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Overview

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Global FDI Flows Face an Unprecedented Decline

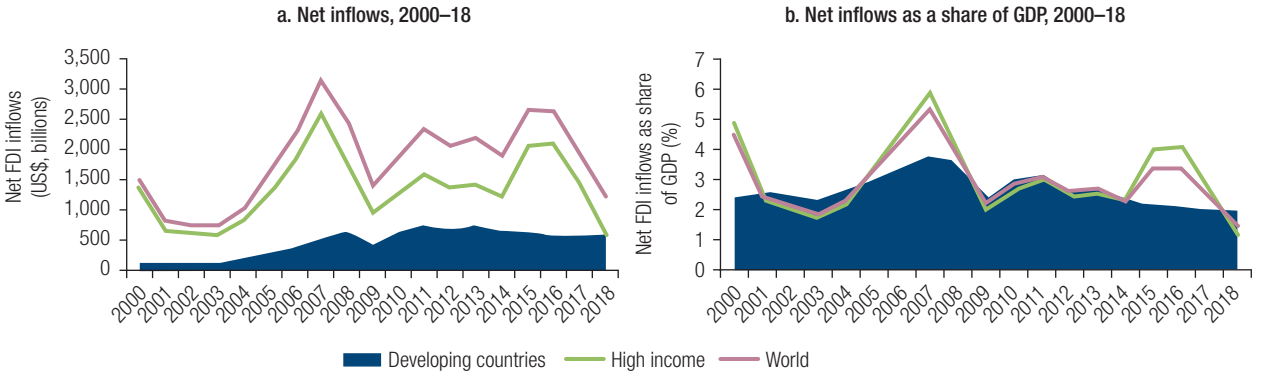
The COVID-19 pandemic is severely impacting multinational enterprises (MNEs) globally. The economic shock of the crisis to the private sector is being transmitted through multiple channels, including falling demand, reduced and disrupted input supply, tightening of credit conditions, a liquidity crunch, and rising uncertainty. The pre-COVID-19 global environment for foreign direct investment (FDI) was already characterized by rapidly eroding investor confidence because of trade and investment policy uncertainty, lagging global growth, falling commodity prices, and rising protectionism. The COVID-19 crisis presents a new, unprecedented source of investor risk that is depressing investor confidence to new lows.

Even before the COVID-19 pandemic upended the global economy, global FDI was sliding to levels even below those last seen in the aftermath of the global financial crisis a decade ago (figure O.1, panel a).[1] The decline was more concentrated in high-income countries, where inflows of FDI fell by nearly 60 percent in recent years. Although FDI to developing countries did not decline as steeply, it nonetheless fell to its lowest levels in decades relative to gross domestic product (GDP).[2] Compared with the mid-2000s, when FDI reached nearly 4 percent of GDP in developing countries, that share fell to under 2 percent in 2017 and 2018 (figure O.1, panel b).

This worrisome global trend in recent years has reflected a mix of (a) *economic factors,* including declining rates of return on FDI; (b) *business factors,* including adoption of digital technologies and increasingly asset-light forms of international production; and (c) *policy factors,* including the erosion of investor confidence due to policy uncertainty and changes in US tax policy that drove repatriation of capital back to the United States.[3] More specifically, worsening business fundamentals have driven much of the decline in FDI since 2015, when FDI flows reached their postcrisis peak. The global average rate of return on FDI decreased from 8.0 percent in 2010 to 6.8 percent in 2018 (UNCTAD 2019). While the rates of return have dropped in both developing and developed countries, the declines have been especially large in developing countries.

Furthermore, changing business models resulting from technological advances have driven declines in FDI levels and returns. In particular, increases in labor costs and the rise of advanced manufacturing technologies have

FIGURE O.1 FDI Inflows to Developing Countries over the Past Decade Have Been Mostly Flat and Have Declined as a Share of GDP



Source: World Development Indicators database.
Note: All country income categories use World Bank-defined classifications; "developing" countries refers collectively to all low and middle-income countries. FDI = foreign direct investment; GDP = gross domestic product.

eroded or decreased the significance of many developing countries' labor cost advantages. At the same time, the increasing importance of the digital economy and services is shifting businesses toward more asset-light models of investment (UNCTAD 2019). In addition, commodity price slumps have adversely affected returns on FDI in more commodity-dependent markets (such as many economies in Latin America and the Caribbean, the Middle East and North Africa, and Sub-Saharan Africa).

Uncertainty Has Been Rising and FDI Rules Tightening

Even before the COVID-19 crisis, the number and magnitude of various global economic, geopolitical, technological, and social shifts have increased uncertainty for citizens, businesses, and policy makers. These changes are reflected in the high values registered in 2019 by various indicators such as the World Uncertainty Index, the Global Economic Policy Uncertainty Index, and the Trade Policy Uncertainty Index (Baker, Bloom, and Davis 2019; Caldara et al. 2019). In 2020, these indexes have reached unprecedented levels.

Citizens are increasingly attributing growing economic disparity and losses in local economic opportunities to globalization. Less than half the citizens in some of the world's largest 27 countries believe that trade and globalization help create jobs, and less than one-third find that they are good for wages, recent data from the Pew Research Center indicate (Gramlich 2019).[4] The anti-globalization sentiment is also heightened by the ongoing shifts in economic and geopolitical power as well as concerns about national security. Such anxiety and discontent are fueling a rise in economic nationalism and protectionism.

Recent events such as withdrawals from global trade agreements, tariff escalations, and other trade tensions have contributed to a new rise in trade and investment policy uncertainty (Baker, Bloom, and Davis 2019). Free trade, unhindered investment, and open markets are under threat. Although these fears are particularly pronounced in the industrialized world, a growing number of developing country governments are also building their policy agendas along similar themes.

The growing protectionist views have gradually translated into more restrictive rules on the entry of FDI. The United States and the European Union have enacted strict screenings of foreign acquisitions in response to perceived risks to national or economic security. Cases of investment withdrawals—investments that are either rejected or withdrawn over security concerns—tripled in

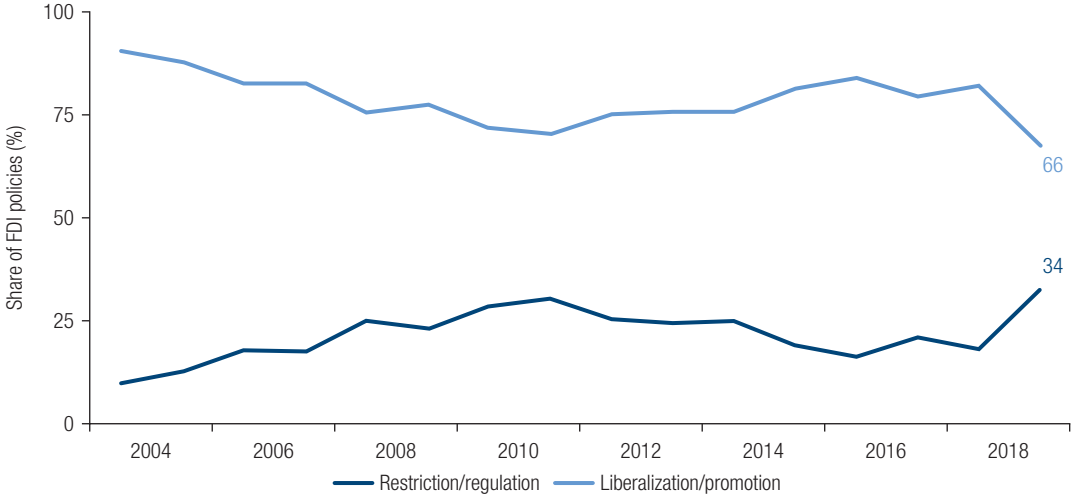
2018 alone, often receiving high publicity (UNCTAD 2019).

Governments have also become increasingly anxious about the potentially noncommercial objectives of foreign investment by state-owned enterprises or sovereign wealth funds. Of particular concern has been foreign ownership of core technologies, manufacturing of health care products, sensitive business assets, and critical infrastructure. Various governments blocked mergers and acquisitions (M&A) deals worth more than US$150 billion in 2018 (more than 10 percent of total global FDI) on the basis of national security concerns (UNCTAD 2019). Member countries of the Organisation for Economic Co-operation and Development (OECD) on both sides of the Atlantic are tightening—or proposing to tighten—their rules governing the entry of FDI.

