues and problems that investors face in their routine operations. Thus, the agencies providing aftercare services will always have a higher operational burden in number of requests, compared with any lead agency in charge of the SIRM. However, the level of investment at risk will logically contrast sharply. For instance, based on the experiences of the case studies of Korea and Costa Rica, taking as a sample a two-year period to calculate an average, less than 5 percent of the total number of cases dealt by the IPAs were at some point serious enough to be considered as placing investments at risk. In the case of a properly functioning SIRM, such rate should be 100 percent. Although in contrast to the SIRM, the number of cases submitted to aftercare will always tend to be

significantly higher, the opposite trend will tend to occur for the impact calculated based on the investment retained indicator.

If the trends supported by the empirical data are correct, the SIRMs should lead to considerably greater amounts of FDI retained, in sharp contrast to aftercare services, simply because investors' issues handled by IPA aftercare services are rarely

serious enough to place any FDI project at risk of withdrawal or expansion cancellation. Preliminary evidence from the SIRM pilots already seems to confirm such a trend. Only counting three FDI projects where the amount of investment effectively retained/expanded has been properly verified according to the World Bank Group's monitoring and evaluation methodology resulted in US\$200 million in investment retained, US\$20 million

TABLE 6. PRELIMINARY DATA FROM THE SIRM PILOTS

Issue classification/ country	A	B	C	D	E	F	G	Total
Sample period	Jan 16 – Dec 17	Jan 18 – Oct 18	Dec 16 – Jun 18	Jan 15 – Dec 18	Sep 16 – Mar 18	Jul 17 – Sep 18	Jan 17– Nov 18	
Expropriation	-	-	2	3	2	-	-	7
Breach of contract	-	1	2	2	-	4	-	9
Restriction of transferability and convertibility	-		-	-	-	-	-	0
Sudden/arbitrary regulatory changes	2	3	6	5	4	0	3	23
Contradictory government action	2	1	-	-	-	-	-	3
Lack of transparency	-	1	5	-	-	-	-	6
Discriminatory treatment against foreign investors	-	-	-	-	-	-	-	0
Abuse of authority	0	1	1	5	4	0	3	14
• Lack of proportionality	-	1	-	1	-	-	-	2
• Abuse of discretion in interpreting laws and regulations	-	-	1	3	2	-	2	8
• Disguised targeted harassment throughout regulation	-	-	-	-	1	-	-	1
• Wrong interpretation of laws and regulations impairing investors	-	-	-	1	1	-	1	3
Total	2	4	10	10	6	4	3	39

in reinvestments, and a conservative estimate of US\$10 million in public cost savings derived from verified prevention of three investor-state arbitration proceedings that the affected investors were ready to start if their grievances were not resolved.

For the most common type of government conduct generating risk of FDI withdrawal and/or expansion cancellation, the pilots seem to confirm the findings of the Multilateral Investment Guarantee Agency/Economist Intelligence Unit 2009–13 Surveys and the 2017 Global Investment Competitiveness Survey. Patterns of sudden or arbitrary regulatory conduct seem to be the most common type of grievances placing investment at risk (box 5). Although each pilot sample has a different period, it is worth noting that with the exception of country “F,” the most common type of conduct

leading to serious grievances falls within this type of regulatory risk conduct. Specifically, abuse of authority, abuse of discretion when interpreting laws and regulations, and lack of transparency are the most common sources of grievances. Box 1 explains in more detail the basis and meaning of each of these subclassification categories.

Further, as shown in table 7, arbitrary conduct as perceived by investors invoking the SIRM tends to concentrate in matters related to taxation, compliance with investment incentives offered to investors (customs duties or tax benefits), customs procedures, cancellation or lack of renewal of licenses required for operations (for mining and services), problems related to renewal/cancellation of land leases, environmental and labor permit delays, or inspection infractions leading to

BOX 5. SUDDEN/ARBITRARY REGULATORY CHANGES

Sudden and arbitrary regulatory changes is a category comprising a wide variety of potential government action. Based on a review of the legal practice related to the application of international investment agreements, this category can comprise patterns of conduct like the following:

Contradictory government action. Lack of compliance by a public agency with a legitimate expectation raised on an investor based on a written commitment, by law, contract, or any other legally binding written instrument. This includes subnational agencies (like municipalities) or specialized offices (like customs authorities) refraining from complying with incentives or guarantees offered by the central government to investors (in particular incentives, in the form of tax or duty exemptions that are not respected).

Lack of transparency. Sudden changes in regulations or the form in which they are implemented taken without any prior notice, comment, or consultation with the affected investors. These changes can occur due to (a) change in government regime, (b) an interest group capturing the regulatory authority, or (c) blatant corruption.

Discriminatory treatment against foreign investors. This is when the government changes the laws and regulations with an open or disguised intention to tilt the level playing field in favor of one or several domestic investors.

Abuse of authority by the government. Even when investors may be notified or consulted, there may be abuse of power expressed in three ways:

- **Abuse of discretionary laws and regulations** derived from broad and often absurd interpretation of laws and regulations by bureaucrats. An example we have seen in one country is that to renew the license of a university, the regulatory authority required the serial number of the specific computers the university was planning to buy, even before the acquisition took place.
- **Disguised targeted harassment through regulations.** For instance, the government enacts a regulation that on its face is of general application, but in practice has been tailor-made against a specific investor (due to capturing of agency by interest groups or retaliation).
- **Lack of proportionality** between an action adopted by the government and the alleged public policy objective being pursued (for instance, withdrawal of a license to a university to continue delivering classes because some students were found cheating on exams).

TABLE 7. MAIN CHALLENGES IN SELECTED SIRM PILOTS

Country	Level/Main Challenging Areas
A	Subnational level: taxation, education, and culture policy; agriculture; and water access and supply
B	National: telecommunications, mineral resources, road and transportation infrastructure, and energy Subnational: operational permits and local content requirements for extractive industries
C	National: taxation, customs procedures, and construction permits Subnational: use of land for agriculture
D	National: mining, health regulations, telecommunications Subnational: construction permits
E	National: taxation, customs procedures, water and sanitation, transport concessions, and environmental matters
F	National: taxation, incentives, customs procedures, trading licenses, labor issues, and immigration Subnational: licensing and operational permits related to manufacturing, services, and use of land and extractives
G	National: taxation and customs procedures, construction, and government contracts Subnational: use of land

cancellation of operations. Interestingly, this finding confirms the trend revealed by empirical research that indicates that violations to the fair and equitable treatment is the most frequent investment protection guarantee invoked in ISDS proceedings and the most frequently breached in international arbitration awards.

Table 7 shows another trend where the SIRM pilots seem to provide preliminary confirmation of the empirical research. The data reveal the critical role that specialized and subnational regulatory agencies play in generating or preventing investor-state grievances.

