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Policy Options to Mitigate Political Risk and Attract FDI

IN FOCUS

Priyanka Kher and Dongwook Chun

FINANCE, COMPETITIVENESS & INNOVATION

INVESTMENT CLIMATE

WORLD BANK GROUP

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The authors are grateful for peer review comments received by Persephone Economou, Rodrigo Polanco and Ivan Nimac. The authors would like to thank Sarah Hebous and Ramprakash Sethuramsubbu for their contribution.

Editing: Barbara Balaj
Design and Layout: Aichin Lim Jones
Photo Credit: Freepik.com and Shutterstock.com

Table of Contents

INTRODUCTION 3

HOW POLITICAL RISKS CAUSED BY GOVERNMENT INTERFERENCE CAN AFFECT FDI 4

- POLITICAL RISK CAN AFFECT A COUNTRY'S INVESTMENT ATTRACTIVENESS 4
- POLITICAL RISK CAN CAUSE INVESTORS TO LEAVE OR NOT EXPAND IN COUNTRIES WHERE THEY ARE ALREADY BASED 6

POLITICAL RISK FACTORS: CHALLENGES FACED BY GOVERNMENTS IN LOWERING POLITICAL RISK 8

PRACTICAL TOOLS TO HELP GOVERNMENTS MITIGATE POLITICAL RISK 10

- QUALITY OF LEGAL PROTECTIONS 12
- MANAGING INVESTOR-GRIEVANCES STEMMING FROM GOVERNMENT ACTIONS 15

CONCLUSION 17

REFERENCES 19

Introduction

Political risks refer to the probability that political decisions, events, or conditions will significantly affect the profitability of a business or the expected value of an economic action.[1] The term covers a wide range of issues ranging from the threat of political violence, to geopolitical tensions and exchange controls. Events in the past year have triggered concerns around political risk. In particular, the global rise in protectionism and policy uncertainty in response to nationalist sentiments and economic security considerations, coupled with some immediate policy actions to tackle the COVID-19 pandemic, present new challenges. With increased strains on government budgets, there are concerns around foreign exchange controls, as well as the inability of governments to fulfill contractual obligations. On the other hand, the pandemic has amplified the backlash against globalization, increasing scrutiny of and interference in companies with foreign ownership[2]. Furthermore, dissatisfaction with government responses to the pandemic can potentially fuel political discontent and/or civil unrest, leading to political instability in some countries.

This note focuses on *a subset of political risk* — specifically, the risks that arise from government actions, whether political or regulatory — that can affect the profitability of an investment in a foreign country (Kobrin 1979). Such government actions may take the form of a seizure of assets, the dishonoring of contracts, arbitrary and unpredictable regulatory and policy changes, unequal protection under the law, or restrictions on capital transfers out of the host country. In other words, it is the risk that the host government may violate the terms of its implicit or explicit contract with an investor (Graham, Johnston, and Kingsley 2018).

The reason for focusing on this subset of risks is that these risks can be influenced by government policies and measures. Investment policies adopted and implemented by governments can directly mitigate these risks. Bad governance and economic crises are two big drivers of political risk. Both are currently prevalent globally, but especially in developing countries. The purpose of this note is to summarize how political risk caused by government actions can impact foreign investment, and what tools countries can use to manage and mitigate such risks.

[1] The term "political risk" is commonly used by the political risk insurance (PRI) industry, offering a range of insurance products for non-commercial risks.

[2] The pandemic has led to nationalizations of healthcare supply chains, conversion of industries, foreign exchange controls, the adoption of measures to allow for flexibility in contract performance, and discriminatory state support measures.

Box 1: Types of Political Risks

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

Breach of contract: the risk of losses resulting from government breaching a contractual agreement with an investor and failing to honor an arbitral award granted to compensate the investor.

Currency inconvertibility and transfer restrictions: the risk of losses arising from an investor's inability to convert local currency into foreign exchange for transfer outside of the host country. This does not include devaluation of a currency.

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

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

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

Civil disturbance: the risk of losses due to social unrest.

Non-Honoring of Sovereign Financial Obligations: the risk of losses due a government's failure to make a payment when due under an unconditional financial obligation or guarantee.

Source: Multilateral Investment Guarantee Agency (MIGA).

How Political Risks Caused by Government Interference Can Affect FDI

Political Risk can Affect a Country's Investment Attractiveness

Economic theory generally predicts that in the presence of fixed and irreversible business establishment costs, uncertainty dampens investment (Bernanke 1983; Bloom 2009; Dixit 1989). The literature concerning political risk and foreign direct investment (FDI) has painted a more complex picture. Reactions are varied depending on the type of risk, the relationship between the host and the source country, firm characteristics, and the sectoral context.

Poor governance and weak institutions are associated with political risk (Busse and Hefeker 2007; Kinoshita and Campos 2003; MIGA 2013). Empirical studies explore this issue further and estimate the impact of specific types of government-related risk to FDI, as measured by some proxies.

Low institutional quality itself poses a major source of risk for investors. Alfaro, Kalemli-Ozcan, and Volosovych (2008) find that low institutional quality (as measured by the composite of the International Country Risk Guide [ICRG] risk categories), is a key deterrent for foreign capital flows into low-income countries.

Institutional quality is a broad term describing distinct, but often related facets of government conduct, many of which have been studied in the literature. Wei (2000) documents that an increase in a host country's corruption level reduces FDI inflows. A well-studied component of institutional quality concerns the honoring of investors' property rights. In this regard, Azzimonti (2018) documents that countries with a high expropriation risk receive low FDI inflows. Moreover, when the risk of expropriation is high, FDI no longer responds positively to improvements in other dimensions of institutional quality (Akhtaruzzaman and others 2017).

Expropriations have significantly declined relative to the 1970s, although the trend has been steadily increasing since the mid-1990s — albeit at levels below the 1970s (Hajzler 2012). Importantly, over time, countries have turned to less drastic measures of property rights violations, such as transfer restrictions, forced sales and contract renegotiations (Esberg and Perlman 2020; Graham and others 2018).

A key question is the relative importance of the various aspects of risky government conduct vis-à-vis FDI. Daude and Stein (2007) use the World Governance Indicators to study the differential effects of six dimensions of governance on bilateral outward FDI stocks from 1982 to 2002. They find that the unpredictability of laws, regulations and policies, excessive regulatory burden, government instability and lack of commitment play a major role in deterring FDI. Akhtaruzzaman and others (2017) undertake a similar exercise using ICRG risk indicators. They show that among the multiple dimensions of institutional quality, expropriation risk has the highest explanatory power vis-a-vis FDI inflows to developing countries.