In fact, a global cross-country analysis of policy trends shows that the share of restrictive and regulatory measures against FDI is the highest it has been in more than 20 years—and the trend may be worsening. The United Nations Conference on Trade and Development's data on FDI policy trends around the world show that 55 countries undertook at least 112 policy measures related to FDI in 2018 (UNCTAD 2019). Of these, more than one-third restricted or regulated FDI more tightly, whereas the share of measures that liberalized and promoted FDI fell to less than two-thirds (figure O.2). In contrast, it was only the previous year (2017) when around 80 percent of the measures promoted FDI. High-income countries have been the primary drivers of the trend toward more restrictive rules on FDI. In 2018, more than 70 percent of new FDI policy measures in developed countries were aimed at restricting or regulating FDI (UNCTAD 2019).

Although most developing countries have so far largely resisted increasing the restrictiveness of their FDI regimes, there is a growing concern that the actions of the governments of developed countries will either set a precedent for the developing countries to follow, or that developing countries will do so as a retaliatory measure. For example, China and South Africa have recently introduced new regulatory frameworks for FDI screening for national security concerns (UNCTAD 2019).

FIGURE O.2 Investment Policies Regarding FDI Are Becoming More Restrictive



Source: UNCTAD 2019.
Note: Sample in 2018 comprised 55 countries that undertook at least 112 FDI-related policy measures. FDI = foreign direct investment.

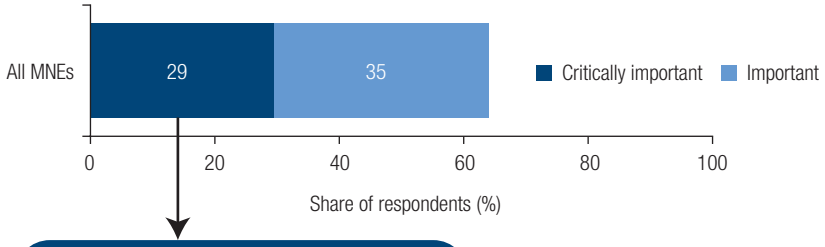
Policy and COVID-19 Uncertainties Adversely Affect Jobs, Investment, and Productivity

Between June and November 2019, a Global Investment Competitiveness (GIC) Survey of more than 2,400 global business executives in 10 large middle-income countries was conducted for this report (see chapter 1). Without taking into account the additional effects of the COVID-19 pandemic, two-thirds of investors—particularly firms that import a greater share of their inputs and larger firms (employing more than 250 people)—reported that policy uncertainty due to protectionism and economic nationalism in trade and investment was "important" or "critically important" in their investment decisions in the past year (figure O.3, panel a). Furthermore, among those investors who considered such policy uncertainty in trade and investment to be a "critically important" investment factor, more than half have already experienced a decrease in employment, firm productivity, or investments as a result (figure O.3, panel b).

These negative effects have been further exacerbated by the economic challenges and

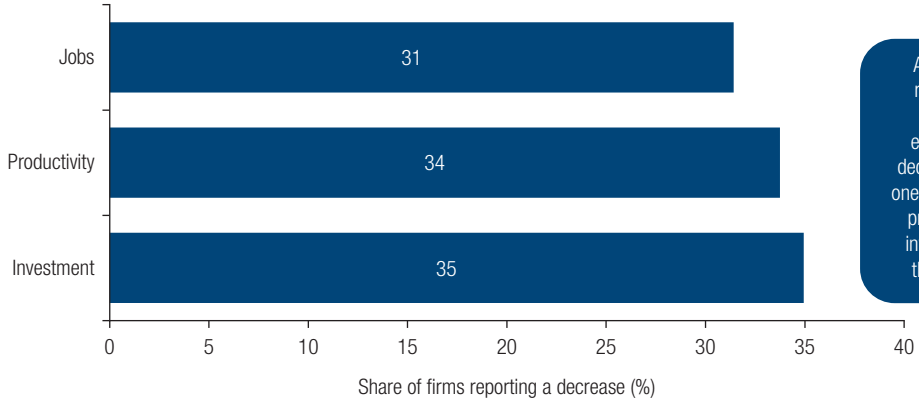
FIGURE O.3 Even before the COVID-19 Crisis, Investors Were Sensitive to Policy Uncertainty in Trade and Investment and Have Been Adversely Affected in the Past Year

a. Question: In the past financial year, how important was rising policy uncertainty due to protectionism and economic nationalism in trade and investment for your company's investment decisions in this country?



The 29 percent of MNE affiliates that considered policy uncertainty in trade and investment to be "critically important" were asked the following question:

b. Question: In the last financial year, what impact has rising policy uncertainty due to protectionism and economic nationalism in trade and investment had on your company's operations in this country?



Among these respondents, 51 percent experienced a decline in at least one category–jobs, productivity, or investment—in the past year.

Source: Computation based on the 2019 GIC Survey.
Note: Affiliates of multinational enterprises were surveyed in 10 middle-income countries: Brazil, China, India, Indonesia, Malaysia, Mexico, Nigeria, Thailand, Turkey, and Vietnam. MNEs = multinational enterprises. The "past financial year" was a 12-month period between January 1, 2018, and September 30, 2019, depending on the country.

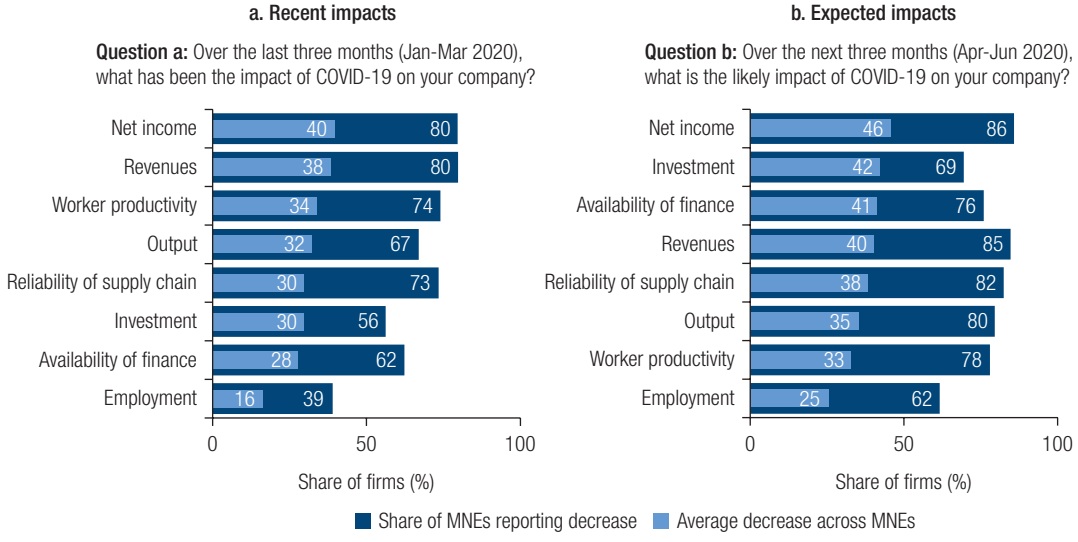
policy uncertainty brought by the spread of COVID-19. The closing of factories, disruptions in transport, and unavailability of production inputs are directly affecting how companies operate across the globe. The shocks, having already spread from directly hit sectors to others, are also spreading across regions through supply linkages. At the epicenter of this turmoil are multinational corporations that have shaped the geography of global value chains (GVCs) over the past three decades.

To assess the impact of the pandemic on MNE affiliates in developing countries, the World Bank conducted a foreign investor "pulse" survey in March–April 2020.[5] The results show that the COVID-19 pandemic has already adversely affected more than three-fourths of investors through both demand- and supply-side channels. Nearly four in five MNEs report reductions in revenues and profits over the past three months, on average by 40 percent (figure O.4, panel a). Demand has fallen sharply because of high uncertainty and precautionary behavior of consumers, resulting in reduced consumer spending and corporate orders.

On the supply side, three in four MNEs report declines in supply chain reliability, on average by 30 percent. Along with the liquidity crunch (experienced by more than 60 percent of respondents) and a decline in worker productivity (reported by three-fourths of businesses), the aggregate effects of these shocks include reductions of roughly one-third in output and investment, reported by most businesses. The shock waves are also reaching companies' employees: two in five businesses report declines in jobs, on average by 16 percent.

Even more worrisome than these shocks over the first quarter of 2020 are companies' dire predictions that the impacts will likely intensify over the second quarter, with performance deteriorating along every measured dimension (figure O.4, panel b). More than 85 percent of surveyed businesses expect that their revenues and profits will decline in April through June 2020, on average by more than 40 percent. Four in five businesses also expect

FIGURE O.4 The COVID-19 Pandemic Had Adversely Affected a Vast Share of MNEs by April 2020



Source: World Bank, forthcoming.
Note: Computation based on the World Bank's Investor Confidence Global Pulse Survey, conducted March–April 2020. Sample represents 105 multinational enterprise (MNE) affiliates operating in 26 developing countries. The reference period of "last three months" ranges approximately from January to March 2020.

an average 35 percent reduction in output in the second quarter. The employment impacts are particularly likely to worsen: three in five businesses expect to have to reduce employment in the second quarter, on average by 25 percent. In addition to the likely downsizing of the workforce, the most precipitous declines are anticipated in the availability of finance (by 41 percent) and in investments (by 42 percent).