The pilots clearly are evolving in confirming the findings of the empirical research previously undertaken by the World Bank Group's IPP team on the political economy of investor-state grievances and their impact on FDI divestments. Such conclusion calls for two immediate considerations. First, it is critical to continue efforts to provide governments with a minimum institutional infrastructure to enable more coherent coordination and collaboration between central national central authorities and subnational and specialized regulatory bodies, to foster greater FDI retention and expansion. Second, this only makes it more important to examine in greater detail the lessons from experience in deploying the SIRM concept and identify which elements are working well and

which ones are not (the next subsection focuses on this discussion).

LESSONS FROM EXPERIENCE

Most SIRM pilots are still in implementation; however, the projects are already generating very important practical and operational lessons on the key elements of the SIRM concept as well as its political economy in practice. The purpose of this assessment is to contribute to improving the execution of the final phases of existing pilots as well as for new SIRM projects that may be launched in the future.

LEAD AGENCY

Most of the pilots show that, rather than starting from scratch testing the idea of establishing a totally new agency in charge of the SIRM, it is more realistic, convenient, and politically feasible to build on the already existing network of agencies dealing with different dimensions of the investor-state relationship. That all SIRM pilots have been selected based on a "demand driven" approach helps show where reform champions locate inside the government, and where the mechanism could be anchored. Each country is different, but there is a clear pattern showing that demand for the SIRM has come from IPAs or agencies dealing with ISDS, that is, ministries in charge of administering

trade and investment agreements or the ministry of justice. Although the former are keen in improving their aftercare services for investors and have shown particularly keen interest in tracking mechanisms to develop their customer relationship management systems, the latter type of agencies are keen on responding to an increase in ISDS litigation activity and thus preventing grievances from escalating into international arbitration.

A key lesson from the pilots is that it should not be assumed that a single lead agency must undertake all stages of the SIRM, nor that the lead agency will act as the point of contact communicating with investors. In some countries, that role can be played by IPAs, whose key mandate visualizes investors as customers, which have the incentive to receive and transfer any issue they may have and advocate within the government for its quick resolution. However, the pilots have shown that it is absolutely critical to avoid confusing the role of an IPA providing aftercare services with the role of the lead agency in leading the SIRM.

IPA aftercare may be extremely useful as a window for receiving submissions by investors interested in invoking the SIRM. However, their mandates, staff profiles and positioning within the government do not enable most IPAs to resolve those grievances properly. Further, the pilots have shown that there are many factors that de-incentivize IPAs from collecting data on FDI lost, as it is perceived that such information would show the weaknesses of the IPA. The SIRM requires the collection of data on successful and unsuccessful cases. Moreover, such data may be particularly useful for fostering an agenda leading to improvement of the government as a whole. Such opportunity will be lost if data on cases leading to investment lost are not collected.

Despite often not being well positioned to act as the lead agency of the SIRM, IPAs are called to play a critical role in the mechanism. IPAs may act as one of the possible reception windows for filing the SIRM grievances, which would be immediately forwarded to the lead agency for filtering and assessment. And, as part of their advocacy role to improve the domestic investment climate,

IPAs could collaborate with the lead agency in the process of information sharing, diffusion, and advocacy of the SIRM system, vis-à-vis all investment stakeholders. Further, IPAs would be key in receiving and following up all the investor-state grievances that do not entail any risk of FDI divestments. During the filtering stage, such grievances may be taken out of the SIRM workflow, but they nevertheless require attention.

In principle, any unit within a regulatory body with direct access to the highest political authority within the administration could play the lead agency role. For instance, in Ethiopia and Rwanda, there are investment authorities that are mandated by law to deal with investment policy issues. In Mongolia, an Investment Protection Council has been established and closely linked to the Chief Cabinet Minister Secretariat. In Georgia, a Business Ombudsman closely reports to the Parliament and the Cabinet. In Colombia, the directorate in charge of negotiating and implementing IIAs of the Ministry of Trade Industry and Tourism reports to the Ministerial Commission of the “System Enabler to Attract Investment,” where the IPA also participates. In all these cases, the standing of the lead agency in the end depends on the empowerment vis-à-vis “offending agencies.” Such empowerment comes with the degree of proximity the lead agency has, even at a personal level, with the highest authority of the government. Such proximity stems not only from the powers and mandated attributions conferred on the lead agency by domestic legislation, but also from the fact that the lead agency becomes the SIRM Secretariat, centralizing oversight and preparing the basis for an informed decision that a collegial political decision-making body makes in the end.

The pilots have also shown some practical considerations that should be taken into account, given the political clout of the lead agency. Because of the lead agency’s potential visibility to the head of government, but also vis-à-vis the private sector, the position of chair of the lead agency is a politically interesting post. Thus, for instance, in the case of one pilot, the chair of the lead agency was quickly promoted to a ministerial position.

Such move became a temptation to move the SIRM functions to the ministry now housing the newly appointed minister, as a result slowing the progress of the pilot.

Another risk associated with the required proximity of the lead agency to the highest government authority is that in countries with frequent alternations of power between administrations, the stability of the lead agency may also be negatively affected due to constant changes in government. This is a challenge that may affect countries with parliamentary systems of government, where ruling coalitions may be very fluid, leading to political instability. For instance, in another pilot, despite the high-level political consensus on setting up the SIRM, and even the ease with which regulations were enacted to anchor the system, the pilot was significantly delayed due to a more frequent than expected change in administrations.

The potential for significant political dividends derived from a well-functioning SIRM has also shown how critical it is to let the agency requesting the SIRM assume that it will be automatically appointed as the lead agency of the process. In more than one pilot, such thirst for political credit has led the agency counterpart requesting the SIRM to make it more difficult to engage the pilot with other agencies in the process, due to fears that peer agencies will become competitors for the SIRM leadership.

A frequent question arising in the pilots when identifying the lead agency has been whether the SIRM should be anchored within a new investment ombudsman office, and if the latter should be independent and impartial and, consequently, detached from the central administration. This question often arises in the context of Korea's experience, where OFIO is recognized worldwide, and it is frequently cited among the best practice examples of institutions that are successful in retaining and expanding a significant amount of FDI and number of jobs. In the case of Korea, such model has been quite successful (annex B).²⁹ common question countries that have considered establishing an ombudsman office to anchor the

SIRM is whether and to what extent such lead agency should be impartial, independent, and separate from the rest of the administration. In some countries, this approach may work well, like in some countries of Central Asia where ombudsman offices have been oriented to the specific mission to deal with endemic corruption in the administration. In the context of the SIRM, however, some pilots show that, at least in some countries, having a totally independent ombudsman office playing an oversight role over the administration, rather than collaboration with and within the administration, may in the end lead to more confrontation and thus limiting its effectiveness to address the regulatory risks derived from government conduct.