A recent study finds that high regulatory risk, that is, risks due to arbitrary government actions, is associated with lower FDI inflows. Estimations from a model of investor location choices suggests that regulatory risk can deter the decisions of multinational enterprises (MNEs) to enter or expand in a host country (Hebous, Kher, and Tran 2020)[3]. Using a new measure of firm-level political risk, another study (Hassan and others 2019) finds that variation in political risk appears to play out at the firm level, and is significantly associated with investment and hiring decisions. This result suggests that reducing country-level risk can improve macroeconomic outcomes through an additional channel — that is, by lowering the distortion of resource allocation across firms as they respond to varying levels of risk.

Beazer and Blake (2018) hypothesize that "home country institutions shape firms' practices and capabilities, thus helping to determine the environments that firms are best prepared to face abroad". They look at the quality of the judicial system in FDI source and host countries, and find that a similarity in the quality level is an important determinant of foreign investment. Relatedly, much of the well-documented relationship between political risk and FDI stems from analyzing flows from developed to developing countries. When explicitly studying FDI from developing economies, Aleksynska and Havrylchyka (2013) and Demir and Hu (2016) confirm that higher institutional quality in host countries (relative to the source country) attracts FDI, whereas lower institutional quality deters it. The latter effect, however, seems to be less pronounced than for FDI from developed economies. Indeed, investors from developing economies seem to have an advantage when operating in other countries with lower institutional quality.

Reinvested earnings from balance of payments data (International Monetary Fund (IMF)) can serve as a proxy for investment expansion. After controlling for economic fundamentals, such as gross domestic product (GDP) per capita, GDP growth and country fixed effects, cross-country analysis shows that reinvested earnings by foreign investors decrease with the increase in political risk (World Bank 2019)[4]. In addition, on average, American MNE affiliates spend more on capital expenditures in countries with lower levels of political risks. A similar negative relationship also exists between country risk and affiliates' research and development expenditure as a share of total assets and employment (World Bank 2019).

[3] This effect is of meaningful magnitude: if the median country improves its performance to the level of a top 25th per-centile performer, investors will be 5.5–22 percentage points more likely to locate/invest in the country. The Regulatory Risk measure developed in the paper examines: (a) whether there is transparency in both the content and process of making laws and regulations that apply to investors; (b) the extent of legal protection provided to investors against arbitrary, unpredictable, and nontransparent governmental interference; and (c) whether investors have access to effective recourse mechanisms.

[4] As measured by the ICRG Country Risk, EIU Legal and Regulatory Risk and OECD Country Risk ratings.

Political Risk Can Cause Investors to Leave or not Expand in Countries Where They are Already Based

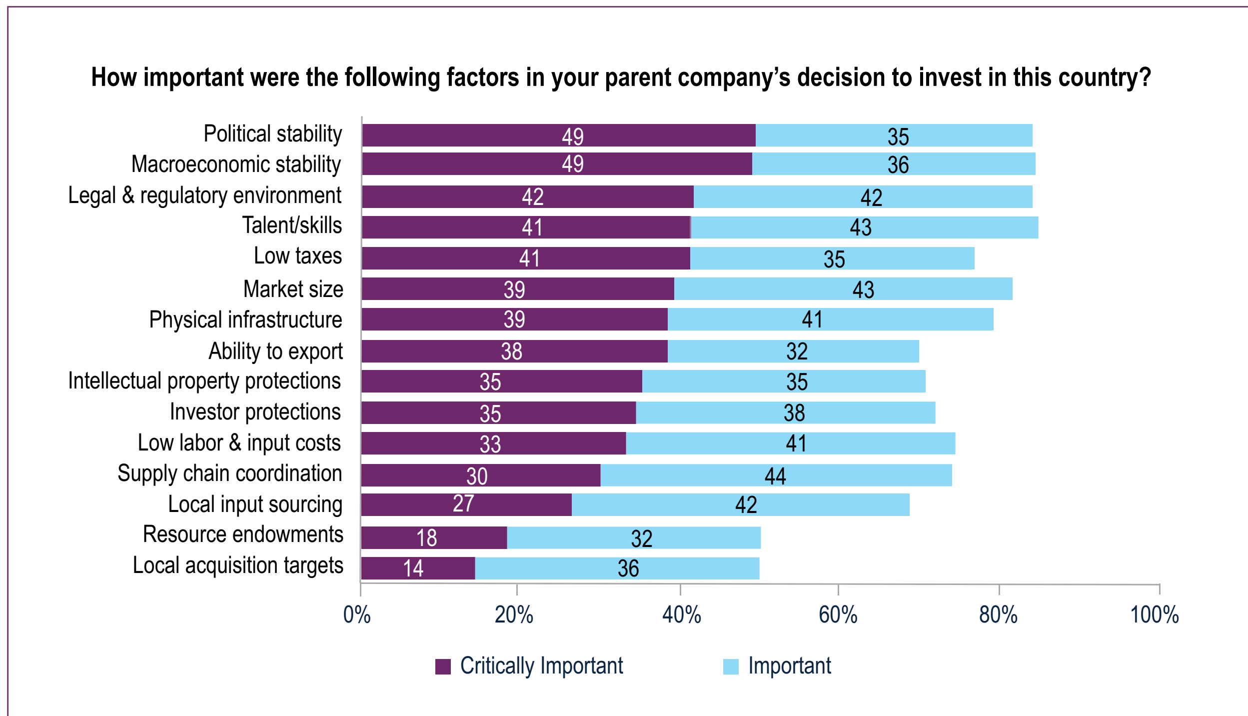
Findings from investor surveys over the last decade complement the economic literature. Investor surveys conducted annually between 2009 and 2013 by MIGA in collaboration with the Economist Intelligence Unit (EIU) (2009–13 MIGA Surveys) consistently rank political risk as the most important FDI constraint when considering investing in developing economies[5]. Between 2009 and 2013, when investors were asked to specify the type of political risk about which they were most concerned, investors consistently identified political risks related to governmental actions, such as adverse regulatory changes, expropriation, breach of contract, and/or transfer and convertibility restrictions.