The gloomy outlook reported by the survey respondents is consistent with emerging evidence on declining investment activity. UNCTAD (2020) estimates that global FDI could decline by up to 40 percent in 2020–21. The world's largest 5,000 MNEs, which account for a significant share of global FDI, have revised their earnings estimates downward by an average of 30 percent. Because a major share of FDI materializes through reinvested earnings, FDI activity among existing investors is set to decline. Furthermore, in the first quarter of 2020, M&A activity is expected to drop by up to 70 percent. In February 2020, new cross-border acquisitions fell below US$10 billion, compared with the normal monthly average of US$40 billion—US$50 billion before the crisis.[6]

FDI Can Help Countries Alleviate the Impact of the Crisis, But Governments Must Rebuild Investor Confidence

With the expected massive global decline in FDI, competition among developing countries to attract foreign investment has only intensified. What can developing countries do to counter prevailing global headwinds and uncertainty and to rebuild investor confidence? How will the factors that affect countries' investment competitiveness change as a result of COVID-19? The report's findings pertaining to these questions are organized around two core pillars focused on (1) FDI contributions to development and economic resilience, and (2) policy actions to rebuild investor confidence and boost investment.

The individual chapters of this report analyze various facets of countries' foundations for investment competitiveness. The GIC Survey analyzes the drivers of FDI and identifies priorities for countries to increase their FDI attractiveness. Several chapters provide new evidence on FDI's contributions to job creation, poverty alleviation, and firm productivity. The report also explores how to boost investor confidence through specific policy and regulatory actions that reduce regulatory risks. The report concludes with an assessment of what governments—and especially their investment promotion agencies (IPAs)—can do to help attract high-quality FDI and transform their economies. If they succeed, FDI can continue to play a critical role in a robust economic recovery from the COVID-19 pandemic.

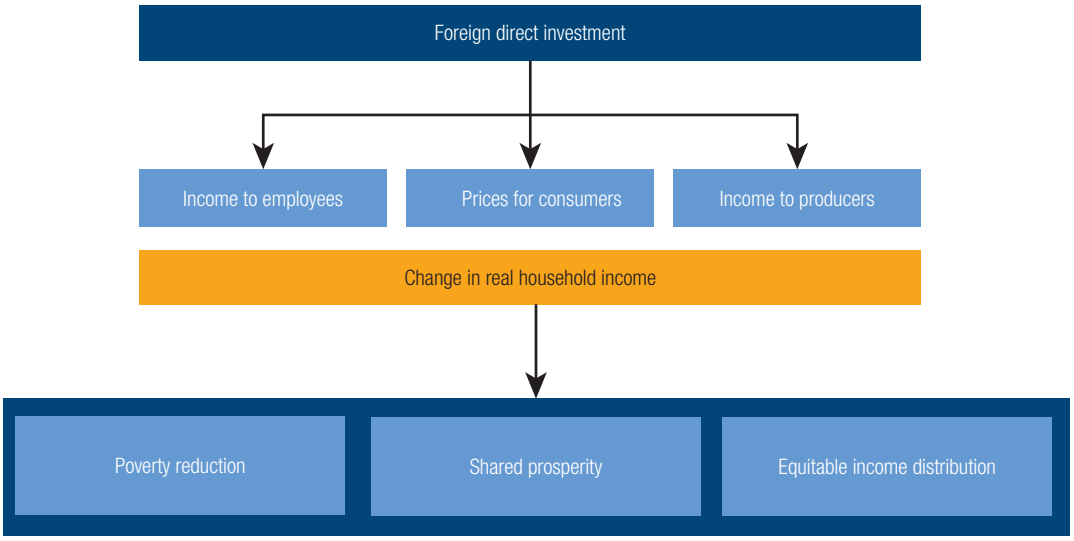
Pillar 1: FDI Boosts Economic Resilience—Easing the Impact of Economic Crises by Creating Jobs, Alleviating Poverty, and Boosting Productivity

FDI has always been a key building block for the economic growth of developing countries, often providing the largest source of external finance—surpassing remittances, official development assistance, and portfolio investment flows. In the post-COVID recovery phase, FDI's role is likely to further increase. Countries' crisis-response policies, such as financial and fiscal stimulus measures, are generating debt. Domestic revenue sources will be insufficient to service that debt. FDI is therefore likely to remain an essential source of capital.

Beyond capital, foreign investment also helps create jobs and reduce poverty. FDI can affect welfare through three main channels (figure O.5):

- *Employment income:* As FDI brings capital and new technologies to a sector, it often raises overall labor demand and productivity in the sector. This can raise total employment and average wages, leading to higher household incomes.

FIGURE O.5 FDI Affects Household Incomes through Several Broad Channels



Source: World Bank and OECD 2017.
Note: FDI = foreign direct investment.

- *Consumer prices:* The entry of new foreign firms increases competition in markets. This may lower the prices of goods and services, thus raising household purchasing power and consumption possibilities.
- *Producer income:* As foreign firms compete with, buy from, or sell to domestic firms, they may influence the productivity and profitability of these enterprises, increasing or cutting into incomes of domestic producers.

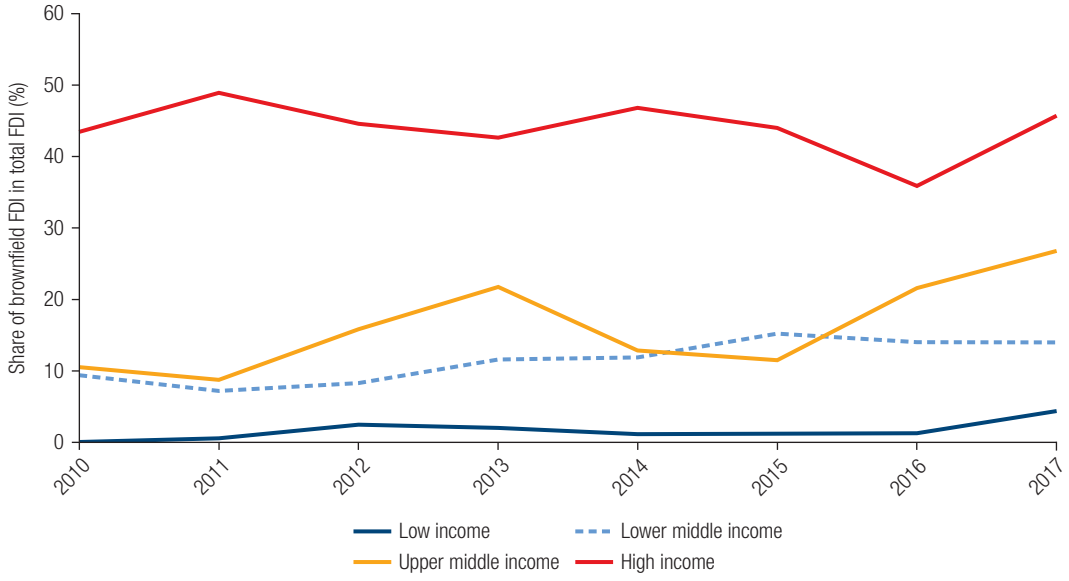
These FDI effects are seemingly more obvious when it comes to greenfield FDI. Greenfield investment adds new elements to the economy: new facilities, new jobs, new production capacity. In contrast, brownfield FDI—acquisitions of domestic firms by foreign investors—transforms existing production. Any positive effect of brownfield investment would therefore tend to materialize over longer time frames and with varying intensity.

Most of the previous evidence on brownfield FDI has come from high-income countries and has focused on macroeconomic growth, overlooking development outcomes at the level of firms, the jobs they create, or the wages they offer.[7] To help fill this gap, this report focuses on acquired firms in developing countries—what they look like, how they evolve, and whether conventional narratives do justice to their contributions to development goals. This is particularly pertinent as brownfield investment has doubled as a share of FDI in developing countries over the past 10 years (figure O.6, as further discussed in chapter 2).

This report analyzes a unique set of industrial censuses from six developing countries—China, Côte d'Ivoire, Indonesia, Moldova, Serbia, and Vietnam—to show that brownfield FDI firms perform better than local firms on some of the key dimensions that matter for development, such as export orientation, product diversification, asset accumulation, labor productivity, and employment (figure O.7).