TRACKING TOOL

The pilots have also been extremely useful in providing practical lessons on the setup and implementation of the SIRM tracking tools. Practical experience has revealed two types of challenges. First, those related to the scope of the tracking tool and, second, those related to properly capturing and processing relevant data.

On the scope of the tracking tool, governments often seek a comprehensive ICT solution that can track the evolution of FDI along the different stages of the investment cycle, from the moment an investor announces its interest in investing in the host country, to the decision to invest, the establishment of the investment, the operation, and even the potential exit of the projects. Such a system entails merging the tracking system used for investment attraction and aftercare with that which may be used by the lead agency to track FDI at risk of divesting. The idea of having one single integrated tracking system centralizing all the stages of the FDI cycle is clearly attractive. Yet, practice has shown that such an outcome may be difficult to reach, especially in some country contexts.

Centralizing the tracking of all FDI established in the host country presupposes the existence of a screening mechanism or at least a single registration record for FDI. The majority of the countries do not have any FDI screening, and those that keep

investment registration systems, based on sound policy reasons, do not distinguish between FDI and domestic investment. Further, different types of FDI enter the country by interacting with different agencies, not just one or the same. For instance, even in countries with strong investment authorities, which would be more easily positioned to track most FDI, concessions and licensing related to access to land or natural resources, as well as direct contracts between investors and government agencies as part of government procurement or public-private partnerships, fall under the jurisdictions of different specialized agencies.

Within this context, attempting to have a single comprehensive tracking system for all FDI transactions would entail a significant, difficult, and certainly extremely expensive exercise. The pilots have shown that it is more realistic, effective, and economical to go for tracking approaches that are focused on a particular stage of the FDI cycle, rather than attempting to build a huge, integrated solution that in the end may not even see the light of day.

For the SIRM, a tracking tool, whether stand alone or part of an integrated system, is critical to the functioning of the lead agency. The tracking tool may be in the form of a simple excel based tool or a more sophisticated software. This decision is based on the resources, capacity and existing IT systems used in the country. Key aspects that should be taken into account, are the data fields and fundamental functionalities that will support lead agency in performing its role. Tracking systems for aftercare should be pursued by IPAs but should not be merged with the SIRM tracking tools. The logic is that the overwhelming majority of the issues addressed through aftercare will never qualify as issues placing FDI at risk, and thus would not be relevant for the SIRM. Further, many of the investors affected by grievances in the natural resource sector or services may fall beyond the mandate of IPAs, and thus will never be captured by their aftercare tracking systems. The solution seems to be to enable IPAs and SIRM lead agencies to have their own simple and low-cost tracking tools, with the possibility that both types of agencies can remand cases to one another.

Another lesson learned from the pilots relates to issues of capturing and properly processing relevant data using the tracking tool. At the core of the SIRM is the identification of investment projects at risk of withdrawal or cancellation of expansion plans. The investment retained indicator is precisely based on that assumption, since FDI projects that were not at risk could not be considered as retained due to the SIRM intervention. Capturing the data entails two stages: first, determination that the FDI affected by the grievance is effectively at risk, and second, estimation of the associated amount of capital or number of jobs at risk of being lost as a result of the grievance.

On the first aspect, determining the risk, the pilots have shown that, in some cases, lead agencies have felt pressure to admit and process all types of grievances, even those that are not effectively placing investment at risk. This has occurred not only as a result of the lead agency's intention to avoid any political cost associated with the rejection of a submission, but especially in countries that lack an effective aftercare program to forward those problems. And, in some circumstances, lead agencies have felt pressure to receive and process all submissions and refrain from rigorously filtering the grievances in an attempt to legitimize the SIRM—and themselves—and quickly start generating success stories. Such experiences show that governments do not always have the right incentives to apply the SIRM methodology with sufficient rigor, and this may in some cases lead to using the SIRM more as an aftercare than a regulatory risk mitigation program.

On the second aspect, estimation of potential loss, in certain cases, the lack of rigorous application of the SIRM methodology in some limited cases has led to exaggerated figures on investment retained and expanded. So far, that the World Bank Group's projects are subject to regular supervision and strict monitoring and evaluation processes has ensured that this has not become a problem. For the same reason, a challenge of tracking systems in the SIRM pilots has been to measure the investment lost as result of unresolved grievances. Tracking lost FDI may be a sensitive issue, not only for the host

country in general, but also for some lead agencies. To deal with these challenges, a potential solution would be to include in the directive, regulation, or law governing the SIRM an obligation to report explicitly data that could later be audited by a third party. Such data could include figures on: (i) the number of cases forwarded by the lead agency to IPAs due to filtering reasons, and (ii) the number and detailed records of grievances not yet resolved by the SIRM system, thus enabling a third party to verify or even independently make estimations of the amount of investment and number of jobs lost.

Finally, experience has shown that in order to capture all the data required for the SIRM to properly operate, in addition to the simple pre-designed templates usually used for investors to submit their grievances to the lead agency, it is paramount that in the filtering process the later can follow up and arrange personal interviews with investors. Indeed, experience has shown that some of the data required to properly assess the grievance, in particular the amount of investment and number of jobs at risk, may be sensitive for investors to transmit in writing due to intra-firm approval processes. Many of the pilots are already dealing with this challenge by arranging interview templates and model questionnaires that personnel from the lead agency can use when carrying out interviews. This approach seems to be working.

Further, in some countries, certain investors have shown doubts about using the SIRM due to fears of potential government reprisals for what they perceive might be interpreted as showing disconformity with the host authorities. This is particularly the case for certain investors who are parties to public procurement or other government contracts. This finding shows the importance of the information-sharing activities that the lead agency must carry out when deploying the SIRM, explicitly stating the government's intention for investors to consider freely the advantages of using this mechanism. Further, this finding shows the importance of exploring and promoting the use of contractual conflict management mechanisms to address these kinds of grievances.

ECONOMIC AND LEGAL ASSESSMENT

Once a grievance is registered in the tracking tool, the next step in the SIRM process is to undertake the estimation of investment and jobs at risk as well as the potential liability for the state should the grievance escalate into a legal dispute. The challenges related to the estimation of investment at risk have been discussed. On the legal analysis examining the potential state liability, contrary to what was originally expected in many of the pilots, countries often have cadres of professionals who are well-versed in domestic and international investment regulation and are capable of quickly assessing and typifying investor-state grievances.

The challenge has been that those experts are usually mapped as staff of the ministry of foreign trade in charge of negotiating IIAs or to the ministry of justice, in charge of representing the country in ISDS cases. Those technical experts are already dealing with significant workloads, and they often have limited or no time available for cross-support to the SIRM lead agency. However, there is an intrinsic interest of both these ministries to have the SIRM work properly. Ensuring proper implementation of the IIAs is a key mandate for ministries of trade negotiating IIAs. Further, the data generated on the types of issues addressed by the SIRM would also be extremely useful for these ministries in their consultations with private sector stakeholders, who often are invited to participate in the annual international ministerial meetings that many IIAs are mandated to celebrate. For ministries of justice, the more disputes are prevented, the lesser is the workload they will have dealing with international litigation.