In the 2017-18 Global Investment Competitiveness (GIC) Survey, international investors indicated that when deciding to invest, political stability and security, as well as a business-friendly legal and regulatory environment, are the two most important factors — both can be taken as proxies for less political risk. These were followed by macroeconomic stability, the size of the domestic market, the state of the country's infrastructure, labor talent and skill, and the relative (low) costs of labor. Eighty-six percent of the investors surveyed found the legal and regulatory environment to be important or critically important when making investment decisions (World Bank 2018).

Most recently, the 2019-20 GlC Survey (World Bank 2020) finds that apart from political and macroeconomic stability, investors consider the legal and regulatory environment to be one of the most important factors shaping their investment entry decisions. In fact, 42 percent of respondents consider it a *critically important* factor in their investment decisions (figure 1). The majority (two of three) of existing investors would consider withdrawing investments or cancelling planned investments in the face of political risk exposure in host countries (figure 2). The risks of expropriation and government breach of contract evoke particularly negative investment reactions. About 50 percent and 40 percent of investors, respectively, would consider withdrawing existing investments and/or cancelling planned investments when faced with these risks.

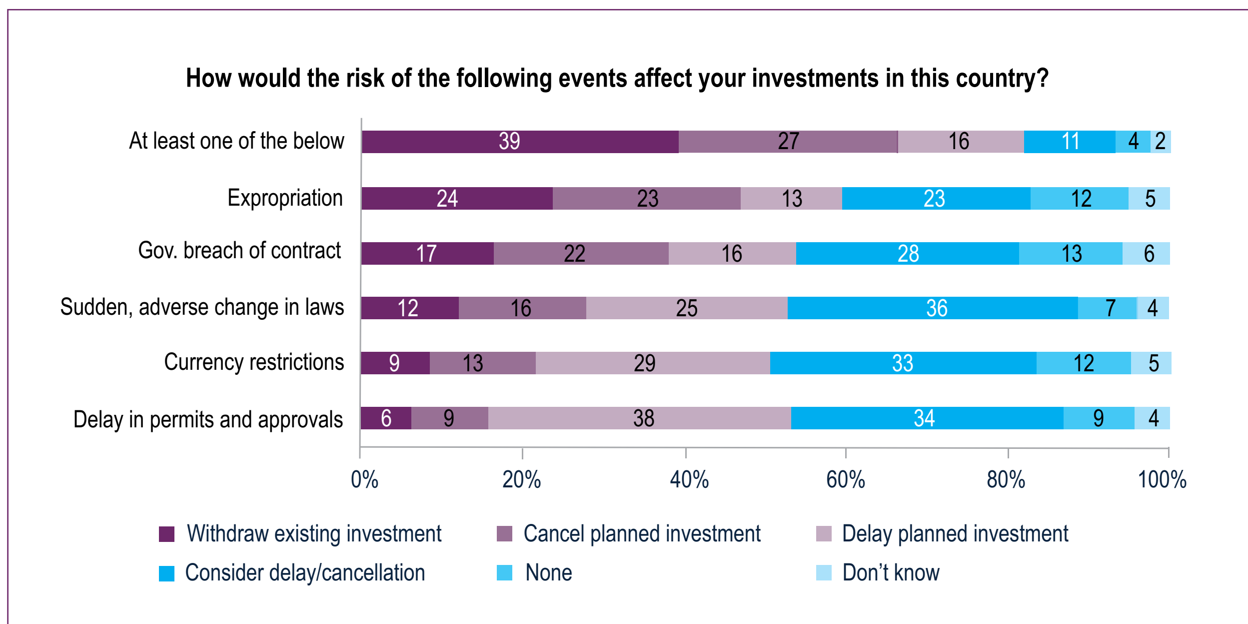
[5] Other factors were considered, such as corruption, access to qualified staff, and infrastructure capacity. These fluctuated between 2009-2013, but political risk consistently emerged as a top FDI constraint as perceived by investors.

Figure 1: Investment Decision Factors



Source: Hebous, Kher and Tran 2020; Calculations based on the 2019 GIC Survey.

Figure 2: Expropriation and Breach of Contract are Most Likely to Affect Investment Adversely



Source: Hebous, Kher and Tran 2020; Calculations based on the 2019 GIC Survey.

Political risk can increase exposure to investor-State disputes

Apart from its effect on investment, political risks can also lead to disputes between host governments and foreign investors (that is, investor-State disputes). Investors are normally protected against major political risks such as expropriation, transfer restrictions, and breach of contract under investor protection guarantees, which are part of domestic investment laws and international investment agreements (IIAs) (figure 3). Individual investors who experience violations of these protections can sue States using investor-state dispute settlement mechanisms, mainly international arbitration.

There is a clear convergence between the specific types of political risks generated due to government actions and factors leading to investor-State disputes. The most common breaches alleged by investors in investor-State dispute settlement (ISDS) proceedings are violations of the fair and equitable treatment (FET) principle; indirect expropriation; full protection and security or similar; and arbitrary, unreasonable, and discriminatory measures — all of which manifest as political risks (figure 4).

Should an investor decide to register a dispute against a State, the costs are substantial, especially for States. Average legal costs for host States in an investor-State arbitration case ranges between US$4 to US$5 million, and damages can run into billions of dollars[6] (Frank 2019; Hodgson and Campbell 2017). The registration of the first investor-State dispute based on a bilateral investment treaty took place in 1987, under the arbitral proceedings of the International Centre for Settlement of Investment Disputes (ICSID). The cumulative number of treaty-based cases has increased to 1,023 as of December 2019, with 603 brought under ICSID arbitration rules (including the ICSID's Additional Facility), 326 under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL), and the remaining before other arbitration fora (UNCTAD Investment Dispute Settlement Navigator).

