Institute of Economic Affairs

CUTS International

BACKGROUND NOTE:
REDUCING POLICY UNCERTAINTY TO REVIVE INVESTMENT

1. Executive summary

This note explores the relationship between policy uncertainty and foreign direct investment (FDI) inflows, reasons of policy uncertainty, and attempts to identify measures to reduce policy uncertainty and develop a roadmap for the same.

A survey of literature on impact of policy and regulatory uncertainty on FDI inflows (Section 2) reveals that uncertainty plays a significant role in investment slowdown. It increases the option value to wait for the firms, resulting in delay of investments, more so when the investment is irreversible (Section 3). Further research has pointed out that key causes of policy uncertainty are unpredictable domestic policy and regulatory environment and ambiguous provisions under international investment treaties (Section 4).

Making the domestic policy environment predictable and ensuring clarity in the investment treaty provisions is thus imminent to reduce policy uncertainty, and to revive FDI inflows. The note concludes with CUTS research proposal focused on reducing policy uncertainty based on its internally developed Research, Advocacy, Networking and Capacity Building (RANC) model (Section 5).

2. Does uncertainty impedes investment?

The world FDI inflows have fallen from the high of USD 2.00 trillion in 2007 to USD 1.45 trillion in 2013 (UNCTAD). This has been attributed to a large extent to the financial meltdown. However, it is increasingly being realised that while the meltdown might have caused the immediate slump, deeper fissures remain, which have impeded speedy recovery.

The World Investment Report (2013) blamed economic fragility and policy uncertainty for slow economic recovery. Anand and Tulin (2014), while investigating causes of low gross fixed capital formation during 2012-13 in India, established that heightened uncertainty and deteriorating business confidence have played a key role in the recent investment slowdown.Baker, Bloom and Davis (2013) developed an economic policy uncertainty (EPU) index and found evidence of substantial increases in policy uncertainty in the United States and worldwide since 2007.Gulen and Ion (2013) discovered that policy-related uncertainty is negatively related to firm and industry level investment, and the economic magnitude of the effect is substantial. Their estimates indicated that approximately two thirds of the 32 percent drop in corporate investments observed during the 2007-2009 crisis period can be attributed to policy-related uncertainty.

Julio and Yook (2013) observed that uncertainty related to election outcomes leads economic agents to postpone private investment abroad until some degree of the uncertainty is resolved. Handley and Limao (2012) provided evidence that policy uncertainty can significantly affect firm level investment and entry decisions in the context of international trade. Stock and Watson (2011) used the EPU index to investigate factors behind the 2007-2009 recession and slow recovery, and come to the conclusion that policy uncertainty is a strong candidate for explaining the poor economic performance, but identifying causality is hard.

3. Why does uncertainty reduce investment?

Bernanke (1983) pointed out that high uncertainty gives firms an incentive to delay investment and hiring when investment projects are expensive to cancel or workers are costly to hire and fire. Uncertainty raises the transaction and adjustment costs associated with investments. Dixit (1989) showed that uncertainty about future prices creates an option value of waiting so firms will delay investments in entry or exit until they receive more information. Dixit and Pindyck (1994) also found that in the presence of uncertainty and given the irreversibility of investment decisions, investors may choose to forego or delay investment to avoid bearing the cost of investing in the wrong activity.

Handley and Limao (2012) established that when market entry costs are sunk, uncertainty can create a real option value of waiting to enter foreign markets until conditions improve or uncertainty is resolved. The dampening effect of policy uncertainty on capital expenditures is stronger for firms that have a higher degree of investment irreversibility.

4. What causes uncertainty?

4.1 Unpredictable domestic policy environment

A random survey of anecdotal evidence from emerging economies in South Asia and Sub Saharan Africa reveals positive correlation between domestic policy unpredictably and low levels of FDI inflows. Summary analysis of select countries is set out below:

4.1.1. Asia

India: Anand and Tulin (2014) found thatrecent levels of the India EPU index look worse in comparison to the post-Lehman spike, suggesting that uncertainty is primarily driven by India's domestic policy challenges, and not by global uncertainty factors, such as the withdrawal of unconventional monetary policy in advanced market economies. Thus, they suggest the need to look for domestic solutions. The World Investment Report (2014) also revealed that policy uncertainties surrounding the FDI policy in retail sector in India has dampened the investment climate.

Nepal: In Nepal, the political instability and post conflict transitional phase are detrimental to the investment climate of the country as it has resulted in uncertainty. A new constitution is being written which would chart out the path for development of the country, however, the process is still ongoing.

Bangladesh: UNCTAD (2013) noted that policy uncertainty in part is due to the political and administrative instability in the country. It also arises from the weaknesses of the judiciary. The weak enforcement of the rule of law hampers investment in the sense that it generates operational and contractual uncertainty for investors, and raises the overall cost.

Myanmar: OECD (2014) highlighted that many factors can account for why the foreign share of total investment in Myanmar might decline over time, including the continuing policy uncertainty or backtracking on reforms, inconsistent implementation of rules, investor-state disputes which have been shown to discourage other foreign investors, or reputational risks for foreign investors from the government's failure to enforce environmental or social legislation which calls into question the responsible business conduct of investors.

