



Retention and Expansion of Foreign Direct Investment

Political Risk and Policy Responses

Summary of Research Findings
and Policy Implications

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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 (Figures 1 and 2). According to the new discontinued Multilateral Investment

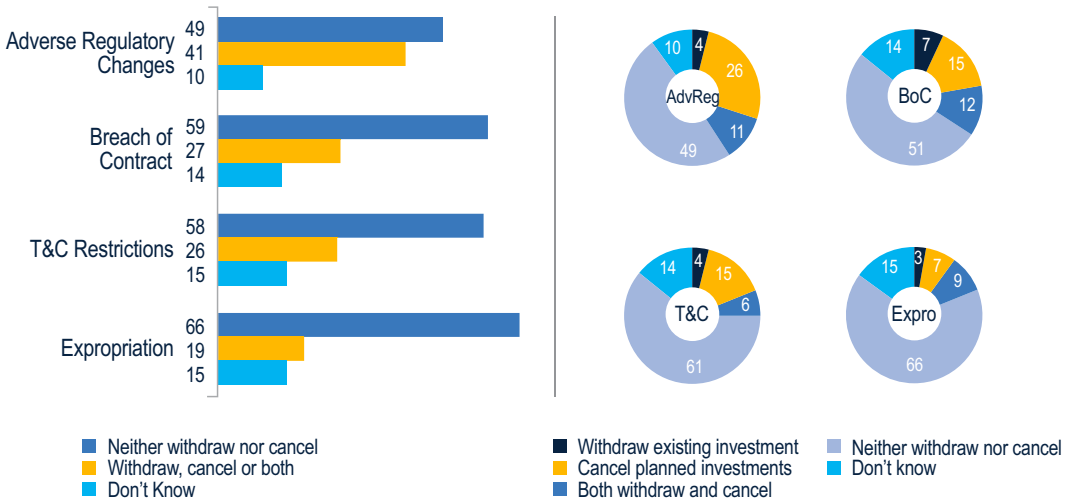
Guarantee Agency surveys conducted between 2009 and 2013, political risk was the most important constraint for FDI in developing economies. The types of political risk include factors such as adverse regulatory changes, breach of contract, and transfer and convertibility restrictions. Similarly, the 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 (Figures 1 and 2). 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 adverse regulatory changes as the most frequent government conduct inducing FDI withdrawals and cancellations.

FIGURE 1. WITHDRAWAL OF EXISTING INVESTMENTS OR CANCELLATION OF PLANNED INVESTMENTS OVER THE PAST TWELVE MONTHS DUE TO POLITICAL RISKS (% OF RESPONDENTS)

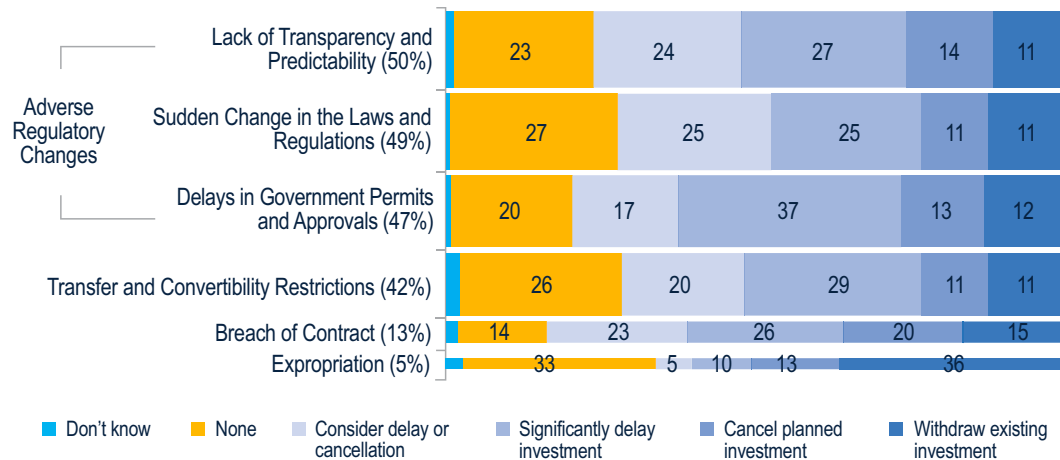


Source: MIGA-EU Political Risk Survey 2013

Note 1: T&C (Transfer and Convertability), 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.

FIGURE 2. IMPACT ON FDI OF POLITICAL RISKS DERIVED FROM GOVERNMENT CONDUCT (% OF RESPONDENTS)



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

Note: The height of the bars and the numbers across rows reflects the percentage of respondents that experienced disruption in any of their investments owing to the political risk identified.

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.

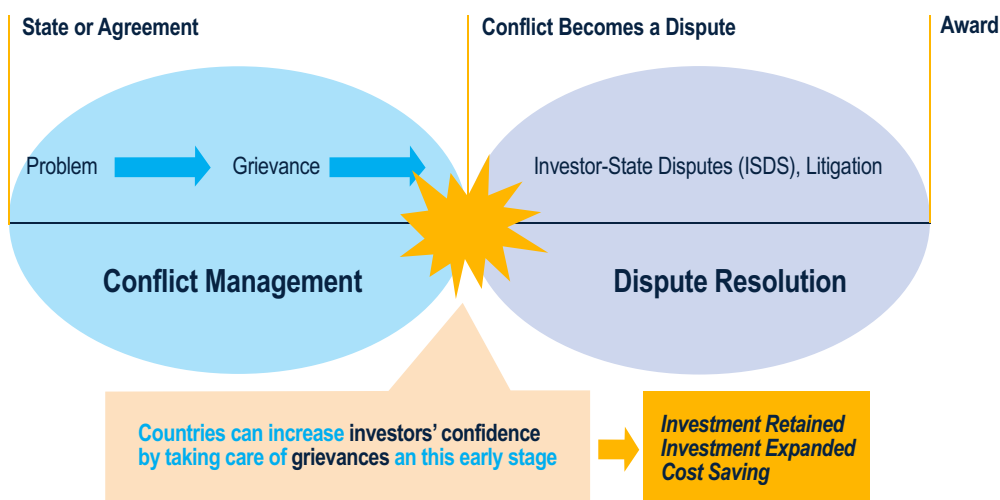
A review of practices around the world led to the design of the Systemic Investment Response Mechanism (SIRM) as a practical solution package designed to enable governments to identify, track, and resolve, in a timely manner, investor-state grievances that put investment projects at risk of withdrawals and cancellations (Figure 3). 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

FIGURE 3. SIRM CONCEPT WITHIN THE INVESTOR-STATE CONFLICT CONTINUUM



Source: World Bank Group research

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 all primary, manufacturing, and tertiary sectors, although there is 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 of the SIRM 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 the “shadow of the law” 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. Box 1 describes the impact of political risk and policy implications that affect investment retention and expansion in developing countries.

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. Box 2 describes policy implications to maximize investment retention and expansion.

BOX 1. THE IMPACT OF POLITICAL RISK ON INVESTMENT RETENTION AND EXPANSION

- 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.

BOX 2. POLICIES TO MAXIMIZE INVESTMENT RETENTION AND EXPANSION

- 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.

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