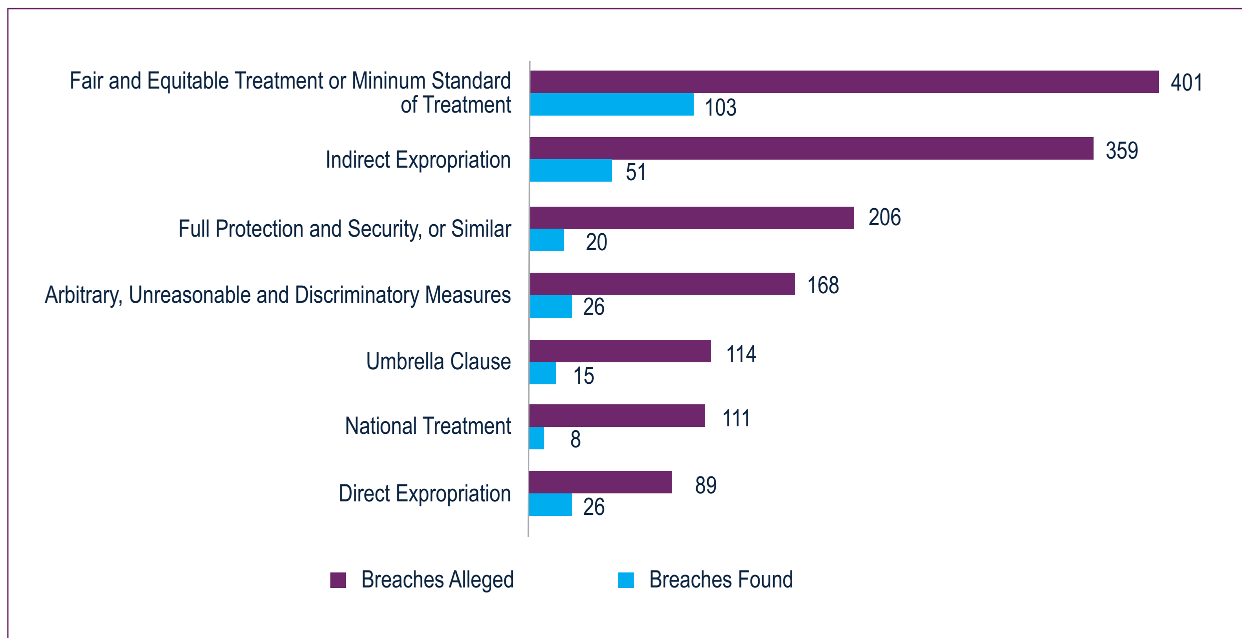
Figure 3: Political Risks and Investor Protection Guarantees

Main Types of Political Risks from Government Conduct	Main Types of Government Conduct that Investors are Protected Against in IIAs/Investment Laws (Protection Guarantees)
Expropriation	Protection from unlawful expropriation
Breach of Contract	Umbrella clauses/expropriation
Transfer and currency convertibility	Protection from transfer restrictions
Lack of transparency and predictability in dealing with public agencies	Fair and equitable treatment/transparency
Sudden adverse regulatory changes	Fair and equitable treatment

Source: Authors' analysis.
Note: IIA= International Investment Agreement.

[6] The estimated average cost is US$4.8 million according to one estimate. Using data from 2013 to 2017, the average cost is US$5.18 million. (Hodgson and Campbell 2017). Another estimate suggests US $4.1 million (Frank 2019).

Figure 4: Breaches most Frequently Alleged/Found in Treaty-based ISDS Cases, 1987-2017



Source: UNCTAD.
Note: ISDS = Investor-State Dispute Settlement.

Political Risk Factors: Challenges Faced by Governments in Lowering Political Risk

Political risks generated by government actions arise due to various factors that are not always linked to bad faith on their part, or to broader economic (technological or other) shifts. Sometimes, low prioritization of FDI and limited capacity of governments, especially to appreciate factors negatively affecting FDI can cause governments to act in ways detrimental to their interests. The nature and structure of government itself makes it challenging for governments to address political risks generated by governmental conduct. Governments are not monolithic. They are comprised of multiple agencies across sectors, ministries, and regions — all of which have different priorities and mandates. Nonetheless, almost all government agencies interact with investors, and may take actions that directly or indirectly impact the operations of investors. For example, the Ministry of Environment may consider environmental protection to be their top priority. As such, the Ministry may take decisions based on environmental protection, but without due consideration of its effect on FDI, including FDI policies and laws. To illustrate, this may occur where project sites are declared "protected" areas, but without payment of any compensation for the expropriation or other adjustments to allow business continuity for investors. This lack of alignment often occurs in highly regulated areas, such as customs, energy, labor and taxes. (UNCTAD 2010)

Information asymmetry within the government can also pose a challenge. FDI policy, law and IIAs are usually drafted by one or two agencies, typically the Ministry of Trade or Investment. There may be another agency, such as the Ministry of Justice or the Attorney General's Office, which is responsible for implementing IIAs and representing the host State in international arbitration proceedings. These agencies have staff that understand FDI policy and

its determinants, as well as investment regulations and agreements. However, other ministries and agencies may not be very familiar with these aspects, particularly the implications of violating domestic investment laws and IIAs.

Due to this information asymmetry, an "offending" agency may be unaware of the full impact of its actions on a FDI project. For example, this may occur when subnational agencies that typically have less awareness of FDI policy and regulation (determined at the federal level) impose additional requirements or terminate operational licenses — without proper notice, consultation or due process.

Investor-State disputes data illustrates some of these challenges. Around 70 percent of the ISDS claims involved measures adopted by subnational entities (such as a municipality or a province) or sector-specific regulatory agencies (Franck 2008; UNCTAD 2010)[7].

Two other important factors generating political risks are the lack of policy continuity during government transitions, and the low capacity of governments to negotiate contracts, leading to contracts with terms and conditions that are difficult to comply with.

The absence of a well-defined coordination mechanism within governments makes it difficult to take effective measures to systematically mitigate political risk. As noted, subnational and sectoral agencies often exercise their own authority, disconnected from other agencies. In many cases in the developing world, the agency overseeing FDI has limited authority and capability to undertake effective information sharing, dissemination and advocacy vis-à-vis all investment stakeholders (World Bank 2019). There may be other agencies tasked with steering the broad investment climate reform agenda. As such, communication between these agencies may be limited. Without proper coordination and communication, it is challenging to respond coherently to investor concerns around political risk.

Sometimes the low capacity of domestic institutions may itself act as a deterrent for governments to implement concrete mechanisms to mitigate political risk. For example, there may be hesitation to undertake comprehensive obligations (in investment laws and IIAs) towards transparency (including consultations) due to apprehensions around the ability of the government to implement those provisions, thus risking increased exposure to disputes.