The pilots have shown useful steps to cope with this challenge. First, the provision of tuition scholarships to world-class training modules in prestigious universities has been a useful incentive to enable temporary assignments of national legal experts to the SIRM lead agency. The advantage has been that such alternatives have been possible to obtain at a very low cost, due to cooperation arrangements between the World Bank Group and academic institutions.

Second, strengthening already existing capacity through additional support by international organizations has proven to be a good way forward. However, capacity-building programs only develop concrete results provided that three conditions apply. First, more than providing individual, ad hoc training sessions, it is critical to develop a curriculum for a multi-session training program including evaluations and grading to ensure effective learning by the participants. Second, the certification program should be aimed at a pre-selected cohort of officials who are forced to attend all the sessions to “graduate” after completion of all the requirements. Success in that capacity-building program should also be part of the professional yearly evaluation many governments carry out for their officials every year. Third, the capacity-building programs must be subject to monitoring and evaluation processes that determine the ratio of people who are approved for the courses coupled with a cost-benefit analysis.

Setting up a SIRM entails a relatively small budget compared with the costs associated with the lack of such mechanism. Indeed, the cost of setting up an SIRM is less than one-third of the lowest average estimation of the litigation costs of just one investor-state dispute. This means that if an SIRM can be used to prevent just one case, it would already be cost effective for the countries. This calculation does not take into consideration the amounts saved in terms of FDI retained and expanded, or the resources saved in preventing a potential award for damages in an eventual dispute. These data should make it easy for the ministries of finance to become one of the main champions of the SIRM. However, so far, no single pilot has been impaired for lack of resources anyway.

INTERAGENCY PROBLEM SOLVING

All the pilots have shown that, to facilitate the success of a SIRM, it is essential to ensure the empowerment of the highest level of the executive from the inception of the mechanism for it to be credible and effective. The SIRM entails the establishment of a small yet very well-trained team in investment law and negotiation skills to deal

with peer agencies. At the same time, the team must have the full trust and support of the office of the head of government, to be able to speak on its behalf if necessary. The pilots have shown that getting the highest political support and qualified people is not difficult. The challenge is to get both types of requirements at the same time. Often, the president’s or prime minister’s office lures excellent professionals, yet they end up being caught fulltime in their tasks. And often, countries have excellent technical cadres, yet they lack access to high political levels.

However, the pilots have shown that these challenges are far from being insurmountable. Although it may take some time, practical experience shows that, in the end, such a task force can be created, and the very process of establishing an SIRM can facilitate that result. Further, rather than creating a new institution, the SIRM pilots have shown that it is critical to work on tweaking existing institutional frameworks and adapting existing institutions rather than starting from scratch.

On problem-solving techniques, the SIRM pilots have shown that the most common method for seeking collaboration between the lead agency and its peers is direct negotiation, ranging from informal exchanges, escalating to peer pressure, and eventually negotiating in the “shadow of the law” or even in the “shadow of power.” However, the most efficient way lead agencies can get peer agencies to collaborate is through “soft” power.

Even when the political clout of the lead agency is clear to ensure the SIRM will work in the long term and generate an impact in changing the administrative culture within government, it is important that the lead agency offers its peers the possibility to gain recognition for their collaboration. To achieve such objective, an idea that has been discussed in the context of the pilots is to include in the lead agency’s annual reports the amount of investment and number of jobs retained and the associated results of the agencies that have collaborated to achieve such goal. Another idea has been to include in already existing indexes measuring the performance of institutions

indicators reflecting the degree of collaboration of peer agencies in governmentwide efforts to retain investment and jobs.

Along the same lines, the pilots have also demonstrated the importance of personal and professional networks of staff working in the lead agency. Lead agencies with personnel who have been involved in IIA negotiations or ISDS cases have the advantage that, as part of their previous tasks, such professionals have had to interact with colleagues in many of the other peer agencies that are later involved in investor-state grievances.

For instance, in the case of one country, many grievances have been easily solved at a technical level due to the good will and personal familiarity between staff from the lead agency and the agency involved in the conflict. Such familiarity has been developed during previous negotiations of IIAs where the lead agency, in this case a ministry negotiating trade agreements, consulted specialized agencies and involved the latter in the negotiation process. Thus, when it later became time to implement and verify compliance with the treaty previously negotiated, the communication channels between the lead agency and its peers were already open. This finding has a very practical implication for the SIRM. The lead agency should not wait for a grievance to arise to interact with other peer agencies. The greater is the interaction through activities not directly related to a particular grievance—such as trainings on IIAs, joint symposia on investment-related topics, and other activities that could be included as part of the SIRM information-sharing activities—the easier it will later be for the lead agency to resolve investor-state grievances at a technical level.

Further, information-sharing activities would also play a double role in the SIRM. These activities would provide a vehicle for properly informing peer agencies about the content and importance of IIAs, investment protection, and other issues with which the latter are usually not familiar. In addition, information-sharing activities could be used as part of a communications campaign to promote greater interaction between staff from the lead agency

and their peer professionals whose collaboration may later be sought in the context of subsequent investor-state grievances.

A fundamental finding derived from observing successful problem-solving techniques in the SIRM pilots is the critical role that IIAs, not domestic law, play in enabling the lead agency to negotiate in the “shadow of the law” when seeking the collaboration of peer agencies. The same can be said of the very persuasive effect that diplomatic pressure exerted by investors’ home-state governments can have in the political economy operation of the SIRM. On the first point, the pilots have shown that the practical implication of using IIAs, rather than domestic legislation, as a point of reference for the lead agency to negotiate in the “shadow of the law” is twofold. First, international treaties have higher legal ranking than domestic laws—the interpretation of which is often invoked as the basis for the “offending” agency to justify its conduct.

Second, the pilots suggest that escalating grievances can play a critical role. Indeed, the whole logic of negotiating outside official legal channels is based on the premise that, in the case of no agreement, the parties may invoke adjudication procedures to enforce the rights conferred by law. If the possibility of effectively enforcing rights does not exist, rule-based negotiation becomes pointless. This is an important conclusion, as it implies that the most useful function of any international investor-state adjudication mechanism, being arbitration or an international investment court, is to act as a deterrent for undesirable conduct. ISDS should work by being a credible option to address grievances, the cost of which would encourage the parties to make all efforts to prevent recourse to it. Non-litigious means of investment conflict management require clear IIA rules and the real option to pursue costly enforcement through adjudication as a last resort. Simply put, ISDS is like a “nuclear option.” It increases the cost of no-rule-based agreement to such extent that the parties would genuinely make an effort to settle. Without ISDS, the parties would simply lose a useful tool for fostering domestic discipline.