Results show that firms acquired by MNEs not only perform better than the average domestic firm at the time of the acquisition, but also improve their performance after acquisition faster than local firms along some of the key dimensions that matter for development. For example, over the first five years of a firm's operation, a brownfield affiliate is

FIGURE O.6 Brownfield Investment Rose as a Share of Total FDI in Developing Countries, 2010–17



Source: World Bank, based on the 2019 United Nations Conference on Trade and Development (UNCTAD) Mergers and Acquisitions (M&A) database, http://www.unctad.org/fdistatistics.
Note: The trend is illustrated using a two-year moving average. All country income categories use 2017 World Bank-defined classifications; "developing countries" refers collectively to low- and middle-income countries. FDI = foreign direct investment.

70–100 percent more likely to export than a domestic firm (figure O.7, panel e). Wages in foreign takeovers at the end of the first five years of operations are 40–50 percent higher than in domestic firms (figure O.7, panel a).

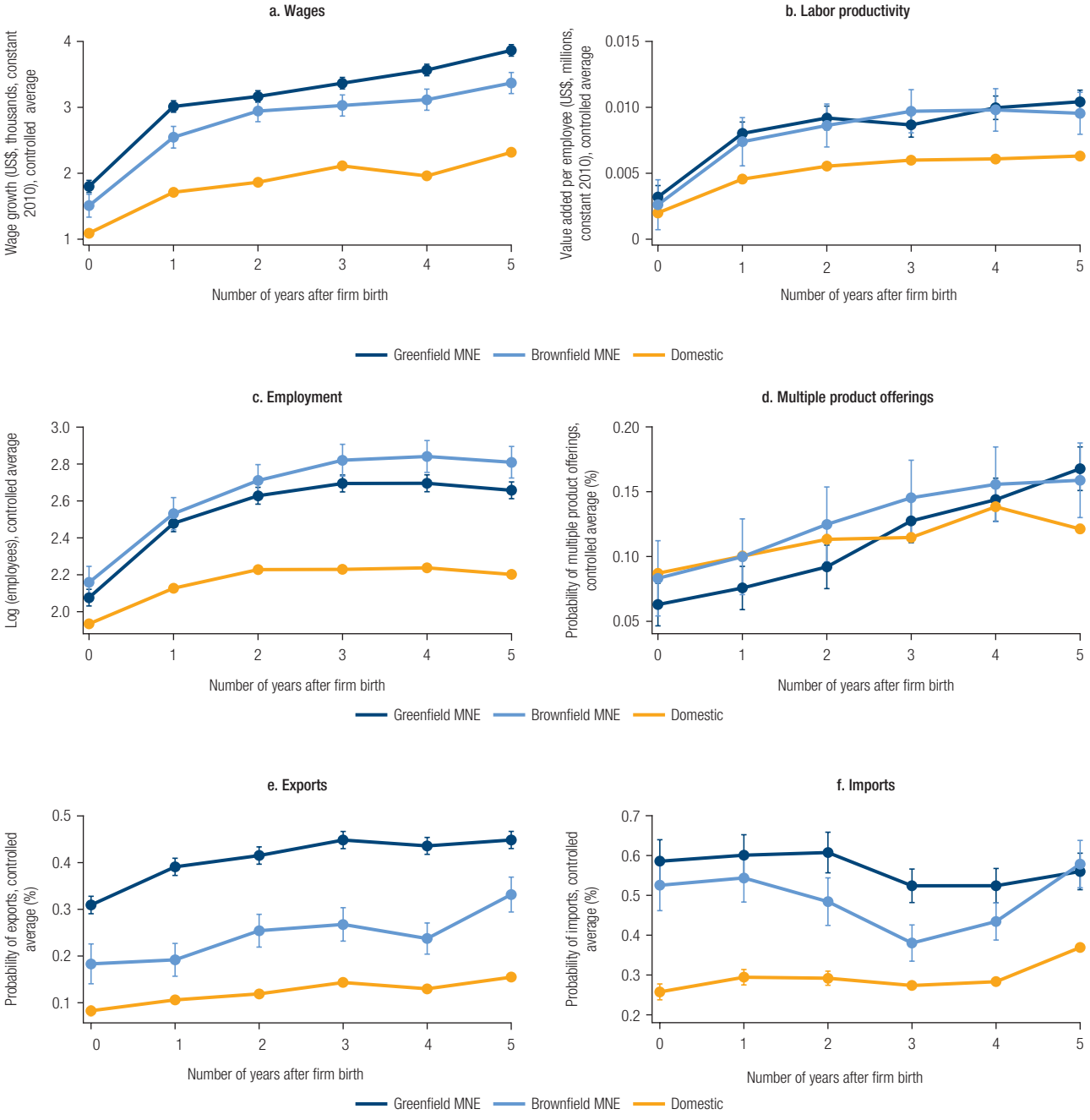
Furthermore, contrary to conventional belief about the potential job-destroying effects of foreign M&A, employment in newly acquired firms tends to grow faster in most countries than employment in domestic firms with similar characteristics. Specifically, two years after acquisition, the average employment in brownfield affiliates expands by approximately 4 percent, compared with 1.5 percent in domestic firms with similar characteristics (figure O.8, panel a). The firms' asset value after the acquisition follows a similar path. The experience of the six countries analyzed in this study suggests that foreign acquisitions can be a helpful complement to greenfield FDI in all developing countries seeking to leverage foreign investment for advancing their development goals.

Looking beyond formal enterprises, the report further finds that FDI has a significant effect on household employment and wages in three developing countries: Ethiopia, Vietnam, and Turkey (see chapter 3). Workers in sectors and regions with a higher presence of foreign firms are generally more likely to be formally employed and receive higher wages.

In Vietnam, FDI allowed more than 350,000 individuals to enter formal manufacturing employment between 2007 and 2016. In Turkey, FDI brought in at least 40,000 additional formal manufacturing jobs between 2009 and 2016. FDI also raised average manufacturing wages, which increased by 32 percent in Ethiopia, 12 percent in Vietnam, and 8 percent in Turkey. Consequently, these wage increases brought about by FDI helped reduce poverty in all three countries. Conservative estimates suggest that FDI contributed to lifting at least 35,000 individuals out of poverty in Ethiopia (2009–14), 24,000 in Vietnam (2007–16), and 15,000 in Turkey (2009–16).

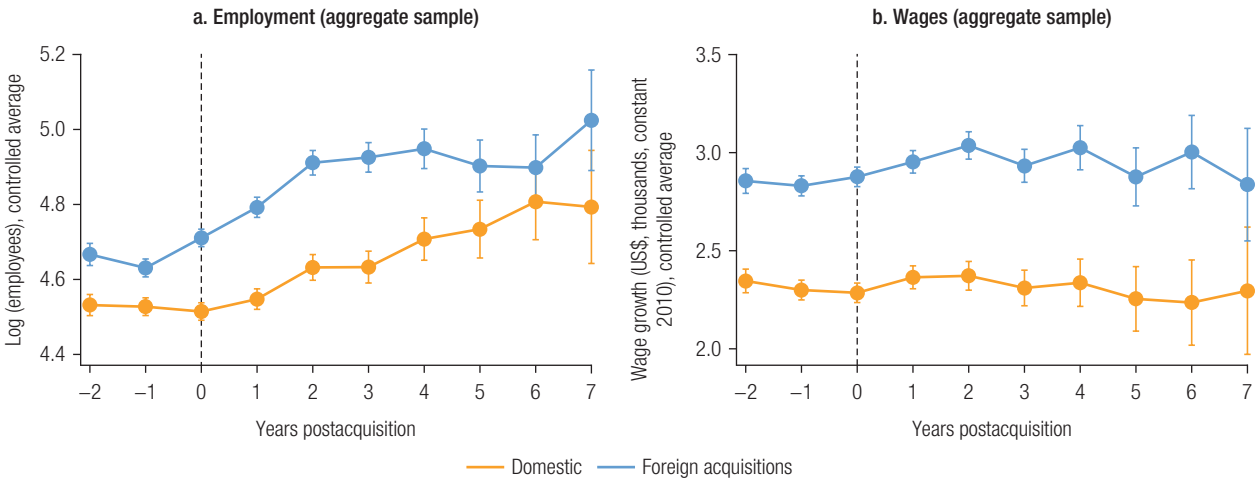
Growth in formal jobs and wages due to FDI has also translated into increased shared prosperity: the FDI-induced wage increases helped improve the income of

FIGURE O.7 Greenfield and Brownfield FDI Firms Perform Better than Domestic Firms over the First Five Years of Operation



Source: World Bank calculations, based on industrial censuses from six countries.
Note: For this figure, industrial census data were analyzed from China, Côte d'Ivoire, Indonesia, Moldova, Serbia, and Vietnam (as further described in chapter 2, annex 2A). Vertical bars indicate the margin of error. "Domestic" refers to the firms that originated as domestic enterprises. Growth paths of firm outcomes can be captured in a simple framework using an interaction between indicators of firm group (greenfield, brownfield, and domestic) and years after entry in the following specification: $y_{ics} = group_i \boldsymbol{\beta} \cdot d_t + \boldsymbol{\alpha}_{cs} + \boldsymbol{\delta} d_{it_0} + \boldsymbol{\varepsilon}_{ics}$. The sample is restricted to cohorts whose entry is observed. To account for differences that might be driven by country characteristics, sector composition, and macroeconomic trends, the regressions also control for country-sector fixed effects and cohort fixed effects. FDI = foreign direct investment; MNE = multinational enterprise.