Practical Tools to Help Governments Mitigate Political Risk

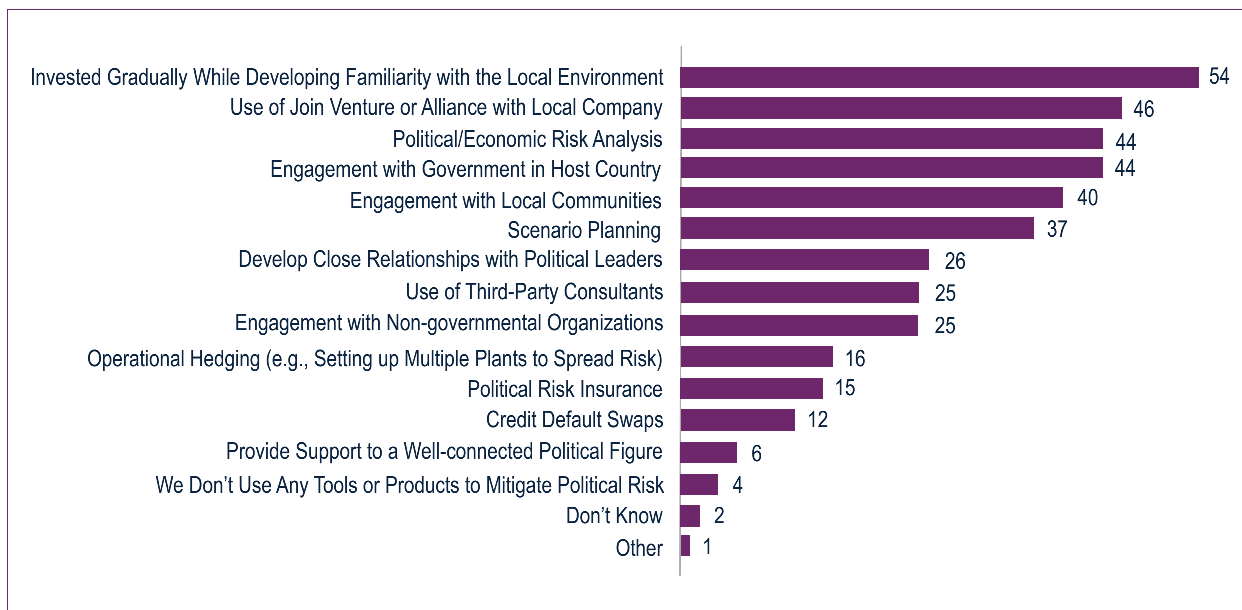
Investors use various tools to minimize political risk. The 2009 MIGA survey found that direct engagement with local public authorities was the preferred choice of investors (60 percent), ranking above other tools such as risk analysis, establishing a joint venture with a local investor, and using risk consultants. This changed over the years. For instance, in the 2013 MIGA Survey, direct government engagement was only the third most common mechanism (44 percent), after gradual investment (54 percent) and joint ventures (46 percent).

Political risk insurance is another important tool[8]. A key limitation of political risk insurance is that it is costly, albeit less costly than responding to

[7] However, IIAs operate under the premise that the state is a single entity—regardless of its internal administrative complexity—and is a subject under international law. Therefore, governments as whole are considered accountable to comply with their international obligations.

[8] It is widely recognized that, from a historical point of view, the evolution of the political risk insurance sector (Ziegler 2010) and the negotiation of thousands of international investment agreements (Vandevelde 2010) were done in response to the need for mechanisms to mitigate and minimize the risks inherent in cross-border investment projects.

Figure 5: Mechanisms Used by Investors to Mitigate Political Risk in Emerging Markets, 2013 (% of Respondents)



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

investor-State disputes. In addition, it does not cover all types of political risks stemming from governmental actions[9]. A Chief Finance Officer survey conducted by Duke University suggested that the use of political risk insurance and other firm-level mitigation efforts is limited, even among large global corporations. According to the survey, some of the most common reactions of firms to perceived political risk are to avoid investing at all or to reduce their exposure in risky environments (Giambona and others 2016).

With limited use and success of private risk mitigating measures, governments clearly have a role to play in de-risking investment. Indeed, governments can take concrete actions over the medium term, including: (i) improving the legal framework to provide protection to investors against political risk; and (ii) managing investor grievances resulting from governmental actions.

Broadly speaking, governments can reduce risks for multinational investors by increasing rules-based constraints on the executive branch of government (Jensen 2008). Legal protections or investor protection guarantees against political risk include provisions protecting investors against expropriation, restrictions on their ability to convert and transfer currency, arbitrary and unpredictable government actions, and breach of contract. These legal protections, and the rule of law more fundamentally, help to promote predictability by limiting the ability of government actors to act arbitrarily. They reduce risk by providing more certainty about possible future outcomes, thereby constraining governmental discretion (Yackee 2009). Of course, even with good rules, the well-known challenges around effective enforcement persist. Nonetheless, legal protections establish the baseline treatment that foreign investors

[9] For example, typically, adverse regulatory changes are not covered by insurance products.

should expect when considering investing in a new location. Investors highlighted this in the 2019 GIC survey; indeed, 73 percent of the respondents considered such guarantees to be important in their decisions to invest in a country (World Bank 2020).

Quality of Legal Protections

The precise drafting of these legal protections may vary by type of instrument, a country's legal traditions, and the overall political economy context. However, there are certain elements that are well-recognized as core elements of protection guarantees. Governments can strengthen the quality of investment protection provided to investors through various instruments. At the international level, there are international investment agreements and at the domestic level, there are investment laws. Both should have clear, well-balanced investment protection provisions (that is, provisions that protect investments and also safeguard States' right to regulate) that can enhance investor confidence and minimize risk. In addition, investors may also have individually negotiated contracts, which include protection provisions. The main types of investor protection guarantees are summarized in Box 2.

Box 2: Main Types of Investor Protection Guarantees

Protection from expropriation: States do have a right to expropriate under international law. However, to be considered lawful, expropriations must: (i) occur for a public purpose; (ii) be non-discriminatory; (iii) follow due process; and (iv) ensure compensation.

Compensation must be prompt, adequate and effective. Both tangible and intangible property should be protected. Expropriation could be direct or indirect. Clarifying what kinds of actions can amount to 'indirect' expropriation allows for greater certainty to investors and to States alike in determining which measures are actual expropriations. Notably, not all government actions impairing business are deemed to be expropriations. States have a right to regulate in the public interest. Therefore, governmental actions or regulations that are non-discriminatory and genuinely seek to improve general welfare are typically not considered expropriations. Thus, they do not result in compensation obligations. Public interest or welfare concerns usually cover public safety, health, and the environment. Exceptions are increasingly included in legal instruments.

