KEY MESSAGES

GLOBAL INVESTMENT TRENDS

Global FDI inflows declined in 2014. Global foreign direct investment (FDI) inflows fell by 16 per cent to $1.23 trillion in 2014, mostly because of the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. New investments were also offset by some large divestments.

Inward FDI flows to developing economies reached their highest level at $681 billion with a 2 per cent rise. Developing economies thus extended their lead in global inflows. China became the world's largest recipient of FDI. Among the top 10 FDI recipients in the world, 5 are developing economies.

The low level of flows to developed countries persisted in 2014. Despite a revival in cross-border mergers and acquisitions (M&As), overall FDI flows to this group of economies declined by 28 per cent to $499 billion. They were significantly affected by a single large-scale divestment from the United States.

Investments by developing-country multinational enterprises (MNEs) also reached a record level: developing Asia now invests abroad more than any other region. Nine of the 20 largest investor countries were from developing or transition economies. These MNEs continued to acquire developed-country foreign affiliates in the developing world.

Most regional groupings and initiatives experienced a fall in inflows in 2014. The groups of countries negotiating the Transatlantic Trade and Investment Partnership (TTIP) and Trans-Pacific Partnership (TPP) saw their combined share of global FDI inflows decline. ASEAN (up 5 per cent to $133 billion) and the RCEP (up 4 per cent to $363 billion) bucked the trend.

By sector, the shift towards services FDI has continued over the past 10 years in response to increasing liberalization in the sector, the increasing tradability of services and the growth of global value chains in which services play an important role. In 2012, services accounted for 63 per cent of global FDI stock, more than twice the share of manufacturing. The primary sector represented less than 10 per cent of the total.

Cross-border M&As in 2014 rebounded strongly to $399 billion. The number of MNE deals with values larger than $1 billion increased to 223 – the highest number since 2008 – from 168 in 2013. At the same time, MNEs made divestments equivalent to half of the value of acquisitions.

Announced greenfield investment declined by 2 per cent to $696 billion. Developing countries continued to attract two thirds of announced greenfield investment. Greenfield investment by both developed- and developing-country MNEs remained unchanged.

FDI by special investors varied. The significance of *private equity funds* in the global M&A market, with $200 billion in acquisitions in 2014, was reflected mainly in transactions involving large companies. *Sovereign wealth funds*, which invested $16 billion in FDI in 2014, are increasingly targeting infrastructure internationally. *State-owned MNEs'* international expansion has decelerated; in particular, their cross-border M&As declined by 39 per cent to $69 billion.

International production by MNEs is expanding. International production rose in 2014, generating value added of approximately $7.9 trillion. The sales and assets of MNEs' foreign affiliates grew faster than their domestic counterparts. Foreign affiliates of MNEs employed about 75 million people.

FDI recovery is in sight. Global FDI inflows are projected to grow by 11 per cent to $1.4 trillion in 2015. Expectations are for further rises to $1.5 trillion in 2016 and to $1.7 trillion in 2017. Both UNCTAD's FDI forecast model and its business survey of large MNEs signal a rise of FDI flows in the coming years. The share of MNEs intending to increase FDI expenditures over the next three years (2015–2017) rose from 24 to 32 per cent. Trends in cross-border M&As also point to a return to growth in 2015. However, a number of economic and political risks, including ongoing uncertainties in the Eurozone, potential spillovers from conflicts, and persistent vulnerabilities in emerging economies, may disrupt the projected recovery.

REGIONAL INVESTMENT TRENDS

FDI inflows to Africa remained flat at $54 billion. Although the services share in Africa FDI is still lower than the global and the developing-country averages, in 2012, services accounted for 48 per cent of the total FDI stock in the region, more than twice the share of manufacturing (21 per cent). FDI stock in the primary sector was 31 per cent of the total.

Developing Asia (*up 9 per cent) saw FDI inflows grow to historically high levels*. They reached nearly half a trillion dollars in 2014, further consolidating the region's position as the largest recipient in the world. FDI inflows to *East and South-East Asia* increased by 10 per cent to $381 billion. In recent years, MNEs have become a major force in enhancing regional connectivity in the subregion, through cross-border investment in infrastructure. The security situation in *West Asia* has led to a six-year continuous decline of FDI flows (down 4 per cent to $43 billion in 2014); weakening private investment in parts of the region is compensated by increased public investment. In *South Asia* (up 16 per cent to $41 billion), FDI has increased in manufacturing, including in the automotive industry.

