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Reducing regulatory risk to attract and retain FDI

by
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Amid the backlash against globalization, policy uncertainty has been a key concern for investors over the past few years. As the COVID-19 crisis continues, fear of contagion and uncertainty over trade and investment policies will further dampen investment activities. Estimates indicate that global FDI flows could decline by 30-40% during 2020-2021. Boosting investor confidence to attract and retain FDI is critical as countries move toward economic recovery.

One important response by countries is to reform their regulatory regimes to reduce risks for investors, while preserving countries' right to regulate in the public interest. Qualitative findings from recent investor surveys consistently show that MNE executives rank countries' legal and regulatory environments as one of the top three factors shaping investment decisions, along with political and macroeconomic stability. Further, investors indicate that exposure to regulatory risks (e.g., expropriation, breach of contract) in host countries can and has triggered withdrawals of investments or the cancelling of planned investments.

A new quantitative measure of regulatory risk—which links directly to specific elements of countries' legal framework—helps gauge the progress of such reforms.[1] It draws on existing and newly collected data sources, including the content of international investment agreements and investment laws, and evaluates them along three dimensions: transparency, investment protection and access to effective recourse mechanisms. Evidence using a database of 14,335 parent companies investing in 159 host countries suggests that this new measure of regulatory risk is correlated with country risk premium and matters for FDI.

Higher regulatory risk—that is, lower levels of transparency, protection and less effective recourse—deters MNEs' decisions to enter or expand in host countries. In aggregate, it is associated with lower FDI inflows. The effect of regulatory risk on investors' location decision is sizeable: if the median country improves its performance to the level of a top 25th percentile performer on the regulatory risk measure, investors will be 5.5–22% more likely to locate in the country.[2]

These results highlight specific policy actions that governments should take to minimize regulatory risk. It is important to note that countries are already implementing these actions: the newly constructed regulatory risk measure helps explore the link between these actions and FDI outcomes.

- To improve transparency and predictability, countries should ensure the systematic publication of, and public consultation on, laws and regulations. Availability of portals and other mechanisms to allow investors to find updated information about relevant laws and regulations can help. In addition, specificity and clarity in legal provisions can reduce room for discretion. For example, where investment approval is required under investment laws, countries can reduce regulatory risk by specifying the approval criteria and time-periods within which such approval should be granted.

- Investment protection against arbitrary government conduct, provided in countries' investment laws or international investment agreements, in accordance with well-established good practices can further reduce regulatory risk. An example is legal provisions on protection against both direct and indirect expropriation and requiring payment of timely and adequate compensation. Equally important is the ability to freely transfer funds in a timely manner and in a freely convertible or freely usable currency. Of course, the drafting of any legal provisions entails not just considerations of well-established principles of investor protection, but the overall context, legal traditions and political economy realities of countries (including flexibility clauses needed to reflect and protect countries' right to regulate).

- Legal provisions are only as good as their implementation. The challenges around lack of implementation across countries are well known. To strengthen the implementation of laws and regulations and balance the risk of potential costly disputes, countries can institute formal mechanisms to systematically address investor grievances and prevent their escalation into investor-state disputes.[3] Overall, strengthening judicial processes (e.g., by promoting specialized commercial courts, stipulating precise time-ranges for judicial processes, reinforcing efficient case-management systems) can further improve effective access to recourse.

The effects of the current pandemic require that governments pursue various avenues to remain successful in attracting and retaining FDI in the highly competitive world FDI market. Reducing regulatory risk is one such avenue.

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[1] See Sarah Hebous, Priyanka Kher and Trang Thu Tran, "Regulatory risk and FDI," in World Bank, *Global Investment Competitiveness Report 2019/2020* (Washington: WBG, 2020), pp. 128-170.

[2] *Ibid*.

[3] The WBG has been supporting countries to set up institutional mechanisms to detect and resolve investor grievances that can potentially escalate into investor-state legal disputes. See World Bank, *Report on Retention and Expansion of FDI: Political Risk and Policy Responses* (Washington: WBG, 2019).

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