Protection from transfer restrictions: Critical to every investment is the ability to transfer funds to the host state to make the initial investments, pay for any investment-related expenses, and transfer the funds outside the host state so that investors can reap the rewards of a successful investment — or exit the host state if an investment fails. States provide for such rights through international investment agreements, as well as through their domestic legal frameworks. From the perspective of international regulation, the IMF grants discretion to States to impose restrictions on capital account transactions. However, for current account transactions, all IMF member States are obliged to permit free transfers. Not all restrictions violate this guarantee. For example, in case of a balance of payments crisis or on legitimate application of certain national laws (for example, those relating to bankruptcy, insolvency, or the protection of the rights of creditors), temporary, non-discriminatory measures implemented in good faith are typically not considered unlawful.

Non-discrimination: Foreign investors are protected from discrimination under the national treatment and most-favored nation standards. National treatment requires that foreign investors not be treated less favorably than domestic investors, whereas most-favored nation standard requires non-discrimination among investors of different foreign nationalities.

Protection from arbitrary, unpredictable, non-transparent actions: Investors are protected from these actions under the fair and equitable treatment (FET) standard, among others. Over time, this standard has been clarified in arbitral decisions to include an obligation on States to act in a transparent, consistent, reasonable, and proportional manner, respecting the legitimate expectations of investors resulting from written commitments. Still, the exact content of the FET standard is not always clear. In addition, specific provisions mandating transparency may also be included in legal instruments, including publication, consultation in the law-making process, and following legal due process.

Access to dispute settlement: Having access to a range of dispute settlement options is important to ensuring the effective enforcement of protection guarantees. This includes the right of a foreign investor to challenge a host country measure before an international arbitration tribunal.

International Investment Agreements

In the absence of a multilateral legal framework regarding substantive investment protection, rules governing the relationship between host States and foreign investors have developed through international investment agreements at the bilateral, regional and plurilateral levels. Bilateral investment treaties (BITs) and treaties with investment provisions, such as investment chapters of preferential trade agreements[10] (PTAs) (cumulatively referred to as (IIAs)), are key instruments used to guarantee protection for foreign investors. Whereas the majority of BITs provide protection for investments already established in the host country,[11] investment chapters in PTAs also promote non-discriminatory treatment in establishing foreign investments in the host country.

The first BIT was negotiated in 1959, and since then, the use of such treaties has grown. The number of IIAs (as of April 30, 2020) stands at 3,287 — of which 2,897 are BITs and 390 are PTAs with investment chapters[12].

Apart from standards of investment protection — including national treatment; most-favored nation treatment; fair and equitable treatment; full protection and security; protection against expropriation; and rights of transfer — most IIAs allow foreign investors to challenge government actions outside of local courts. This can be done using investor-State dispute settlement, usually through binding investor-State arbitration[13].

During the past few years, major reforms have been undertaken to address concerns around IIAs, specifically, around broad provisions impeding the State's right to regulate, expansive and inconsistent interpretations of treaty provisions, and inadequacies in investor-State disputes (such as lack of transparency, high costs, the possibility of frivolous claims, qualifications and the independence of arbitrators). (UNCTAD 2018) Although the need for such reforms is undisputed, IIAs remain important instruments, providing core protection guarantees to investors and access to rules-based dispute settlement. They can serve either as a commitment device or as a signal that countries have laws and policies in place that protect all foreign investment. (Buthe 2009)

Suggestions have been made by organizations such as United Nations Conference on Trade and Development (UNCTAD) to identify options for IIA reforms (UNCTAD 2018)[14]. Decisions in investment disputes have greatly influenced the refinement of provisions contained in the new generation of IIAs. Several procedural and substantive innovations have been introduced in these agreements. For example, regarding substantive protection guarantees, the

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10 PTAs range from agreements that provide only for economic cooperation to agreements that create a common market. They may be bilateral, plurilateral, regional, interregional, or multilateral.

11 There are exceptions to this trend. In particular, BITs negotiated by the United States and Canada have traditionally applied to both the pre- and post-establishment phases.

12 Evidence about the impact of IIAs on FDI is mixed and nuanced. See Bonnitcha, Skovgaard Poulsen, and Waibel 2017 for a review of evidence. Recent literature shows that it is not the ratification of IIAs, per se, but the treaty "strength"— including dispute provisions — that are important for FDI inflows. For example, Dixon and Haslam (2016) find a positive association between the strength of protection clauses and FDI inflows. Frenkel and Walter (2019) find that stronger international dispute settlement provisions are associated with positive effects on FDI. Various dimensions are explored in literature. However, one common finding is that IIAs act as complements rather than substitutes for local property rights. As such, countries must have the necessary domestic institutions in place to make these international commitments credible and valuable to investors (Hallward Driemeier 2003; and Tobin and Rose-Ackerman 2011).

13 Recent treaties have introduced innovations in dispute settlement. For example, the European Union's Free Trade Agreements with the governments of Canada, Singapore, and Vietnam include a standing investment court system, which incorporates an appellate tribunal as well.

14 See also the UNCITRAL Working Group III for Investor-State Dispute Settlement Reform, https://uncitral.un.org/en/working_groups/3/investor-state

Canada-European Union Comprehensive Economic and Trade Agreement (CETA) provides elements of fair and equitable treatment (FET) (as opposed to an undefined guarantee). In addition, treaties such as the Belarus-India BIT enumerate specific measures that constitute a violation of international law. The CETA also clarifies indirect expropriation. In another case, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)[15] includes important exceptions and carve-outs regarding the right to regulate.

As countries determine their own reform paths, new generation IIAs that respond to investors' expectations of predictability, stability and transparency in the investment environment as well as preserve States' right to regulate, will continue to evolve. Of course, decisions to reform IIAs will be influenced by a range of considerations, including the quality and effectiveness of countries' own domestic legal systems. With apprehensions around the credibility and neutrality of domestic court systems in host countries, foreign investors seek alternatives for the effective enforcement of their rights. In this regard, membership in the main international conventions that allow for stronger investment protection, such as the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and the International Centre for Settlement of Investment Disputes Convention, can complement available dispute settlement mechanisms.