FDI flows to Latin America and the Caribbean (down 14 per cent) decreased to $159 billion in 2014, after four years of consecutive increases. This is mainly due to a decline in cross-border M&As in Central America and the Caribbean and to lower commodity prices, which dampened FDI to South America. The FDI slowdown, after a period of strong inflows driven by high commodity prices, may be an opportunity for Latin American countries to re-evaluate FDI strategies for the post-2015 development agenda. *FDI in transition economies decreased by 52 per cent to $48 billion in 2014.* Regional conflict coupled with falling oil prices and international sanctions have damaged economic growth prospects and shrunk investor interest in the region.

FDI inflows to developed countries fell by 28 per cent to $499 billion. Divestment and large swings in intracompany loans reduced inflows to the lowest level since 2004. Outflows held steady at $823 billion. Cross-border M&A activities gathered momentum in 2014. Burgeoning FDI income is providing a counterbalance to trade deficits, particularly in the United States and more recently in Japan.

FDI flows to structurally weak, vulnerable and small economies varied. FDI to the least developed countries (LDCs) increased by 4 per cent. Landlocked developing countries (LLDCs) experienced a fall of 3 per cent in FDI inflows, mostly in those in Asia and Latin America. By contrast, FDI inflows to small island developing States (SIDS) increased by 22 per cent, due to a rise in cross-border M&A sales. The relative importance of FDI, its greater stability and its more diverse development impact compared with other sources of finance means that it remains an important component of external development finance to these economies. Over the past decade (2004–2014), FDI stock tripled in LDCs and SIDS, and quadrupled in LLDCs. With a concerted effort by the international investment-development community, it would be possible to have FDI stock in structurally weak economies quadruple again by 2030. More important, further efforts are needed to harness financing for economic diversification to foster greater resilience and sustainability in these countries.

INVESTMENT POLICY TRENDS

Countries' investment policy measures continue to be geared predominantly towards investment liberalization, promotion and facilitation. In 2014, more than 80 per cent of investment policy measures aimed to improve entry conditions and reduce restrictions. A focus was investment facilitation and sector-specific liberalization (e.g. in infrastructure and services). New investment restrictions related mostly to national security concerns and strategic industries (such as transport, energy and defence).

Measures geared towards investment in sectors important for sustainable development are still relatively few. Only 8 per cent of measures between 2010 and 2014 were specifically targeted at private sector participation in key sustainable development sectors (infrastructure, health, education, climate-change mitigation). In light of the SDG investment gap (*WIR14*), greater focus on channeling investment into key sectors for sustainable development would be warranted.

Countries and regions continue their search for reform of the international investment agreements (IIAs) regime. Thirty-one new IIAs were concluded in 2014, most with provisions related to sustainable development. Canada was the most active country (with seven new treaties). The IIA universe grew to 3,271 treaties. At the same time, countries and regions considered new approaches to investment policymaking. Reacting to the growing unease with the current functioning of the global IIA regime, together with today's sustainable development imperative and the evolution of the investment landscape, at least 50 countries and regions were engaged in reviewing and revising their IIA models. Brazil, India, Norway and the European Union (EU) published novel approaches. South Africa and Indonesia continued their treaty terminations, while formulating new IIA strategies.

Pre-establishment commitments are included in a relatively small but growing number of IIAs. Some 228 treaties now provide national treatment for the "acquisition" or "establishment" of investments. Most involve the United States, Canada, Finland, Japan, and the EU, but a few developing countries (Chile, Costa Rica, the Republic of Korea, Peru and Singapore) also follow this path.

There were 42 new investor-State dispute settlement (ISDS) cases in 2014, bringing the total number of known treaty-based claims to 608. Developing countries continue to bear the brunt of these claims, but the share of developed countries is on the rise. Most claimants come from developed countries. Forty-three decisions were rendered in 2014, bringing the overall number of concluded cases to 405. Of these, States won 36 per cent, investors 27 per cent. The remainder was either settled or discontinued.

REFORMING THE INTERNATIONAL INVESTMENT REGIME: AN ACTION MENU

There is a pressing need for systematic reform of the global IIA regime. As is evident from the heated public debate and parliamentary hearing processes in many countries and regions, a shared view is emerging on the need for reform of the IIA regime to ensure that it works for all stakeholders. The question is not about *whether* or not to reform, but about the *what*, *how* and *extent* of such reform. *This report offers an action menu for such reform.*

IIA reform can build on lessons learned from 60 years of IIA rule making: (i) IIAs "bite" and may have unforeseen risks, and safeguards need to be put in place; (ii) IIAs have limitations as an investment promotion tool, but also underused potential; and (iii) IIAs have wider implications for policy and systemic coherence, as well as capacity-building.

