POLICY UNCERTAINTY IMPEDES INVESTMENT

SIDE EVENT AT UNCTAD WORLD INVESTMENT FORUM 2014

Jointly Organised by CUTS International and the Institute of Economic Affairs, Kenya

This side event took place in room XXIII of Palais des Nations in Geneva, Switzerland, in the afternoon of 16 October 2014. The objective was to help the stakeholders in developing an actionable programmatic agenda to work towards reducing policy uncertainty and reviving investment.

Pradeep S Mehta, Secretary General of CUTS International chaired. He outlined the background of the event in his opening remarks, indicating that the evidence points to an inverse relationship between policy uncertainty and the level of investment. While political and regional milieu play their part, policy and regulatory prescriptions at domestic and international levels substantially influence uncertainty, thus impacting investment.

There is a need for country specific interventions with the objective to assist select low and middle income countries, specifically in South Asia and sub-Saharan Africa to adopt and implement measures to reduce investment related policy uncertainty at domestic, bilateral and multilateral levels.

He further pointed out that given that uncertainty negatively impacts investment inflows, in order to contain it, and revive investment, one needs to understand what causes uncertainty. In early 2014, Anand and Tulin found that uncertainty in India was primarily driven by its domestic policy challenges, and not by global uncertainty factors. However, it is not the only factor. Ambiguous interpretation of investment treaties is also a source of uncertainty, among others.

Therefore, there is a need for deeper research for understanding such causes, finding solutions, developing action plan to implement such solutions, and involving stakeholders in all such activities. CUTS has the experience of implementing country-specific and multi-country research-led advocacy projects, which involves stakeholders throughout the process, and results in positive policy changes. He believed this model can be used in this area as well.

Mr. Mehta then invited the four panellists, eminent experts in this field, to make their presentations.

Prabhash Ranjan, Assistant Professor in the South Asian University, made the main presentation that summarised preliminary research undertaken by him and CUTS International on the subject and set out specific issues for discussion for the panel. It was highlighted that the causes for policy uncertainty at domestic level mainly are: (i) lack of transparency in rules and procedures – such as granting environmental no-objection certificates on ad-hoc basis; (ii) change of government/political differences between major political parties (e.g. regarding FDI in multi-brand retail in India); (iii) policy-confusion on allotment of natural or state resources, which are later challenged in courts leading to long-litigation and eventual termination or cancellation of licenses (e.g. telecom spectrum, coal blocks etc); (iv) role of judiciary – overly activist approach (e.g. the case of White Industries arbitral award against Indian Public sector company Coal India); (v) lack of clarity and understanding on how international instruments regulating foreign investment impact domestic economy, and; (vi) lack of coordination between different government departments/ministries on major policy issues (such as policy on Bilateral Investment Treaties).

Secondly, Mr. Ranjan outlined some international causes for policy uncertainty related to investment. These included: (i) a patch work of BITs and investment chapters in Regional Trade Agreements; (ii) the current backlash against the BIT regime, which has added to the policy chaos (i.e. some Latin American states and countries like South Africa have denunciated their BITs, which implies that foreign investors will not be able to rely on treaty protection to safeguard their investment); and (iii) suggestions not to accept investor-state dispute settlement mechanism in BITs also create uncertainty in the minds of foreign investors.

He presented the following proposals to address the above issues:

- → Forge a political consensus on core economic policy issues at the domestic level, in every country
- → Have clearer, transparent rules dealing with foreign/private investment.
- → Cut down red-tape and repeal archaic laws that are not needed any more.
- → Re-define the role of judiciary; curb the overly-expansionist zeal and undue-interference in policy-making, which is the domain of the Executive.
- → Evolve a clear policy on international instruments such as BITs, investor-state dispute settlement and linkages between different investment treaties (such as BITs and investment chapters in free trade agreements).

Mr. Mehta then invited the other three panellists to comment on the presentation by Mr. Ranjan and share their own views and perspectives on the subject.

Ken Poonoosamy, Managing Director of the Mauritius Board of Investment, started his comments by affirming that his country has built a sound network of Investment Protection and Promotion Agreements (IPPAs) over the years. Coupled with its network of Double Taxation Avoidance Treaties, it reinforces the country as a major investment hub for FDI into Africa and provides confidence, certainty and predictability to investors.

Mr. Poonoosamy also presented two instances where policy uncertainty impacted on investment. First, he explained that without a clear policy and absence of incentives formulated in a scheme, Mauritius has not managed to attract substantial investment in the manufacturing sector resulting in a gradual decline in the contribution of the sector to GDP. In 2014, the overall number of large enterprises operating in the industry decreased to 240 down from 404 in 2000. Second, the government introduced an income tax on the gains derived from the sale of immovable property in the 2010 fiscal year at the rate of 10% for individuals not engaged in the business of property dealings and 15% in other cases. This newly introduced tax had the effect of diluting the competiveness of the Mauritian realty sector and blurred the image of Mauritius as a jurisdiction with a stable fiscal platform. It resulted in delayed investment decisions as it lowered capital return opportunities on investments and tightened exit avenues in Mauritius (through a lower absorption of real estate property by the market) vis-à-vis other competing jurisdictions. The newly introduced gains tax also triggered residential property resellers to increase their sale prices by 10%-15% to offset the tax impact, thereby increasing the product-price point of properties in Mauritius. The overarching effect of the tax on gains was a decrease in the competitiveness of Mauritius property market.