Investment Laws

At the national level, governments can pass an investment law that embodies good practice investment protections (Box 2). About 118 countries have investment laws, of which 73 apply to both foreign and domestic investors, and 45 to foreign investors only[16]. Countries with civil law traditions tend to codify laws more than countries with common law traditions. This is also reflected in investment laws, which appear to be most frequently passed by countries with civil or mixed law traditions. A review of all publicly available investment laws indicates that the most common objectives of investment laws, as identified in the text of the law itself are, investment promotion, economic development and investment protection. Indeed, fostering investor confidence is a core objective of investment laws, signaling a strong regard for investor rights. Notably, fewer countries with high GDP per capita tend to have an investment law. This may be because these countries invest significantly in creating comprehensive legal frameworks and in building institutional capacity to ensure implementation. Therefore, they rely less on instruments such as investment laws, which are often used as a signaling device (Hebous, Kher, and Tran 2020).

At a minimum, good practice vis-à-vis investment laws is to provide clarity on investment entry and establishment requirements, the main investment institutions and investor protection guarantees. However, the focus here is only on investment protection guarantees, given their direct link with political risks. Ideally, investor protection guarantees should apply across the board to foreign and domestic investors.

Foreign investors from countries that have an IIA with the host country will benefit from protection guarantees included in the IIA. However, inclusion in the domestic investment law allows for leveling of the playing field between foreign and domestic investors. It is important that the law guarantees protection of tangible and intangible assets. Apart from incorporating widely accepted good practice elements of protection guarantees, clarity regarding terms such as 'indirect' expropriation should be provided. Where exceptions apply, for example, those related to a state's right to regulate, they should be specified in the law. This will enable

[15] CPTPP is a free trade agreement between Australia, Brunei Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

[16] https://investmentpolicy.unctad.org/investment-laws.

investors to know upfront the possible cases for which exceptions may apply.

Of the 118 publicly available investment laws[17], 100 have at least one investor protection guarantee, albeit of varying strength and quality. The vast majority include provisions pertaining to expropriation and transfer restrictions. This is followed by provisions on dispute settlement (allowing both domestic and international arbitration) and non-discrimination (national treatment) (figure 6). In addition, a few recently implemented laws also include provisions pertaining to transparency, that is, publication and consultation on legal instruments.

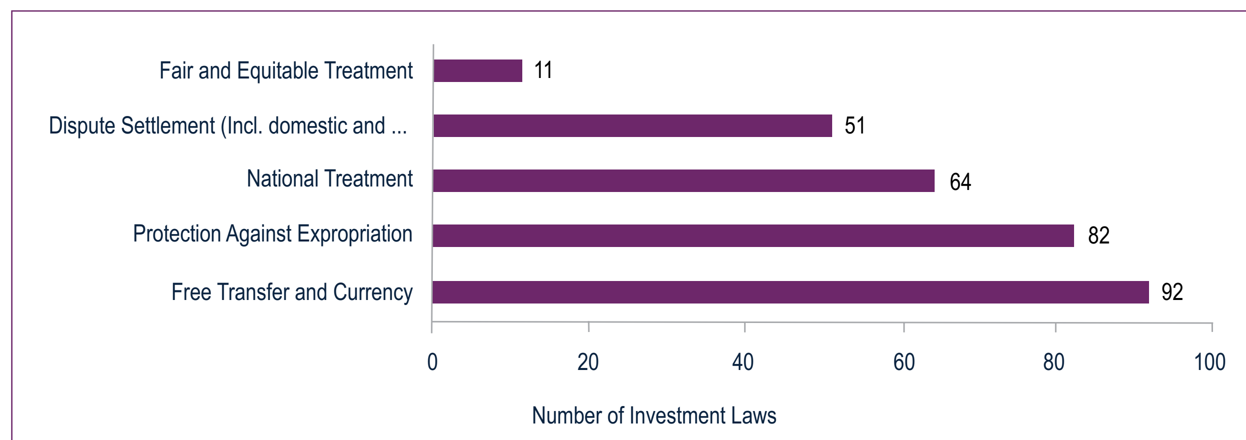
In case a country is a party to IIAs, its domestic laws should reflect the commitments under these agreements. It is important to ensure consistency and coherence in the domestic legal framework, thereby avoiding uncertainty and challenges in enforcement. For example, the investment law of a country may have a provision stating that expropriation must be non-discriminatory, but the land act may specifically allow for the taking of land leased to foreign investors — and not domestic investors.

Managing Investor-Grievances Stemming from Government Actions

Ultimately, legal provisions are only as useful as their implementation. Non-implementation can lead to investor grievances, which if not effectively addressed, can sometimes escalate into legal disputes. Therefore, countries have been establishing specific mechanisms to address investor grievances. One such mechanism is the investor grievance management mechanism (IGM)[18]. This is a tool to enable governments to identify, track, and timely resolve investor-State grievances that may put FDI projects at risk of divestment and/or create risks for the host State through potential liability under applicable domestic or international investment rules.

The concept of IGM is rooted in the distinction between the notion of "conflict" on the one hand, and "legal dispute" on the other. It visualizes a legal dispute at the end of a "continuum". Figure 7 describes this continuous process of degradation, whereby a state of agreement among the parties to a relationship devolves into the identification of a problem, a conflict arising from that problem, and then to a dispute arising from that conflict (Echandi 2011).

Figure 6: Types of Investment Protection Guarantees in Investment Laws



Source: UNCTAD Investment Policy Hub.

[17] As of May 1, 2020.