CONCLUSION

The SIRM pilots have provided a unique opportunity to address a blind spot of investment policy making. The work done through the pilots has effectively connected the dots between applied research and real-world experiences. Starting with empirical research examining the impacts of political risks derived from government conduct on FDI retention and expansion, and translating those findings into the SIRM, the SIRM pilots have made it possible to test how such design may work, and which elements may need to be tweaked, when applied to the reality of various developing countries.

The SIRM concept has been successful in three key aspects. First, it responds to a need that has been validated by many governments. Second, it is a realistic tool that can be implemented at a low cost relative to the cost of ISDS. Third, it can be implemented within the timeframe of one government administration (three or four years).

However, there are two important caveats. First, by its very collaborative nature, the SIRM may only deliver effective results when there is clear and effective support from the highest levels of government. Such explicit and direct empowerment is essential to enable the mechanism to function properly and generate trust among investors. Second, although they may complement aftercare services, SIRMs are not intended to replace them, or vice versa. Although both may entail addressing investors' concerns once they are established in the host country, the SIRM is a tool with very different objectives, processes, and political-economic dynamics compared with those of aftercare services.

Contrary to the latter, the success of which may be measured by the number of inconveniences that IPAs may assist investors in solving, in the case of the SIRM, the number of serious grievances should ideally be significantly lower. Rather, the impact of the SIRM should be assessed by the amount of investment and number of jobs that, despite having been at risk of being lost, are nevertheless retained or expanded as a result of the SIRM. Although most of the pilots are still in implementation, they have shown that just counting a few of properly verified cases has shown impact translated into hundreds of jobs and hundreds of millions of dollars in investment retained.

In contrast to aftercare enquiries, the number of SIRM cases will always be significantly lower. This means that, at least in principle, the SIRM could be a tool that is not exclusively targeted to foreign investors, but also could address serious investment grievances from national investors as well. Such finding has significant policy implications, a key one being opening the possibility to use IIAs to level the playing field among foreign and national investors when dealing with public agencies in the host state. The SIRM would use the IIAs as criteria for domestic, rule-based interagency negotiations. Considering that in some countries domestic investors are exposed to a lower level of protection than their foreign counterparts covered by an IIA, at least in those contexts, the SIRM would have the effect of upgrading the standards of protection for domestic investors. In this sense, the SIRM would be the tool to ensure that IIAs benefit all investors and not just foreign ones.

The SIRM has the potential to level the regulatory playing field upward. In a couple of the pilots, some of the larger multinational enterprises and top national investors seem not to perceive the SIRM as an immediate necessity for them. Indeed, given their direct access to the highest instances of government, heavyweight investors may not need an SIRM to make their voices heard. This may lead to the conclusion that the SIRM may be more useful for medium-size and smaller investors.

Although the SIRM responds to the need of governments to set up a minimum institutional infrastructure quickly to coordinate statewide responses to investor-state grievances, it is just one of the various alternatives envisaged in a dispute system that is designed to manage conflicts early on. For instance, to respond to the specificities of investments in certain sectors or under certain types of contracts, it may be worth taking the SIRM concept further and exploring ways to adapt it or other mechanisms for dealing with those specific types of conflicts.

The SIRM pilots are ongoing, and thus practical lessons will continue to be learned and the SIRM will continue to be finetuned. However, based on the empirical research discussed in part 1 of this paper and the work done on the SIRM pilots, is it possible to identify key implications and lessons for policy making going forward:

- Including investment retention and expansion in policy making is critical, and the SIRM is a useful tool in this respect. Discussions that place too much emphasis on initiatives

aimed at investment attraction have the effect of downplaying equally important initiatives on investment retention and expansion, which, paradoxically, are often much easier to implement.

- Investment retention and expansion and dispute prevention are distinct, and one may not necessarily entail the other. Governments should therefore avoid confusing mechanisms to prevent ISDS disputes (dispute prevention) with mechanisms to prevent investors from withdrawing or canceling FDI projects.
- By inducing the desired behavior among domestic regulatory agencies, the SIRM can serve as a tool for properly implementing IIAs on the ground and in a way that is more in tune with their original intent to mitigate political risks in cross-border investment transactions. At the same time, by improving the domestic institutional framework and inducing positive changes in the investment climate, the SIRM would equally benefit domestic investors.
- The empirical research that led to the design of the SIRM concept and its initial positive performance draw attention to the merits of including FDI retention and expansion within the broader discussion on investment facilitation in various international forums. A mechanism such as the SIRM can respond to the need of governments, to help them quickly set up an institutional infrastructure to coordinate statewide responses to investor-state grievances.



MIGA-EIU SURVEY METHODOLOGIES³⁰

MIGA-EIU POLITICAL RISK SURVEY 2009

The survey was conducted on the Multilateral Investment Guarantee Agency's (MIGA's) behalf by the Economist Intelligence Unit (EIU). The survey was conducted in June 2009 and contains the responses of 351 executives from multinational enterprises around the world. Quota sampling was used to ensure that the industry and geographic composition of the survey sample approximates actual foreign direct investment (FDI) outflows: following a first round of responses to the questionnaire, additional e-mail campaigns targeting respondents in specific sectors or locations were conducted until all the demographic quotas were met. All respondents were involved in, or familiar with, their company's investment plans in emerging markets, and 47 percent described themselves as board members or C-level executives. They represent companies with global annual revenues of US\$500 million or more and 37 percent exceed US\$10 billion on an annual basis.

MIGA-EIU POLITICAL RISK SURVEY 2010

The survey was conducted on behalf of MIGA by the EIU. The survey was conducted in June 2010, and it contains the responses of 194 executives from multinational enterprises investing in developing countries, 55 percent of which were also represented in last year's survey. Quota sampling was used to ensure that the industry and geographic composition of the survey sample approximate the

composition of actual FDI outflows to developing countries: following a first round of responses to the questionnaire, additional e-mail campaigns targeting respondents in specific sectors or locations were conducted until all the demographic quotas were met.

MIGA-EIU POLITICAL RISK SURVEY 2011

The survey was conducted on behalf of MIGA by the EIU. The survey, which was carried out in June/July 2011, contains the responses of 316 senior executives from multinational enterprises investing in developing countries. Eighteen percent of the respondents in the 2011 survey also participated in the MIGA-EIU Political Risk Surveys of 2009 and 2010. Quota sampling was used to ensure that the industry and geographic composition of the survey sample approximates the composition of actual FDI outflows to developing countries: following a first round of responses to the questionnaire, additional e-mail campaigns targeting respondents in specific industries or geographic locations were conducted until all the demographic quotas were met. For some questions, the percentages add up to more than 100 percent because of multiple selections.