FIGURE O.8 Employment and Wages in Brownfield Firms Grow Faster than in Domestic Firms with Similar Characteristics



Source: World Bank calculations, based on industrial censuses from six countries.
Note: For this figure, industrial census data were analyzed from China, Côte d'Ivoire, Indonesia, Moldova, Serbia, and Vietnam (as further described in chapter 2, annex 2A). Vertical bars indicate the margin of error. "Domestic" refers to the firms that originated as domestic enterprises. Growth paths of firm outcomes can be captured in a simple framework using an interaction between indicators of firm group (greenfield, brownfield, and domestic) and years after entry in the following specification: $y_{ics} = group_i \boldsymbol{\beta} \cdot d_t + \boldsymbol{\alpha}_{cs} + \boldsymbol{\delta} d_{it_0} + \boldsymbol{\varepsilon}_{ics}$. The sample is restricted to cohorts whose entry is observed. To account for differences that might be driven by country characteristics, sector composition, and macroeconomic trends, the regressions also control for country-sector fixed effects and cohort fixed effects. Wage growth paths are calculated using constant deflated values in US dollars. FDI = foreign direct investment.

the bottom 40 percent of the population in all studied countries. However, the distributional effects differ significantly across the three countries (figure O.9). In Ethiopia, the benefits of FDI are more concentrated in the bottom 40 percent, while in Vietnam, the welfare gains are evenly distributed across the income distribution. Turkey had the greatest average wage benefits from FDI but also experienced increases in income inequality in services.[8]

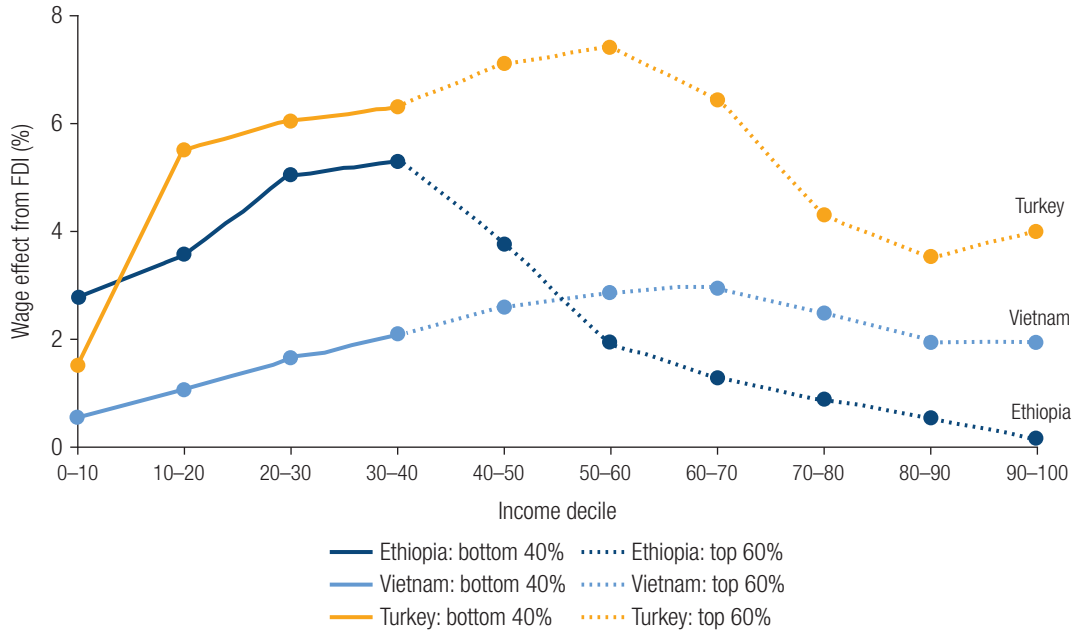
These differences in the distributional effects of FDI across the three countries are likely driven by differences across sectors and workers' education levels (table O.1). In general, the average effects of FDI on formal employment and wages are positive for manufacturing and high-skilled services but neutral for extractive sectors and low-skilled services.

The analysis also finds significant evidence of a skill premium for high-skilled versus low-skilled workers in FDI affiliates. In regions and sectors with higher MNE activity (relative to those not receiving FDI), higher-skilled workers experience large benefits while low-skilled workers may see no changes or even see relative declines in formal employment and wages. Overall, this skill premium is more pronounced for FDI in services than in manufacturing.

Given that FDI disproportionately benefits better-educated and higher-skilled workers, those labor force participants who lack these characteristics tend to be left behind. Such workers tend to be more concentrated in the less economically advanced parts of their countries; as a result, FDI can exacerbate geographic disparities within economies. In particular, the analysis of Turkey presents a case of FDI-led skill premiums leading to wage dispersion, explaining why FDI in Turkey is associated with an increase in income inequality. This dynamic emphasizes the importance of a country's labor market and education policies.

The effects of multinational firms' production patterns on income and wage disparities are also explored in the recent *World Development Report* on global value chains (World Bank 2020). The report finds that GVCs increase wage inequality in countries at all income levels for at least three reasons: First, FDI and offshoring increase the

FIGURE O.9 FDI Has Had Varied Effects on National Income Distributions in Ethiopia, Vietnam, and Turkey



Source: World Bank calculations; individual labor market data from World Bank's International Income Distribution Database (I2D2), supplemented with Labor Force Surveys; firm-level data from sources including Ethiopia's Large and Medium Manufacturing Survey, Vietnam's Enterprise Census, and Turkey's Enterprise Information System data.
Note: FDI = foreign direct investment.

TABLE O.1 The Effects of FDI on Labor Markets Vary by Sector and Workers' Skill Levels

Broad sector	*Average effect*	*Low-skilled workers*	*High-skilled workers*
Extractives	No effect	No effect	No effect
Low-skilled manufacturing	Positive	Positive	Positive
High-skilled manufacturing	Positive	Neutral	Positive
Low-skilled services	Neutral	Negative	Positive
High-skilled services	Positive	Negative	Positive

Source: World Bank calculations; individual labor market data from World Bank's International Income Distribution Database (I2D2), supplemented with Labor Force Surveys; firm-level data from sources including Ethiopia's Large and Medium Manufacturing Survey, Vietnam's Enterprise Census, and Turkey's Enterprise Information System data.
Note: In the table title, "effects of FDI on labor markets" refers to the effects on both wages and the probability of formal employment. The table summarizes an analysis of data from three countries: Ethiopia, Turkey, and Vietnam. (For complete results, see chapter 3, annex 3C.) "Low-skilled" workers are those with primary education or less, while "high-skilled" workers have completed at least secondary education. All results are *relative* to workers in sectors with less or no investment by multinational enterprises (MNEs). FDI = foreign direct investment.

demand for skilled workers in low- and middle-income economies and put upward pressure on wage inequality. Second, GVCs are often more skill-sensitive because they tend to produce goods destined for quality-sensitive consumers in high-income countries. This can in turn create "a war for talent" in the developing countries and bid up the wages of skilled workers. Third, firms in GVCs tend to adopt more capital-intensive techniques than comparable domestic firms. The deepening and upgrading of physical capital contribute to the increase in the relative demand for skilled workers.

Pillar 2: Government Actions Can Rebuild Investor Confidence—Reducing Investor Risk, Fostering Investment Expansion, and Attracting New FDI through Policy Predictability, Regulatory Certainty, and Targeted Investment Promotion

The COVID-19 pandemic has rapidly escalated business uncertainty, in turn magnifying investment risks and depressing foreign investor confidence. Multinational firms are realizing that their historical push toward low-cost, low-inventory supply chains has opened them up to significant risk. In response, some of them are changing their corporate strategies, reassessing their approaches to sourcing production inputs, diversifying their suppliers, and making greater use of digital technologies (Baldwin and Evenett 2020).

They are also responding to changes in the policy environments, which in some markets have seen introductions of more-restrictive regulations, including during the outbreak. For example, to protect sensitive assets from foreign takeovers—notably in sectors such as health, medical research, biotechnology, and infrastructure—some countries are adopting new foreign investment screening mechanisms.