IIA reform should address five main challenges. IIA reform should aim at (i) *safeguarding the right to regulate in the public interest* so as to ensure that IIAs' limits on the sovereignty of States do not unduly constrain public policymaking; (ii) *reforming investment dispute settlement* to address the legitimacy crisis of the current system; (iii) *promoting and facilitating investment* by effectively expanding this dimension in IIAs; (iv) *ensuring responsible investment* to maximize the positive impact of foreign investment and minimize its potential negative effects; and (v) *enhancing the systemic consistency of the IIA regime* so as to overcome the gaps, overlaps and inconsistencies of the current system and establish coherence in investment relationships.

UNCTAD presents policy options for meeting these challenges. This report sets out options for addressing the standard elements found in an IIA. Some of these reform options can be combined and tailored to meet several reform objectives:

- *Safeguarding the right to regulate:* Options include clarifying or circumscribing provisions such as most-favoured-nation (MFN) treatment, fair and equitable treatment (FET), and indirect expropriation, as well as including exceptions, e.g. for public policies or national security.
- *Reforming investment dispute settlement:* Options include (i) reforming the existing mechanism of ad hoc arbitration for ISDS while keeping its basic structure and (ii) replacing existing ISDS arbitration systems. The former can be done by fixing the existing mechanism (e.g. improving the arbitral process, limiting investors' access, using filters, introducing local litigation requirements) and by adding new elements (e.g. building in effective alternative dispute resolution or introducing an appeals facility). Should countries wish to replace the current ISDS system, they can do so by creating a standing international investment court, or by relying on State-State and/or domestic dispute resolution.
- *Promoting and facilitating investment:* Options include adding inward and outward investment promotion provisions (i.e. host- and home-country measures), and joint and regional investment promotion provisions, including an ombudsperson for investment facilitation.
- *Ensuring responsible investment:* Options include adding not lowering of standards clauses and establishing provisions on investor responsibilities, such as clauses on compliance with domestic laws and on corporate social responsibility.
- *Enhancing systemic consistency of the IIA regime:* Options include improving the coherence of the IIA regime, consolidating and streamlining the IIA network, managing the interaction between IIAs and other bodies of international law, and linking IIA reform to the domestic policy agenda.

When implementing IIA reform, policymakers have to determine the most effective means to safeguard the right to regulate while providing for the protection and facilitation of investment. In so doing, they need to consider the compound effect of options. Some combinations of reform options may "overshoot" and result in a treaty that is largely deprived of its traditional investment protection rationale.

In terms of process, IIA reform actions should be synchronized at the national, bilateral, regional and multilateral levels. In each case, the reform process includes (i) taking stock and identifying the problems, (ii) developing a strategic approach and an action plan for reform, and (iii) implementing actions and achieving the outcomes.

All of this should be guided by the goal of harnessing IIAs for sustainable and inclusive development, focusing on the key reform areas and following a multilevel, systematic and inclusive approach. In the absence of a multilateral system, given the huge number of existing IIAs, the best way to make the IIA regime work for sustainable development is to collectively reform the regime with a global support structure. Such a structure can provide the necessary backstopping for IIA reform, through policy analysis, coordination among various processes at different levels and dimensions, management of the interaction with other bodies of law, technical assistance and consensus-building. UNCTAD plays a key role in this regard. Only a common approach will deliver an IIA regime in which stability, clarity and predictability help achieve the objectives of all stakeholders: effectively harnessing international investment relations for the pursuit of sustainable development.

INTERNATIONAL TAX AND INVESTMENT POLICY COHERENCE

Intense debate and concrete policy work is ongoing in the international community on the fiscal contribution of MNEs. The focus is predominantly on tax avoidance – notably in the G20 project on base erosion and profit shifting (BEPS). At the same time, sustained investment is needed in global economic growth and development, especially in light of financing needs for the Sustainable Development Goals (SDGs). *The policy imperative is to take action against tax avoidance to support domestic resource mobilization and continue to facilitate productive investment for sustainable development.*

UNCTAD estimates the contribution of MNE foreign affiliates to government budgets in developing countries at approximately $730 billion annually. This represents, on average, some 23 per cent of total corporate contributions and 10 per cent of total government revenues. The relative size (and composition) of this contribution varies by country and region. It is higher in developing countries than in developed countries, underlining the exposure and dependence of developing countries on corporate contributions. (On average, the government budgets of African countries depend on foreign corporate payments for 14 per cent of their funding.)