MIGA-EIU POLITICAL RISK SURVEY 2012

The survey was conducted on behalf of MIGA by the EIU. The survey, which was carried out in July/August 2012, contains the responses of 438

senior executives from multinational enterprises investing in developing countries. Quota sampling was used to ensure that the industry and geographic composition of the survey sample approximates the composition of actual FDI outflows to developing countries: following a first round of responses to the questionnaire, additional e-mail campaigns targeting respondents in specific industries or geographic locations were conducted until all the demographic quotas were met. For some questions, the percentages add up to more than 100 percent because of multiple selections.

MIGA-EIU POLITICAL RISK SURVEY 2013

The survey was conducted on behalf of MIGA by the EIU. The survey, which was carried out in July and August of 2013, contains the responses of 459 senior executives from multinational enterprises investing in developing countries. Quota sampling was used to ensure that the industry and geographic composition of the survey sample approximates the composition of actual FDI outflows to developing countries. Following a first round of responses to the questionnaire, additional e-mail campaigns targeting respondents in specific industries or geographic locations were conducted until all the demographic quotas were met. For some questions, the percentages add up to more than 100 percent because of multiple selections.



REGULATORY RISK AND FDI

A recent study presents a new framework to measure regulatory risk that is linked directly to specific legal and regulatory provisions (Hebous, Kher, and Tran 2019). Regulatory risk in the study is related to characteristics of the legal and regulatory framework that might affect the expected profitability of a business. In the same vein that political risk reflects the variability in economic returns that stems from uncertainty about political events, concept is closely related to uncertainty about laws and regulations. It captures features of countries' regulatory frameworks that can limit the potential for unexpected losses due to arbitrary government conduct.

It is organized around 3 pillars – transparency and predictability, investment protection, and recourse mechanisms - drawing on existing indicators and newly constructed data on the content of selected legal instruments. Specifically, the measure covers the following questions:

- Is there transparency in the content as well as the process of making laws and regulations that apply to investors?
- What is the extent of legal protection provided to investors against arbitrary and non-transparent government interference?
- Do investors have access to effective mechanisms for recourse?

To ensure cross-country availability, the data used focuses on a few regulatory areas – investment

(specifically investment laws and treaties), public procurement, select doing business topics (property registration, construction permit, contract enforcement) and other cross cutting regulatory governance measures. An important criterion for all included data source is that they can be linked to specific regulatory provisions that lend themselves to government's action. The legal provisions included across all these data sources are “scored” based on how they increase transparency, protection, and access to recourse through a specific set of principles.

The study finds that regulatory risk, as measured in this framework, matters for investment. First, the constructed risk measure is associated with higher perception of risk as reflected in risk insurance premium and other risk ratings. Second, lower regulatory risk is associated with higher aggregate as well as bilateral FDI inflows and higher likelihood of multinationals to enter or expand in a host country. On average, a 1 percent reduction in regulatory risk increases the likelihood of an investor to enter or expand by between 0.5 to 2 percentage points. To put this result in further perspective, in the same model, the explanatory power of our regulatory risk measure on investment decision is comparable in magnitude to trade openness.

Finally, investors in different sectors appear to respond to changes in regulatory risk differently, indicating that countries wishing to attract certain types of investments should pay attention to investors' sensitivities to risk.

FIGURE B.1. COUNTRIES WITH HIGHER REGULATORY RISK TEND TO HAVE HIGHER EXPROPRIATION RISK PREMIUM

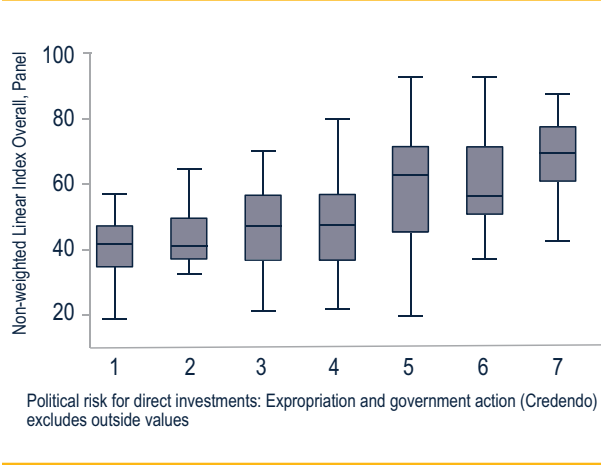
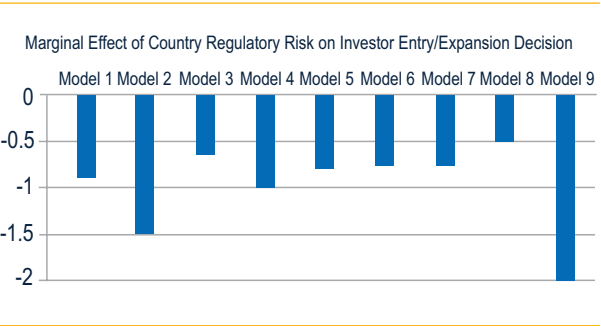


FIGURE B.2. MARGINAL EFFECT OF COUNTRY REGULATORY RISK



Note: Coefficient estimates and 95% confidence interval on regulatory risk from a discrete location choice model using investor-level (fDiMarkets) data. All models control for ln (population), ln (GDP per capita), GDP growth (annual %), and trade openness. In addition, model 1 to model 9 include one of the following variables in this order: lower secondary completion rate, bank deposits (% GDP), top combined Corporate Income Tax rate (%), WGI regulatory quality, Polity IV democracy measure, volatility of GDP per capita growth, exchange rate volatility, Fitch sovereign rating (categorical variables)



GLOBAL GOOD PRACTICE IN THE REPUBLIC OF KOREA

OVERVIEW

The Korean Office of the Foreign Investment Ombudsman (OFIO) aims to resolve grievances of foreign-invested companies operating in the Republic of Korea. OFIO was established in 1999, and the current seventh Ombudsman, Dr. Sung Jin Kim, was commissioned in 2018 (figure C.1). With years of grievance resolution experience, OFIO is considered successful in preventing disputes and improving Korea's investment environment.³¹ Korea's OFIO is often introduced as having the most well-known experience in the mechanism for investment retention and confidence.³² The United Nations Conference on Trade and Development and Asia-Pacific Economic Cooperation have reported that Korea's Foreign Investment Ombudsman system is an effective way to prevent investor-state disputes.³³

LEGAL BASIS AND HISTORY OF OFIO

OFIO is based on the Foreign Investment Promotion Act. Article 15-2 (1) of this Act says that, "for the purpose of supporting the affairs of grievance settlement in foreign-capital invested companies, the foreign Investment Ombudsman is commissioned from among the persons of abundant learning and experience in foreign investment business." The Ombudsman is commissioned by the president on the recommendation of the Minister of Trade, Industry & Energy, via the deliberation of the Foreign Investment Committee (Article 15-2 of the Foreign Investment Promotion Act).