Traditionally, investors rely on a country's legal and regulatory framework to recognize their property rights and enforce those rights in a predictable and efficient manner. Economic theory suggests that when investors incur fixed and irreversible setup costs, uncertainty about the local conditions—especially policy uncertainty—will have a dampening effect that reduces investors' response to new investment opportunities (Bernanke 1983; Bloom 2009; Dixit 1989). Amid the COVID-19 outbreak, nationalization of essential supply chains, cancellation of government procurement contracts, and exchange control restrictions have come as sudden regulatory changes. Investors identify these political risks among their top concerns in the current crisis. It is therefore vital for governments to endeavor to reduce investor risk and help restore their confidence.

This report presents a new global database and a novel quantitative measure of regulatory risk (see chapter 4). This measure draws on, among others, data on the content of domestic laws and international treaties to assess countries' regulatory frameworks for investment in three dimensions (figure O.10): transparency, protection, and recourse. More specifically, it evaluates (a) transparency and predictability in both the content and process of making laws and regulations that apply to investors; (b) legal protection of investors against arbitrary and nontransparent government interference; and (c) investor access to

FIGURE O.10 Three Pillars of Addressing Regulatory Risk

Pillar 1. Transparency	Pillar 2. Protection	Pillar 3. Recourse
Is there *transparency* regarding 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, unpredictable, or nontransparent government actions?	Do investors have access to effective mechanisms for *recourse* in case of grievances or disputes?
• Systematic publication of and consultation on laws and regulations • Registries or ICT platforms and similar mechanisms to allow investors to find information about relevant laws and regulations • Specificity and clarity of legal provisions (to reduce space for discretion)	• Absolute treatment standards • Protection guarantees against direct and indirect expropriation, transfers of funds, fair and equitable treatment (FET)	• Investor-state dispute settlement and prevention • Land dispute resolution • Quality of judicial processes

Source: World Bank GIC Report team.
Note: ICT = information and communication technology.

effective mechanisms for recourse, including grievance management and dispute settlement.

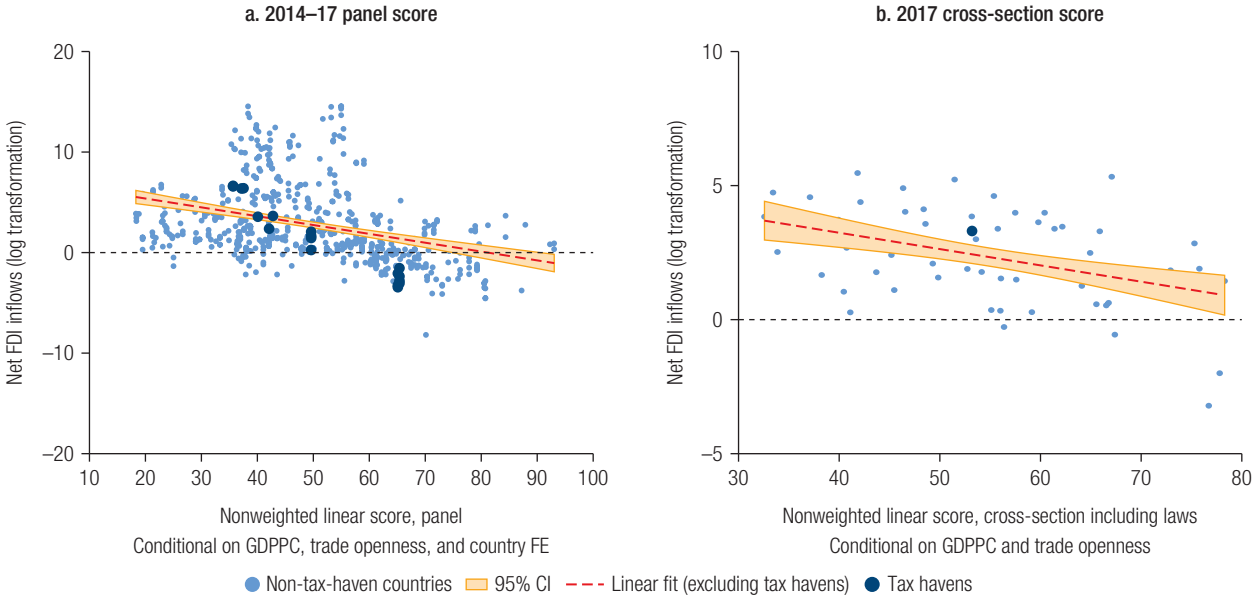
Evidence at both the country and investor levels suggests that regulatory risk—as measured in this framework—matters for investment decisions. First, at the country level, higher regulatory risk is correlated with higher risk premia measured by other indexes. Second, higher regulatory risk is associated with lower FDI inflows (figure O.11).

Consistent with this result, investor data lend support at the microeconomic level to the negative relationship found between regulatory risk and FDI. To test the relationship between a host country's regulatory risk and foreign companies' investment entry and expansion decisions, the report uses a dataset of over 14,000 parent companies investing in nearly 28,000 FDI greenfield and expansion projects across 168 host countries between 2014 and 2016.[9] Estimations from this investor location decision model suggest that regulatory risk can deter MNEs from entering or expanding operations in a country.

The effect of regulatory risk on FDI is sizable and comparable in magnitude to the investment-enhancing effects of trade openness in the same regression models. In fact, in some of the models, the effect of regulatory risk on FDI exceeds that of trade openness, showing that a 1 percentage point reduction in regulatory risk increases the likelihood of an investor entering or expanding in a host country by 0.5–2 percentage points. In contrast, a 1 percentage point increase in the host country's trade-GDP ratio is associated with a 0.3–0.6 percentage point increase in an investor's likelihood to enter or expand.

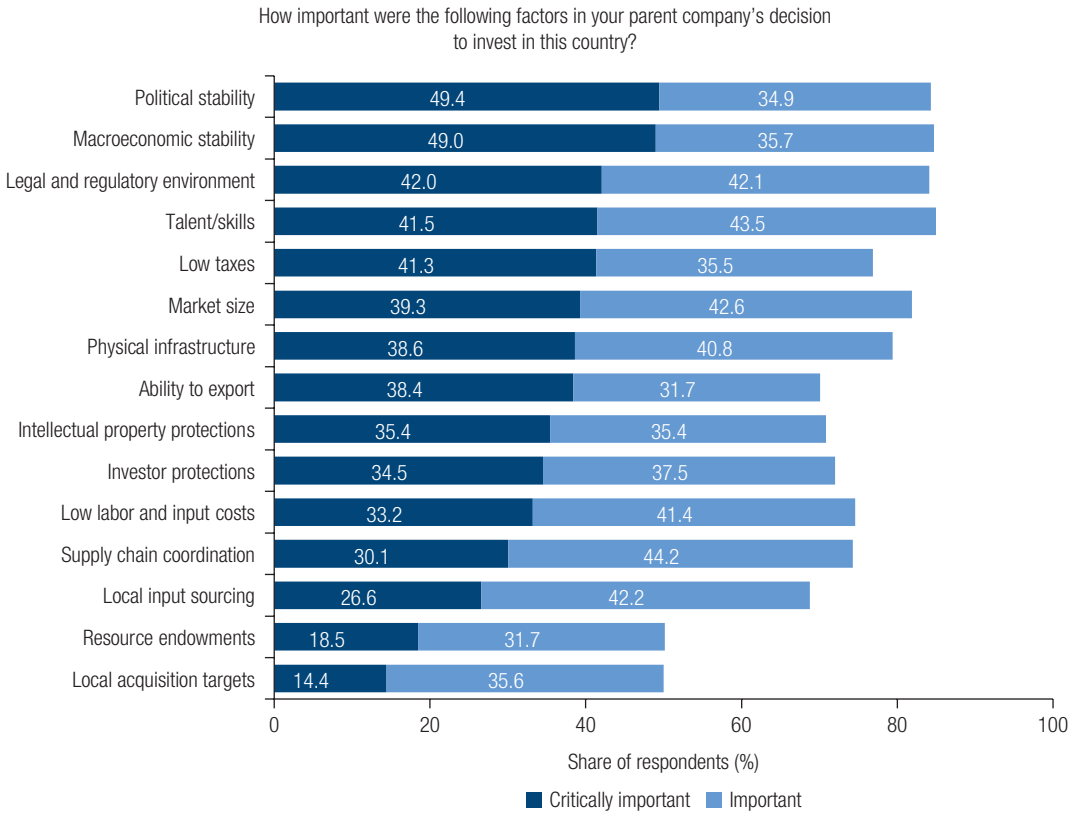
The critical importance of the regulatory environment is further confirmed by results from the 2019 GIC Survey, in which investors rank countries' legal and regulatory environments as one of the top three factors for investment. In line with findings from the 2017 GIC Survey (World Bank 2018), 84 percent of respondents list regulatory environment as an "important" or "critically important" factor in their investment decisions (figure O.12).