4.1.2. Africa

UNCTAD (2014) noted that in order to attract investment, African countries need to work towards reduction of level of risk and uncertainty. In 2012, there were 21 African countries among the 40 riskiest countries in the world, with the five riskiest countries all located in Africa. Such risks, whether perceived or real, lower incentives for entrepreneurs to invest. Bayraktar and Fofack (2007) found that uncertainty in the form of macroeconomic volatility is a significant determinant of private investment in Africa. Investment decisions are also affected by risk and uncertainty arising, for example, from political instability, macroeconomic volatility and policy reversals.

Mozambique: UNCTAD (2012) pointed out that lack of clear and detailed transfer pricing regulations not only constrain Mozambique’s ability to fight tax evasion, but also generate uncertainty for foreign investors.

Ghana: In Ghana, it has been noted that uncertainty for foreign investors arises out of political developments, changes in the regime leading to modifications in policy. The unsteady growth patterns of the country, policy initiatives to improve local value add which are not always in line with the international commitments, fiscal deficit, increasing cost of necessities and irregular power supply are some other causes for concern for foreign investors.

Tanzania: OECD (2013) noted that cross border agricultural trade flows are hindered by weak administration capacities and regulatory restrictions that increase investor uncertainty. This is exacerbated by complex; long and costly land registration process leading to low land registration levels, weak decentralisation of land management and overlapping government responsibilities.

Kenya: The World Bank (2013) highlighted some of the issues hampering foreign investments in the country. The unstable political situation, lack of adequate infrastructure facilities primarily in energy and roadways, rising labour costs and an uncertain regulatory environment have resulted in discouraging higher levels of foreign investment. The long delays involving judicial disputes and security threats from terrorists further dampen the foreign investments.

Ethiopia: U.S DS (2013) indicated that in Ethiopia, foreign investment is not permitted in various sectors such as banking, insurance, financial services and many sectors are state owned such as telecommunications, power transmission and distribution and postal services. There is lack of clarity on regulations and procedures relating to accounting and taxation are not standardized leading to uncertainty. Though a step in the positive direction has been taken with the Ethiopian Investment Agency’s “one-stop-shop” service that aims to reduce the time taken to acquire necessary licenses, however this has not been successful so far. Investors have also expressed concern over the judiciary to assess and resolve disputes as they are short staffed, excessively burdened. The regulatory scenario though considered fair by most, has received complaints regarding abrupt cancellation of government tenders and lack of transparency.

Uganda: U.S DS (2012) highlighted that in Uganda, though policies, regulations and laws are generally considered favourable, reforms are required to reduce uncertainty. The perceptions of corruption in the judicial process and the government make it difficult for the foreign companies to operate. Sometimes, the government agencies are unwilling to accept the judicial remedies. The process of registration and obtaining clearances, though streamlined in process has not been implemented affectively, thus leading to delays.

Kearney (2014) also highlighted that companies are frustrated by a business environment that is more unpredictable than ever. This uncertainty has resulted in firms closely monitoring macro trends.

It is important to point out here that while it might be easy to link unstable domestic policy environment to uncertainty, each country has different reasons for such domestic policy instability. Consequently, country specific programmes would be required to identify sources and devise specific measures to help countries to increase predictability and clarity in domestic policies.

4.2 Ambiguous interpretation of investment treaties

Johnson (2014) noted that investment treaties are tools which investors can use to secure compensation for damages caused by the host state's conduct. Such protections can be particularly important in the eyes of investors whose investments require large sunk costs and significant commitments of time in the host country, face risks associated with high degrees of uncertainty regarding future legal and economic conditions affecting the investment, and involve activities of heightened public and political interest.
Thus, existence of investment treaties can be an influencing factor for a company in its decision to invest in a particular nation as apart from protecting its investments they also encourage predictability and stability of the investment policies. They help portray an image of commitment and act as a substitute to policy credibility (UNCTAD (2009). Büthe and Milner (2004) indicated that higher number of BITs signed by a developing country results in greater attractiveness for the country as an investment destination and greater inward FDI.

While the investment treaties have potential to give some solace to the foreign investors in wake of uncertain domestic environment, they could also increase uncertainty, as they have the likelihood of resulting in significant liability for states, and it is becoming increasingly challenging for states to know just precisely what type of conduct will trigger claims or require them to pay damages.

This is because the obligations under treaties are generally vaguely stated, leaving much room for interpretation. Moreover, details regarding awards are not publicly available, hindering the ability of national and local government officials charged with implementing the treaties to understand just how treaties are being interpreted and applied. This is also because the government officials are ill-equipped to interpret the treaties, and they lack the expertise and knowledge to understand their rationale. Ambiguities in definition of 'investment', interpretation of 'object and purpose of the treaty' and determinants of conditions like 'sufficient contribution to a country's economic development', has caused inconsistencies in treaty interpretation.Additionally, there is currently no formal system of precedent or overarching appellate mechanism designed to promote consistency across decisions, which exacerbates the situation.