Rajneesh Narula, Director, John H. Dunning Centre for International Business, Henley Business School, in his comments affirmed that political uncertainty is often caused by the absence of formal and informal regulations, and their enforcement (or lack thereof). However, firms are able to adapt to this situation if this is consistent and hence predictable. On the other hand, inconsistency and instability, through frequent changes in policy, regulations and their enforcement, has a greater adverse effect on foreign investment, and discourage the deepening of value-chain by TNCs in a country. Mr. Narula added that high risk, high uncertainty and high instability lead also to outward FDI that has the characteristics of 'flight capital'. Such activity has largely negative consequences for developing economies.

Anca Radu, Policy Officer (Investment) at the European Commission presented some thoughts to address the issues as outlined by other panellists. She explained that there is usually a set of pre-conditions based on which a stable and predictable investment framework can be achieved. Most important of these pre-conditions include: a long-term vision and strategy on investment; a political endorsement of the strategic framework; a legal framework setting the conditions; and a public administration able to implement it. Uncertainty could be generated (or fuelled) by the lack of any of these conditions. This also means that in many cases uncertainty can be reduced on the basis of good governance principles (e.g. transparency, accountability) or better regulation tools (e.g. impact assessment of new legislation, early consultation of stakeholders, publication of legislative initiatives, etc). According to her, solutions can hence be found through e.g. technical assistance or capacity building, ideally in a comprehensive, multi-annual programming framework. Solutions could also be found through improving the international legal framework on investment (e.g. investment agreements with clearer provisions) and raising awareness in this respect. In fact, a major challenge is often represented by the insufficient awareness among various levels of public administration in host countries with regard to investment agreements and their consequences.

According to Ms. Radu, addressing the causes of domestic uncertainty would normally represent a more sustainable option in attracting FDI, compared to solutions that only compensate for the effects of such uncertainty, e.g. incentives or various guarantees. At the same time, however, addressing the root causes is much more difficult. Hence the initiatives such as the one proposed by CUTS deserve to be appreciated and encouraged.

In the ensuing discussion, several points were raised by the participants and panellists. These are:

It is clear that a certain level of uncertainty is inevitable but the emphasis should be to establish stability and predictability to the extent possible by avoiding frequent changes and improving transparency.

International arbitration is promoted in bilateral treaties. However it is usually proposed by developed countries and not the developing countries. This gap between developed and developing countries needs to be filled.

Analysis shows that successful economic integration can promote investment. However, and assuming that that any regional integration is like a club, the result will depend on the nature of the club the country is joining. If the club is working well and has already a good reputation, it would promote investments. A number of studies demonstrate the positive impacts on investment in countries that have acceded to the European Union (EU). However, it should be noted that the EU is the only regional cooperation regime that promotes integration of its internal market. Moreover, a successful regional integration process takes a long time and requires substantial resources and commitments. On the other hand, some African countries are facing the challenge of being members of more than one regional economic agreement, which are sometimes conflicting.

There is a difference between the policy stability and the actual reality on the ground. The notion of uncertainty should not be read as "no change", but rather as "possible changes in accordance with the rules of law", because "no change" in itself can create uncertainty. This point shows clearly that risk/uncertainty/instability are three different but overlapping concepts.

Similarly, there is a misunderstanding of the BITs. In fact, they do not freeze the national/ regional/ international legislations but only put some limits to the possible changes. It is about "how to change in a predictable way".

The discussions are often centered on FDI. However, domestic investments are very also very important and should be promoted. Policy uncertainty has an adverse impact on domestic investments as well.

The issue of different treatments given to domestic vs foreign investors was pointed out, which is quite an anomaly and results in discrimination of the domestic investor. FDI was originally more valued than domestic investments, as foreign investors supposedly bring new skills, access to markets, technology, value addition, etc. However, there are certain initiatives being taken by different countries to make the environment fairer and more equitable between foreign and local investors. For instance, the Brazilian government did not ratify the BIT because foreign investors could access international arbitration but not the domestic ones.

Mr. Mehta concluded the discussion. He pointed out that all the presentations and interventions during this event have highlighted that policy uncertainty is adversely impacting investments. The need for more transparent and predictable rules is undeniable. This has to be addressed rapidly by governments, through implementing an investment policy in place for at least the next 5 years while balancing the interests of foreign and domestic investor as well as consumers. He thanked the panellists and participants and reiterated that CUTS will continue to work in this area with a view to taking forward the analysis and suggestions made in this event.

****