FIGURE C.1. HISTORY OF THE OFFICE OF THE FOREIGN INVESTMENT OMBUDSMAN



The Ombudsman leads the Office of the Ombudsman, which provides aftercare and grievance management services. OFIO operates a “Home Doctor” system under which specialists from various fields, including labor, taxation, information technology and intellectual property, finance, living environment, customs, construction, and the environment, to provide foreign-invested companies with one-on-one service by investigating and resolving a wide range of grievances (figure C.2).

OFIO ACTIVITIES IN 2018

OFIO’s most important mandate in Korea is to address and resolve grievances experienced by foreign investors and foreign-invested companies in Korea through prompt aftercare services. In Korea, OFIO addresses all types of grievances, ranging from corporate management to the living environment of investors, including investment incentives, taxation, finance, foreign exchange, tariffs, customs, construction, environmental law, visa/immigration, and intellectual property. In 2018, OFIO resolved 269 cases, and the most frequently

raised grievance was about labor relations and human resources issues, followed by visa and immigration and investment incentives.

OFIO activities can also be categorized into three areas based on resolution type: legislative improvement, administrative intervention, and Home Doctor Resolution. Legislative improvement refers to regulatory reforms and/or a change in laws, and administrative intervention refers to steps taken to make improvements within an existing legal framework. “Home Doctor Resolution” refers to problems that are solved internally by Home Doctors, quite often through consultations. Specifically, a Home Doctor is assigned to each company and often visit to the site to identify and offer consultations about grievances.

In 2018, 58 percent of the cases were resolved by Home Doctor services, and 40 percent of the cases were resolved by administrative intervention. For six cases, grievance resolution was through legislative improvements, which could be reforms to ensure more certainty and predictability. For example, the Electrical Appliances Safety Control Regulation

FIGURE C.2. ACTIVITIES OF THE OFFICE OF THE FOREIGN INVESTMENT OMBUDSMAN

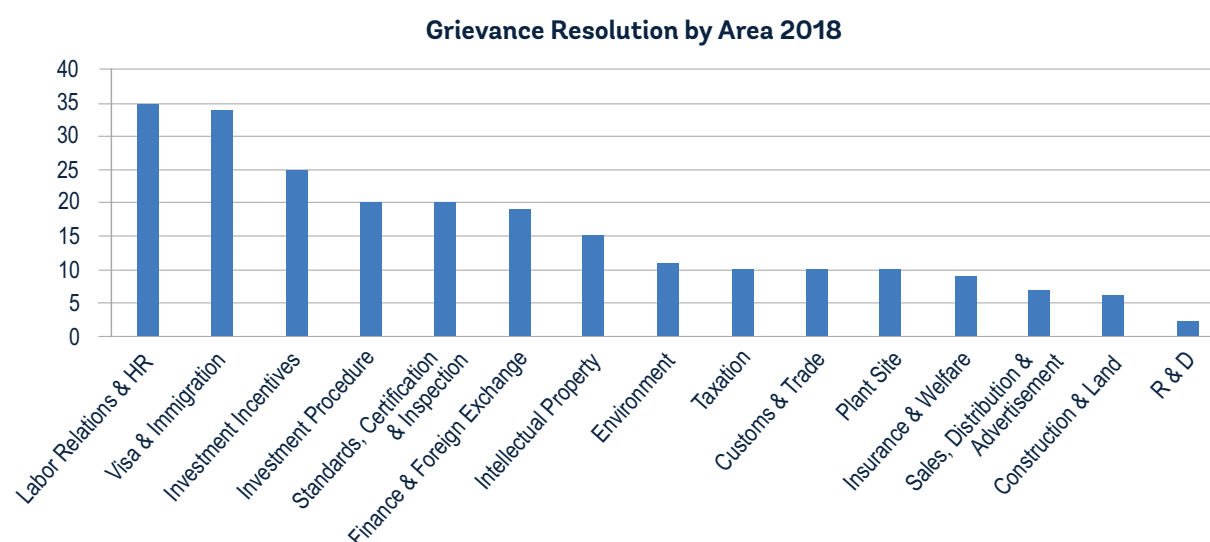


Source: InvestKorea Website
<http://www.investkorea.org/en/investkorea.do>

was amended reasonably to enhance legal stability and reflect the needs of investors. Moreover, the Korea Customs Service newly inserted a provision stipulating the definition of express goods under the

amendment regarding the notification on disposal of “Import Clearance of Express Cargos,” which was requested by the invested company.

FIGURE C.3. INVESTMENT GRIEVANCE CASES, BY TYPE



Source: 2018 Foreign Investment Ombudsman Annual Report.

TABLE C.1. GRIEVANCE RESOLUTION PERFORMANCE

Grievance Resolution Performance				(Unit: No. of Case, 2018)
Resolution Type	Legislative Improvement	Administrative Intervention	Home Doctor Resolution	Total
No. of Cases	6	108	155	269

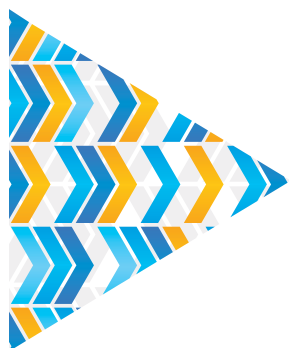


ENDNOTES

1. For a methodological note on these surveys, see annex A.
2. The first known treaty-based ISDS case was filed in 1987.
3. For the purposes of this paper, ISDS is a term comprising all mechanisms of international dispute resolution that provide a private right of action to foreign investors to enforce investment protection guarantees included in IIAs, through investor-state arbitration or any other dispute settlement mechanism.
4. The study presents a new framework to measure regulatory risk that is linked directly to specific legal and regulatory provisions. It is organized around 3 pillars – transparency and predictability, investment protection, and recourse mechanisms - drawing on existing indicators and newly constructed data on the content of selected legal instruments..
5. Enterprise Surveys are firm-level surveys of a representative sample of an economy's private sector. The surveys cover a broad range of business environment topics for 131,000 firms in 139 countries (www.enterprisesurveys.org).
6. The advantage of this data set is its global coverage of developing countries. However, a caveat is that country coverage in the World Bank Enterprise Surveys data varies from year to year. Only half of the foreign firms in the Enterprise Surveys data reported information on the percentage of fixed assets funded by internal funds/retained earnings, and many reported having 100 percent fixed assets financed internally. This figure might indicate potential reporting errors.
7. A review of the academic literature undertaken by MIGA (2009) shows that among those finding a negative co-relation between FDI and political risk are Kobrin (1979), Schneider and Frey (1985), Nigh (1985), Woodward and Rolfe (1993), Loree and Guisinger (1995), Lim (2001), Nonnenber and Cardoso (2004), Li (2005), Busse and Hefeker (2005), and Meon and Sekkat (2008). Another set of econometric studies focusing on particular case studies has not found political risk to be a clearly significant determinant of FDI; among them are Fatehji-Seddeh (1997), Wheeler and Mody (1992), Asiedu (2002), and Bevan and Estrin (2000).
8. Credendo expropriation risk premium, the EIU legal and regulatory risk, the International Country Risk Guide Political Risk Rating, and a constructed index of regulatory risk.
9. For a description of the survey methodologies, see annex A.
10. The 2009–13 MIGA/EIU Surveys asked investors about their prospects to invest in the near future, understood as in the following three years from the date of the survey. For a methodological note on these surveys, see annex A.