The World Investment Report (2013) also noted that recurring episodes of inconsistent findings by arbitral tribunals have resulted in divergent legal interpretations of identical or similar treaty provisions as well as differences in the assessment of the merits of cases involving the same facts. Inconsistent interpretations have led to uncertainty about the meaning of key treaty obligations and lack of predictability as to how they will be read in future cases. Graugnard (2013) pointed out that the International Chamber of Commerce has repeatedly noted that the varying breadth and depth of coverage of the international investment agreement regime - coupled with the risk of new austerity measures – also contributes to policy uncertainty, thus making investment predictability increasingly difficult for businesses. In order to reduce uncertainty due to ambiguous interpretation of treaty provisions, Roberts (2014) suggested redrafting of treaties by states taking greater interest. However, this would require significant upgradation in states' skills.

While ambiguous interpretation of investment treaties by arbitral tribunals is a cause for uncertainty, Caddel and Jensen (2014) found that the majority of government decisions that lead investors to seek arbitration are associated with actions taken by the executive branch. Thus, they suggest that reforms that limit the discretion of the executive to interfere with foreign investment are likely to reduce investor-state claims and, more generally, may reduce political risk. They also suggest that efficient and high-quality investor-state arbitration can serve as an additional external check on executive discretion, particularly where domestic checks are weak.

Providing training and building capacity of executives to efficiently interpret investment-treaties related matters is also necessary. Governments need to understand the compelling logic behind international agreements on investment openness, which are intended at least as much for the benefit of the host economy as for the benefit of a foreign investor.

Thus, there is a strong case for identification of specific capacity deficits, hand-holding and capacity building of regulatory/government bodies in emerging economies to enable them to better appreciate the benefit of investment agreements.

5. Approach to reduce uncertainty

In order to reduce policy uncertainty, it would be imperative to identify specific sources of policy uncertainty, and devise pointed programmes to make domestic policy environment more predictable and investment treaty provisions more comprehensible.

5.1. Making domestic policies predictable

From the country examples mentioned in the section before, it could be deduced that each country operates in a unique set of political-economic conditions and suffer from a distinct problem that accentuates domestic policy uncertainty.

Complexity in domestic policy regime might arise due to various reasons. These factors could be conceptual, legislative, structural, institutional or administrative in nature. Conceptual factors would include lack of clarity on the issues such as need and importance of competition policy, competitive neutrality, national treatment, investment in human capital, compliance with labour regulations, importance accorded to environment, social, governance and such other sustainability-oriented objectives, which play a key role in attracting foreign investment. The legislative factors include complex legislations, multiple statutes, archaic regulations, etc. Structural limitations could comprise of lack of regulatory independence, absence of accountability mechanisms, and inadequate powers to achieve objectives. Examples of institutional factors include overburdened or under-staffed institutions such as judiciary, ill-equipped quasi-judicial bodies, amongst others. Administrative factors include lax enforcement and supervision mechanism, limited capacity, unreasonable targets.

These factors might be present in different countries in varying proportions. Consequently, there is a need to identify and pin point the specific causes of policy uncertainty. Depending on the nature of problem, an appropriate mix of solutions will be required, ranging from conceptual, legislative, structural, institutional or administrative reforms. To ensure long-lasting impact, stakeholders must be involved in the process since the beginning and, and regular training and capacity building would need to be provided to make transition to optimal situation. Internationally recognised tools such as regulatory impact assessment and competition impact assessment would have to be utilized in this regard.

Consequently, in order to support countries to make domestic policy environment certain, country specific researches would need to be undertaken to diagnose specific problems and formulate and suggest country-specific solutions.

5.2. Reducing ambiguities in investment treaties

Johnson and Volkov (2014) pointed out that the long term nature of investment agreements, differing interests of the public and private sector contracting parties, and a range of uncertainties and changing circumstances affecting the expected costs and benefits of the relevant transaction stresses on the contractual relationship between investors and states. In such situation, Johnson (2014) highlighted that there is need to strike a proper balance between private rights and government’s regulatory powers.

This is easier said than done. It must be noted that emerging economies have historically provided incentives for foreign investors. Luca (2014) pointed out that on one hand, generous national incentive schemes may help attract FDI, on the other, subsequent changes to incentive schemes affecting foreign investors might be challenged under the investment agreements, with host countries facing the risk of being overwhelmed with investment arbitration claims.

However, minor tinkering of investment agreements sans a comprehensive review might not provide the much needed stability and predictability in the investment regime. Selective adjustments may lay the groundwork for further change, thus creating uncertainty instead of stability. As UNCTAD (2014) pointed out, more holistic and far-reaching reform reflects a government’s dilemma: more substantive changes might undermine a country’s attractiveness for foreign investment, and first movers could particularly suffer in this regard. However, such long-term view is unavoidable.

To ensure a long-lasting reform, the need is to work closely with stakeholders including arbitration tribunals and government officials in select countries, to provide them necessary training and capacity building to formulate and interpret treaty provisions in a better manner. This would be possible if the benefits of long-term treaty related reforms are demonstrated to the stakeholders, a roadmap for transition is formulated in their consultation, and one works closely with such host countries to ensure adoption and implementation of reforms.

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