FIGURE O.11 FDI Inflows Are Higher in Countries with Lower Regulatory Risk



Source: World Bank calculations, from the World Development Indicators database.
Note: The scatterplots show the correlation between net foreign direct investment (FDI) inflows and regulatory risk index. Panel a uses a 2014–17 panel score; panel b uses a 2017 cross-section score. CI = confidence interval; FE = fixed effects; GDPPC = GDP per capita.

FIGURE O.12 The Legal and Regulatory Environment Was among the Top Three Factors for FDI in 2019



Source: Computation based on 2019 GIC Survey.
Note: Affiliates of multinational enterprises (MNEs) were surveyed in 10 middle-income countries: Brazil, China, India, Indonesia, Malaysia, Mexico, Nigeria, Thailand, Turkey, and Vietnam. FDI = foreign direct investment.

When it comes to investors who consider these factors "critically important," the legal and regulatory conditions of the host countries rank behind only political and macroeconomic stability, and ahead of considerations such as low taxes and low input costs. The legal and regulatory environment is especially important for larger firms. On average, large firms rank it as their top investment consideration.[10]

Overall, to reduce risks, governments need to remain committed to creating open and predictable environments for FDI. Given that the sources of policy uncertainty that erode investor confidence are both international and domestic, solutions at both levels are needed.

Internationally, reaffirming commitments to market access and rules-based international systems would decrease policy uncertainty related to protectionism and economic nationalism. To further advance this objective, a growing group of countries is calling for a new multilateral framework on investment facilitation. Although the framework's future is not yet clear, its emerging contours suggest it could encompass a set of practical measures concerned with improving the transparency and predictability of investment frameworks; streamlining procedures related to foreign investors; and enhancing coordination and cooperation between stakeholders such as host and home country governments, foreign investors, and domestic corporations as well as societal actors (Berger, Gsell, and Olekseyuk 2019; WTO 2017).

In addition to pursuing global, multilateral, or bilateral efforts toward providing clearer policy directions and investment frameworks, the 2019 GIC Survey results presented in this

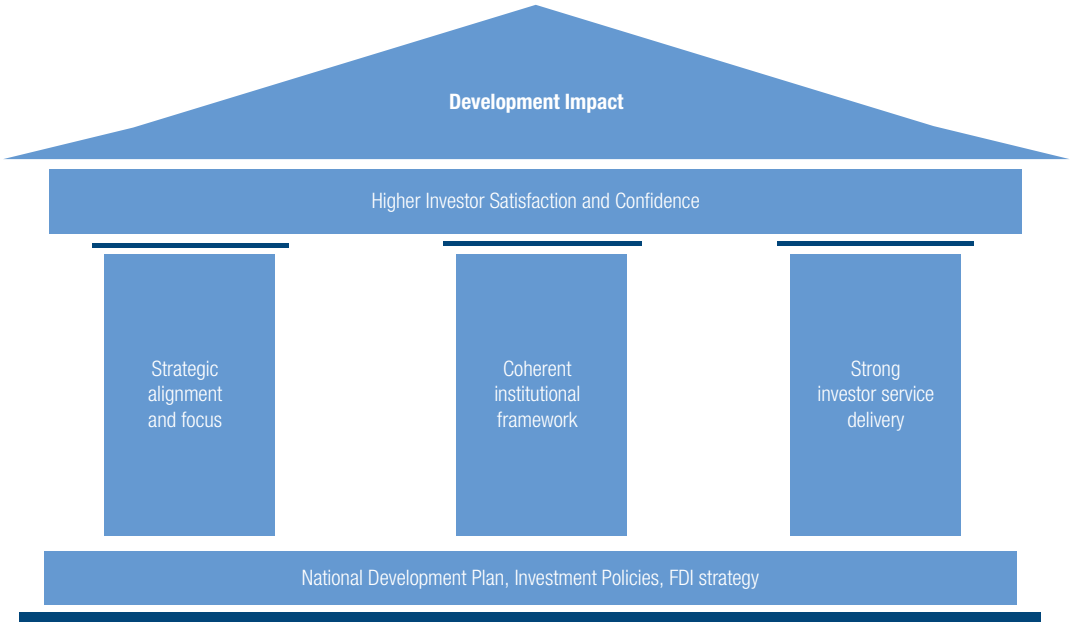
report point to the central role of domestic policy stability, with a particular emphasis on political and macroeconomic conditions. Indeed, evidence shows that the key elements of stable political environments include strong institutions, a level playing field, and predictable policy making. Macroeconomic stability is also vital, centered on implementing macroprudential policies, ensuring central bank independence, and optimizing fiscal policy.

Governments can further help reduce risks for investors by improving the legal, regulatory, and institutional frameworks for FDI. Business operations can be made more predictable by improving transparency and reducing room for bureaucratic discretion. Transparency can be strengthened by systematically consulting with the private sector and other stakeholders, developing information portals to make laws and regulations publicly available, and articulating clear and specific FDI-related legal provisions and administrative procedures.

Investment promotion agencies can play a critical role in these efforts given their role as governments' key interlocutors with foreign businesses. Empirical evidence shows that IPAs can help increase FDI inflows, attract higher-quality FDI, and even transform their economies (Charlton and Davis 2007; Freund and Moran 2017; Harding and Javorcik 2012; Moran et al. 2018; Morisset and Andrews-Johnson 2004; Wells and Wint 2000). They can play a significant role in strengthening their countries' investment competitiveness (see chapter 5).

Yet although IPAs have proliferated over the past two decades, success stories are still scarce, especially in the developing world. Many IPAs are unfocused—with too many mandates and target sectors—and are not providing the key services investors expect. At the same time, many IPAs are not evolving dynamically enough to align with both challenges and opportunities in the changing FDI landscape. The current literature, combined with surveys of IPAs and operational experience by the World Bank Group, suggests that IPAs can have greater positive impact if they sharpen their strategic alignment and focus, adopt a coherent institutional framework, and strengthen their delivery of investor services (figure O.13). In contrast, IPAs should not overestimate the role of investment

FIGURE O.13 Core Elements for Increasing the Development Impact of Investment Promotion Agencies



Source: World Bank, based on Heilbron 2020.
Note: FDI = foreign direct investment.

BOX 0.1

Key Success Factors in High-Performing IPAs in Developing Countries

World Bank research and operational experience have identified the following key success factors common to high-performing investment promotion agencies (IPAs) in developing countries:

- *High-level government support* (from the president or prime minister), granting a high priority to investment (or foreign direct investment [FDI]) and directly or indirectly championing the needed legal, regulatory, and institutional reforms for investment.
- *Strong strategic alignment* stemming from consultations with public and private sectors and cascading from a national development plan or FDI strategy to IPA corporate plans and industry-specific strategies.
- *A clear, uncontested mandate*, ideally focused on investment promotion, especially when starting or restructuring the IPA. Developing-country IPAs with multiple mandates take much longer to, or never do, deliver substantial FDI impact. Regulatory functions (including one-stop shops) are best performed by a separate public institution that ensures proper delivery of this essential function without compromising the equally essential investment promotion mandate of an IPA.
- *A high degree of institutional and financial autonomy* (or semiautonomy), emulating private sector flexibility to act according to agreed-upon strategic plans and to hire staff using specified and transparent job qualifications; avoiding political interference; and providing sustainability through political cycles.
- *An independent and well-functioning board of directors* or advisory board with strong and active private sector representation to better understand investors and provide direction in catering to their needs.
- *A strong investor-centric service orientation* to design and provide relevant and high-quality services to investors throughout their investment cycle.
- *Management and key promotion staff with strong private sector experience*, as well as international exposure and language skills, within the IPA's mix of employees with public and private sector experience.
- *Sufficient and sustained financial resources* over three- to five-year periods to provide continuity of strategic efforts over the long-cycle nature of investment promotion and to avoid struggling over funds every year or having to charge fees.

Source: Adapted from Heilbron and Whyte 2019.

incentives in increasing a location's overall investment competitiveness, although these may be needed to help companies during the pandemic crisis.[11]

When creating or strengthening their IPAs, policy makers should consider critical success factors (box O.1). The right strategic and institutional frameworks vary, depending on the country's political economy, the government's existing institutional setup, available legal formats, the civil service culture, and the institutional collaboration culture (Heilbron and Whyte 2019).