11. An EIU survey of 602 investors conducted in 2007 found that companies expected political risk to become a much greater problem for investments in the future than in the recent past, especially in emerging markets (EIU 2007). A survey by Ernst & Young identified political risk as the main investment constraint for companies based in developed countries (Ernst & Young 2007). A report from Lloyd's, in cooperation with the EIU, found that global businesses were becoming more concerned about risks from political violence. More than one-third of 154 survey takers said that they were avoiding overseas investments for fear of political violence (Lloyd's 2007). A report by Grant Thornton (2008), based on survey evidence, found political and economic stability to be of equal importance as market size and growth potential when determining the location of FDI. A survey by Atradius and EIU (2008) found that political instability tops the list of government or bureaucratic obstacles in emerging markets.
12. However, this finding should be pondered with care, as the majority of respondents to the 2017 GIC Survey were investors already with ongoing operations in developing countries rather than prospective investors.
13. Such findings echo the literature documenting the generally positive impacts of IIAs on FDI inflows (Echandi, Krajcovicova, and Qiang 2015).
14. In addition to the political economy factors that are explained in this section, a variable that may also explain the high number of claims based on fair and equitable treatment grounds is the vague and diverse wording used in this standard of protection in IIAs negotiated during the early 1990s. The use of vague wording in an international agreement has the effect of granting a significant degree of discretion to tribunals when interpreting treaty clauses. With many thousands of IIAs using similar yet different wording, combined with many arbitrators with different legal cultures and ideologies interpreting those texts, it is not surprising that interpretations of the FET standard have not always been precise nor consistent in international law jurisprudence. This has generated a degree of uncertainty among governments and investors alike, and likely contributed to a higher number of disputes.
15. ICSID case load data, 1987–2017.
16. ICSID case load data, 1987–2017.
17. Although figure 24 shows the sector distribution of the ISDS cases submitted to ICSID, the same pattern arises in cases submitted to ISDS under United Nations Commission on International Trade Law rules (2018 ICSID Case Law Statistics, [https://icsid.worldbank.org/en/Documents/resources/ICSID%20Web%20Stats%202018-1\(English\).pdf](https://icsid.worldbank.org/en/Documents/resources/ICSID%20Web%20Stats%202018-1(English).pdf)).
18. The data show that ISDS defendants over the period come from all regions in the world: 39 governments from Europe; 24 from North, Central, and South America; 32 from Sub-Saharan Africa; 17 from Asia; and 11 from the Middle East and North Africa (Wellhausen 2016).
19. Fair and Equitable Treatment: UNCTAD Series on Issues in International Investment Agreements II, United Nations, New York and Geneva 2012.
20. In addition to Korea, the World Bank Group's IPP team closely studied other aftercare programs implemented by investment promotion agencies in different parts of the world, including Ireland, Singapore, Costa Rica, Brazil, the Philippines, Mexico, and Turkey, among others.
21. The World Bank Group's IPP team undertook several case studies focusing on good practices undertaken by countries in the region in preventing investor-state disputes, including Peru, Mexico, Colombia, and Costa Rica.

22. Contrary to general aftercare programs, the SIRM is designed to deal not with all, but only those investor-state grievances that meet at least two requirements: (i) they are of such impact that it makes the investor claim that the investment project is at risk of withdrawal or at risk of generating a cancellation of an FDI expansion; and (ii) they stem from government conduct that may make the state accountable under domestic or international legal instruments. This point is further developed in section 4.
23. For a more detailed explanation of the political economy of grievances between investors, civil society, and governments in natural resource-seeking FDI, see Gonstead H. Mariana, A new chapter in natural resource-seeking investment: using shared decisions system design to strengthen investor-state and community relationships, in Cardozo Journal of Conflict Resolution, 2018, available online at https://heinonline.org/HOL/Page?handle=hein.journals/cardcore18&div=27&g_sent=1&casa_token=8fTL1eGunQAAAAA:9kLtP3JExybH5zp-Ts6uTGdm5qetMDLAIXijp9pBb7RAOT7yvBvmuuHwuYudpfBXuwo5MPE&collection=journals.
24. For such purpose, the SIRM design also developed a methodology to estimate in a practical, swift, and low-cost manner, the potential amounts of FDI and jobs at risk. For such methodology, please see section 3.
25. In addition, there are incipient projects in Afghanistan, Brazil, Myanmar, and the Kyrgyz Republic. In these projects, the diagnostic is in process, but a solution design has not yet been created and implementation has not yet started.
26. Some countries are using simple Excel tool to track and monitor cases. In other countries, tracking tool can be a part of broader Customer Relationship Management (CRM) system.
27. That is the case of the pilot in Rwanda. In Ethiopia, the lead agency initially used an Excel system, but it is now upgrading to an online portal system to allow for easier registration, tracking of investment grievances, and electronic data exchange. The online system launch will be done as part of the installment of a full customer relationship management system that will not only track minor inconveniences experienced by investors, but also grievances placing investment at risk resulting from government conduct. Once set up, it will fully integrate workflows and data management end-to-end.
28. Early neutral evaluation is the legal opinion of an expert external to the government on a particular grievance, assessing the prospects of losing or winning a case should the conflict escalate into an ISDS process.
29. In the context of the SIRM pilots, despite the success of the Korean OFIO, many governments have opted for different models, basically to avoid all the problems associated with creating a new institution, but also due to financial, administrative culture, and political economy considerations.
30. Excerpts from MIGA Reports on World Investment and Political Risk for 2009, 2010, 2011, 2012 and 2013, available at: <https://openknowledge.worldbank.org/discover?query=MIGA%20political%20risk%20reports>.
31. Invest Korea website, <http://www.investkorea.org/en/index.do>.
32. Investment Protection Toolkit, p. 125.
33. Invest Korea website, <http://www.investkorea.org/en/index.do>.



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