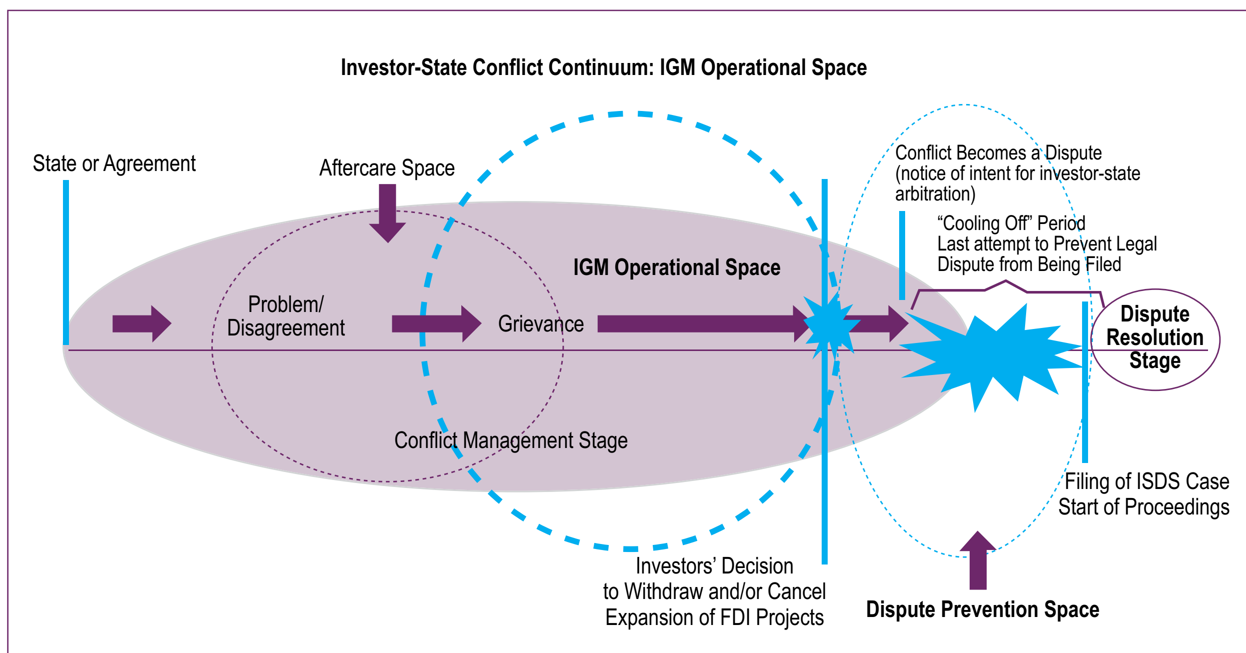
[18] IGM is also referred to as the systemic investment response mechanism (SIRM).

Indeed, several countries have aftercare programs dealing with investor concerns. However, experience shows that countries will also likely have to deal with issues that go beyond aftercare services. Specifically, this involves government conduct that places FDI at risk of withdrawal, cancellation of expansion, or potential liability for the country. Experience also shows that disagreements with investors that remain unresolved tend to fester into grievances that may escalate further into disputes, thereby leading to domestic litigation or investor-State arbitration. In many countries, the very first time that authorities dealing with investor-State disputes hear about a grievance is when they receive a formal notice of intent for arbitration. By then, the opportunities to resolve disagreements quickly and at minimum cost have already been lost (figure 7). (World Bank 2019)

Countries have followed a variety of approaches in handling investor grievances. First, those countries focusing on investment retention and expansion have deployed aftercare programs. For example, the Republic of Korea developed the Foreign Investment Ombudsman Office, which is considered one of the most sophisticated aftercare programs in the world. Second, countries that have been respondents in investment disputes have focused on measures to prevent disputes. This has been the experience of various Latin American countries, which over the past two decades have been frequent respondents in investor-State arbitrations. As a result, they have actively explored initiatives to prevent disputes under international investment agreements.

Figure 7 depicts the entire continuum of a typical investor-State conflict — beginning with a disagreement and ending with a legal dispute. Countries have either focused on the beginning of the investor-State conflict continuum, addressing problems affecting investors at an early stage before they have escalated to grievances and placed the FDI at risk of withdrawal or expansion cancellation. Alternatively, others have focused on the opposite side of the continuum. In the latter case,

Figure 7: IGM and the Investor-State Conflict Continuum



Source: World Bank research based on Echandi (2013)
Note: FDI = foreign direct investment; IGM=Investor Grievance Management Mechanism

governments that have been frequent respondents in ISDS have used coordinated, inter-institutional efforts to manage and respond to investor-State disputes. However, as illustrated by figure 7, the problem with these approaches is that neither fully connects the two ends of the continuum.

The World Bank has been providing support to client governments in establishing an Investor Grievance Management Mechanism. This is an early warning and tracking mechanism to identify complaints and issues that arise from governmental actions. It collects data and identifies patterns in the sources of government-generated political risks affecting investments. As such, it quantifies investments that are retained, expanded, or lost. Implementation of the IGM entails the empowerment of a reform-oriented government agency (that is, a Lead Agency) and the establishment of an intergovernmental mechanism for systematically addressing grievances arising from governmental actions, thereby reducing these types of political risks at their source. The Lead Agency is responsible for bringing grievances to the attention of high-level government bodies to address the issues before they escalate further. In this way, immediate attention is given to adverse governmental actions that may lead to elevated perceptions of political risks. The operation of the IGM includes the following:

- Identifying the origins of governmental conduct generating political risks;
- Measuring affected investments and jobs as evidence for the need to advocate for timely changes; and
- Strengthening capacity in the offending institutions to minimize the recurrence of these events.

The mechanism is normally customized to the specified context of a country. However, some key elements have emerged from implementation of pilot projects, including effective support from the highest levels of government; a supportive legal framework; systematic data collection; and an emphasis on capacity building of the Lead Agency.

In the context of the COVID-19 pandemic, the IGM can serve as a valuable tool. With countries adopting increasingly interventionist approaches regarding FDI, investors will likely experience more grievances. Further, budgetary strains coupled with supply and demand side shocks, are amplifying challenges around contract performance, and could result in an increase in investor-State disputes. In fact economic crises are positively associated with the number of investor-state arbitration cases (Belak and Leibrecht 2019). Implementing mechanisms to detect and address investor concerns before they escalate into legal disputes is key.

Conclusion

Political risks have a dampening effect on FDI flows and investor decisions. The current state of the global economy — overshadowed by the COVID-19 crisis and its far-reaching economic consequences — has created more opportunities for increased exposure to political risks. Yet FDI has an important role in economic recovery from the crisis.

With the global decline in FDI over the past few years, and a projection of a 30-40 percent decline in 2020-21 (UNCTAD 2020), the competition between developing countries to attract FDI has only intensified. Attracting and retaining FDI will require effective government actions to reduce risks for investors. Several factors determine macroeconomic and other types of risks, many of which are beyond direct government control. However, risks generated by governmental action itself present an opportunity for improvement. Governments can influence these risks through targeted and concerted actions.

Improving legal provisions in investment laws and IIAs to protect investors from political risks, such as expropriation, transfer restrictions, and non-transparent or arbitrary conduct is important. In drafting such guarantees, well-established principles of investor protection should be considered. In addition, the country's political economy realities and required flexibilities

(to regulate in public interest) and legal traditions should be taken into account.

Ultimately, the goal should be to provide assurance to investors of the government's continued commitment to effective protection of property rights and transparency.

Lastly, it is critical to establish effective mechanisms to address specific investor grievances related to political risk. This is a concrete way to address real, tangible investor concerns. As such, it will facilitate retention and expansion of investment, and prevent costly investor-State legal disputes.

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