In the current COVID-19 crisis situation, IPAs are in large part shifting their principal focus from FDI attraction to retention of existing foreign investors as well as preservation of supply chains connecting foreign firms and their domestic suppliers. Through IPAs' responses to market signals and MNEs' needs, governments have an opportunity to minimize the risk exposure of MNEs and their associated supply chain linkages. Specific investment services to be prioritized by IPAs include (a) identifying and directly contacting at-risk or systemically strategic firms according to number of employees, region, or sector; (b) expediting foreign exchange approvals; and (c) advocating for urgent government actions to solve the firms' grievance issues more systematically.

Governments Can Leverage FDI for Robust Recovery from COVID-19

What can governments do, on the one hand, to leverage FDI to strengthen the resilience of their economies and help absorb future shocks, and on the other hand, to turn the current COVID-19 crisis into new opportunities to increase their competitiveness for FDI?

Avoid Protectionist Policies

Governments should avoid protectionist policies, which would further exacerbate disruptions to GVCs and amplify the already elevated uncertainty. Instead, to attract additional investment, countries should counter the global protectionist trend by further easing FDI entry and operational restrictions. Being more open to FDI relative to peers helps attract new investment. In fact, some countries are already using this crisis as an opportunity to open new sectors of their economies to foreign investment.

Enhanced regional cooperation can also be a critical element in the removal of barriers to intraregional trade and investment. Regional integration helps countries overcome divisions that impede the flow of goods, services, capital, people, and information. These divisions are a constraint to economic growth, especially in developing countries. While Europe, North America, and East Asia have historically led the way in regional integration, the momentum has lately also increased in some of the less integrated regions—as evidenced, for example, by the recently concluded negotiations on the African Continental Free Trade Area (AfCFTA). Experience has shown that deepened regional integration allows countries to improve market efficiency, accelerate reform processes in a coordinated and predictable manner, and foster multiregional cooperation.[12] Bilateral and regional trade and investment agreements also help enhance policy certainty by committing national governments to specific policy priorities and by fostering open and conducive trade and investment environments.

Seize New Opportunities from Changing FDI and GVC Patterns

Countries can seize new opportunities to increase their competitiveness for FDI as a result of shifting trade and investment patterns and policies. In the face of higher tariffs resulting from the 2019 trade war between China and the United States, importers have already sought new sourcing locations in the global marketplace (Constantinescu et al. 2019). Trade diversion may in turn cause a shift in FDI as firms adjust global supply chains and centers of production (Blanchard 2019). Developing economies with large export bases could emerge as suitable FDI hosts. Specifically, countries that already export similar products are likely to attract greater investment (Cali 2018).

With the COVID-19 crisis, the push to diversify supply chains will likely be intensified. Yet no consensus has emerged on how the global FDI and GVC landscape will look after COVID-19. Some economists hold the view that no major changes will take place and that adjustments will concentrate in health-related industries, as the economic rationale for GVCs holds the same (Baldwin and Evenett 2020; Freund 2020; Miroudot 2020). Others believe that COVID-19 has become a wake-up call for a new balance between risk and reward for GVCs, as pandemics, climate change, natural disasters, and other man-made crises may expose the world to increased risks (Goldberg 2020; Javorcik 2020). Regardless of which outcome prevails, as the main architects of GVCs, multinational firms will adjust production networks to improve their resilience and robustness in response to COVID-19.

Policy makers should reflect on these possible shifts in investment preferences and let business realities guide their policy response. Countries should assess which sectors and value chains have proven resilient during the

COVID-19 crisis. This will involve evaluating the risk exposure, value proposition, and competitiveness factors of individual sectors and value chains. In addition, governments should identify emerging competitive sectors in their countries that may arise from the possible reorganization of GVC and FDI landscapes.

Should new investment patterns emerge, they will require new priorities in investment policy and promotion reforms. These will entail realigning the investment incentive regimes to the new national development priorities likely to emerge after COVID-19, such as job creation. Reforms may also be needed to limit or phase out crisis-related investment screening and approval mechanisms. In addition, measures to address investor protections and grievance issues might be appropriate in some countries to enable governments to resolve grievances before they become legal disputes. Finally, measures to increase local firms' resilience and to strengthen supplier development programs will be needed to enhance FDI linkages to the local economies.

Strengthen Global Cooperation

Tackling the complex challenges presented by the current global environment will require global cooperation. The pandemic has illustrated the shared public health and economic vulnerabilities that countries face. It has also highlighted the critical importance of exchanging data, sharing information on good practices, and strengthening collaboration.

The magnitude and scale of the crisis require policy makers to employ their full arsenal of policy tools to improve business confidence and boost countries' investment competitiveness. During the global financial crisis, an unprecedented synchronized, coordinated policy response was critical to containing it. Once again, the times are testing policy makers. They must rise to the occasion by acting quickly, decisively, and collaboratively.

Notes

1. FDI data (here taken from the World Bank's World Development Indicators database) should be interpreted with caution. Research shows that multinational corporations' tax engineering and the role of investment hubs distort traditional FDI statistics. A growing body of evidence demonstrates that multinational corporations are reallocating royalties and other intangible assets to low-tax locations to reduce their aggregate corporate tax liability. Such "phantom investment" into corporate shells may account for almost 40 percent of global FDI (Damgaard, Elkjaer, and Johannesen 2019). At the same time, the main results reported in figure O.1 still hold, even if the analysis excludes tax havens as FDI destinations.
2. "Developing" countries in this report refers to low- and middle-income countries as defined by the World Bank. "Developed" countries are high-income countries. For the definitions of all income classifications and the countries therein, see "World Bank Country and Lending Groups," World Bank Knowledge Base: https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups.
3. The 2017 Tax Cuts and Jobs Act (TCJA) essentially exempts U.S. companies' foreign earnings from taxation, albeit with a one-off tax on past profits to ease the transition to the new system (Toder 2018). The implementation of the TCJA led to a massive increase in the repatriation of foreign-earned profits by the US multinationals back to the United States, resulting in negative FDI inflows from the United States for the affected host countries (OECD 2019). Although reinvested FDI earnings returned to positive levels in the first half of 2019—suggesting that many of the negative FDI flows were from one-time repatriations of past profits—rates of reinvestment remain below averages observed in the five years leading up to the implementation of the TCJA (OECD 2019). This pattern may signal a "new normal" for reinvestment levels as US companies now have fewer incentives to reinvest their foreign earnings to avoid taxation (OECD 2019).
4. The Pew Research Center's Spring 2018 Global Attitudes Survey included respondents from 27 countries: Argentina, Australia,

Brazil, Canada, France, Germany, Greece, Hungary, India, Indonesia, Israel, Italy, Japan, Kenya, the Republic of Korea, Mexico, the Netherlands, Nigeria, the Philippines, Poland, the Russian Federation, South Africa, Spain, Sweden, Tunisia, the United Kingdom, and the United States.

5. This short, English language, web-based survey was sent to known email addresses of MNEs, leveraging existing sampling frames for developing countries (World Bank, forthcoming). To extend reach, the survey was also circulated to known foreign investors through the countries' investment promotion agencies (IPAs). The period of data collection was March 24 to April 24, 2020. Data underlying the analysis comprise responses from 105 MNE affiliates operating in 26 developing countries. The results of the pulse survey are not generalizable to all developing countries but are an indicative estimate of impact of MNEs operating in developing countries.
6. Cross-border acquisition data are from the Thomson Reuters Refinitiv Mergers and Acquisitions Database (https://www.refinitiv.com/en/financial-data/company-data).
7. At the same time, several notable exceptions exist. These studies tend to focus on the employment and productivity of acquired firms in the context of a single developing country: Arnold and Javorcik (2009); Bircan (2019); Gong, Görg, and Maioli (2007); and Lipsey, Sjöholm, and Sun (2013).
8. Data analysis conducted for this chapter finds that Turkey's Gini coefficient currently stands at 0.35, but it would have been 0.33 (indicating lower inequality) without FDI.
9. These data are from fDi Markets, a *Financial Times* dataset (https://www.fdimarkets.com).
10. These differences may be driven by the presence of restrictions that are applicable only to larger firms and the greater regulatory scrutiny that large companies tend to experience.
11. This guidance suggests that developing countries should be careful and conservative in their use of tax incentives to stimulate their investment competitiveness. Other factors such as good investment climates, political stability, regulatory quality, and market opportunities are more critical to investors' initial location considerations than are tax rates and incentives (Andersen, Kett, and von Uexkull 2018; UNIDO 2011; World Bank 2018). Effective use of incentives requires greater regional and international coordination, political commitment, and common reporting standards to enhance transparency (IMF et al. 2015).
12. See "Overview," Regional Integration topic page, World Bank website: https://www.worldbank.org/en/topic/regional-integration/overview.

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