Furthermore, the lower a country is on the development ladder, the greater is its dependence on non-tax revenue streams contributed by firms. *In developing countries, foreign affiliates, on average, contribute more than twice as much to government revenues through royalties on natural resources, tariffs, payroll taxes and social contributions, and other types of taxes and levies, than through corporate income taxes.*

MNEs build their corporate structures through cross-border investment. They do so in the most tax-efficient manner possible, within the constraints of their business and operational needs. *The size and direction of FDI flows are thus often influenced by MNE tax considerations, because the structure and modality of investments enable opportunities to avoid tax on subsequent investment income.*

An investment perspective on tax avoidance puts the spotlight on the role of offshore investment hubs (tax havens and special purpose entities in other countries) as major players in global investment. *Some 30 per cent of cross-border corporate investment stocks have been routed through offshore hubs before reaching their destination as productive assets.* (UNCTAD's FDI database removes the associated double-counting effect.)

The outsized role of offshore hubs in global corporate investments is largely due to tax planning, although other factors can play a supporting role. MNEs employ a range of tax avoidance levers, enabled by tax rate differentials between jurisdictions, legislative mismatches, and tax treaties. MNE tax planning involves complex multilayered corporate structures. Two archetypal categories stand out: (i) intangibles-based transfer pricing schemes and (ii) financing schemes. Both schemes, which are representative of a relevant part of tax avoidance practices, make use of investment structures involving entities in offshore investment hubs – financing schemes especially rely on direct investment links through hubs.

Tax avoidance practices by MNEs are a global issue relevant to all countries: the exposure to investments from offshore hubs is broadly similar for developing and developed countries. However, profit shifting out of developing countries can have a significant negative impact on their prospects for sustainable development. Developing countries are often less equipped to deal with highly complex tax avoidance practices because of resource constraints or lack of technical expertise.

Tax avoidance practices are responsible for a significant leakage of development financing resources. *An estimated $100 billion of annual tax revenue losses for developing countries is related to inward investment stocks directly linked to offshore hubs.* There is a clear relationship between the share of offshore-hub investment in host countries' inward FDI stock and the reported (taxable) rate of return on FDI. The more investment is routed through offshore hubs, the less taxable profits accrue. On average, across developing economies, every 10 percentage points of offshore investment is associated with a 1 percentage point lower rate of return. These averages disguise country-specific impacts.

Tax avoidance practices by MNEs lead to a substantial loss of government revenue in developing countries. The basic issues of fairness in the distribution of tax revenues between jurisdictions that this implies must be addressed. *At a particular disadvantage are countries with limited tax collection capabilities, greater reliance on tax revenues from corporate investors, and growing exposure to offshore investments.*

Therefore, action must be taken to tackle tax avoidance, carefully considering the effects on international investment. Currently, offshore investment hubs play a systemic role in international investment flows: they are part of the global FDI financing infrastructure. Any measures at the international level that might affect the investment facilitation function of these hubs, or key investment facilitation levers (such as tax treaties), must include an investment policy perspective.

Ongoing anti-avoidance discussions in the international community pay limited attention to investment policy. The role of investment in building the corporate structures that enable tax avoidance is fundamental. Therefore, *investment policy should form an integral part of any solution to tax avoidance.*

A set of guidelines for *coherent international tax and investment policies* may help realize the synergies between investment policy and initiatives to counter tax avoidance. Key objectives include removing aggressive tax planning opportunities as investment promotion levers; considering the potential impact on investment of anti-avoidance measures; taking a partnership approach in recognition of shared responsibilities between host, home and conduit countries; managing the interaction between international investment and tax agreements; and strengthening the role of both investment and fiscal revenues in sustainable development as well as the capabilities of developing countries to address tax avoidance issues.

WIR14 showed the massive worldwide financing needs for sustainable development and the important role that FDI can play in bridging the investment gap, especially in developing countries. In this light, strengthening the global investment policy environment, including both the IIA and the international tax regimes, must be a priority. The two regimes, each made up of a "spaghetti bowl" of over 3,000 bilateral agreements, are *interrelated*, and they face similar *challenges*. And *both are the object of reform* efforts. Even though each regime has its own specific reform priorities, there is merit in considering a joint agenda. This could aim for more inclusiveness, better governance and greater coherence to manage the interaction between international tax and investment policies, not only avoiding conflict between the regimes but also making them mutually supportive. The international investment and development community should, and can, eventually build a common framework for global investment cooperation for the benefit of all.