



SPECIAL EDITION FOR THE THIRD INTERNATIONAL CONFERENCE ON FINANCING FOR DEVELOPMENT

2

UNCTAD: Investing in Sustainable Development Goals

*Reforming International
Investment Governance*



UNITED NATIONS



FINANCING FOR
DEVELOPMENT
13-16 July 2015 - Addis Ababa - Ethiopia
TIME FOR GLOBAL ACTION



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NOTES

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- Transition economies: South-East Europe, the Commonwealth of Independent States and Georgia.
- Developing economies: in general, all economies not specified above. For statistical purposes, the data for China do not include those for Hong Kong Special Administrative Region (Hong Kong SAR), Macao Special Administrative Region (Macao SAR) and Taiwan Province of China.

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Two dots (..) indicate that data are not available or are not separately reported. Rows in tables have been omitted in those cases where no data are available for any of the elements in the row.

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- A slash (/) between dates representing years, e.g., 2010/11, indicates a financial year.
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- Reference to “dollars” (\$) means United States dollars, unless otherwise indicated.
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1. GLOBAL INVESTMENT TRENDS

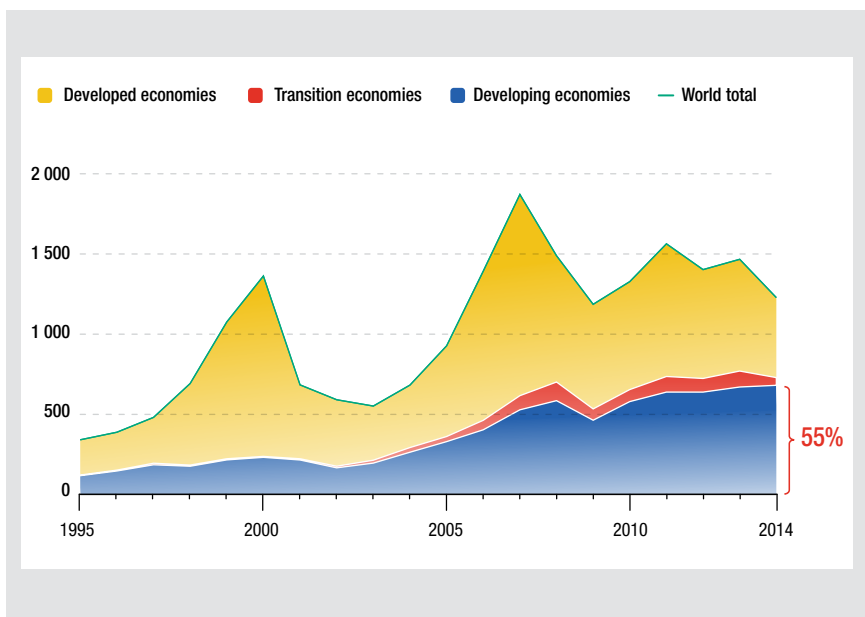


GLOBAL INVESTMENT TRENDS

Global FDI fell in 2014 but recovery is in sight

Global foreign direct investment (FDI) inflows fell by 16 per cent in 2014 to \$1.23 trillion, down from \$1.47 trillion in 2013 (figure 1). This is mostly explained by the fragility of the global economy, policy uncertainty for investors and elevated geopolitical risks. New investments were also offset by some large divestments. The decline in FDI flows was in contrast to macroeconomic variables such as GDP, trade, gross fixed capital formation and employment, which all grew (table 1).

Figure 1. FDI inflows, global and by group of economies, 1995–2014
(Billions of dollars)



Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Table 1. Growth rates of global GDP, GFCF, trade, employment and FDI, 2008–2016 (Per cent)

Variable	2008	2009	2010	2011	2012	2013	2014	2015 ^a	2016 ^a
GDP	1.5	-2.0	4.1	2.9	2.4	2.5	2.6	2.8	3.1
Trade	3.0	-10.6	12.6	6.8	2.8	3.5	3.4	3.7	4.7
GFCF	3.0	-3.5	5.7	5.5	3.9	3.2	2.9	3.0	4.7
Employment	1.2	1.1	1.2	1.4	1.4	1.4	1.3	1.3	1.2
FDI	-20.4	-20.4	11.9	17.7	-10.3	4.6	-16.3	11.4	8.4
Memorandum									
FDI value (in \$ trillions)	1.49	1.19	1.33	1.56	1.40	1.47	1.23	1.37	1.48

Source: UNCTAD, FDI/MNE database for FDI in 2008–2014; United Nations (2015) for GDP; IMF (2015) for GFCF and trade; ILO for employment; and UNCTAD estimates for FDI in 2015–2016.

^a Projections.

Note: FDI excludes Caribbean offshore financial centres. GFCF = gross fixed capital formation.

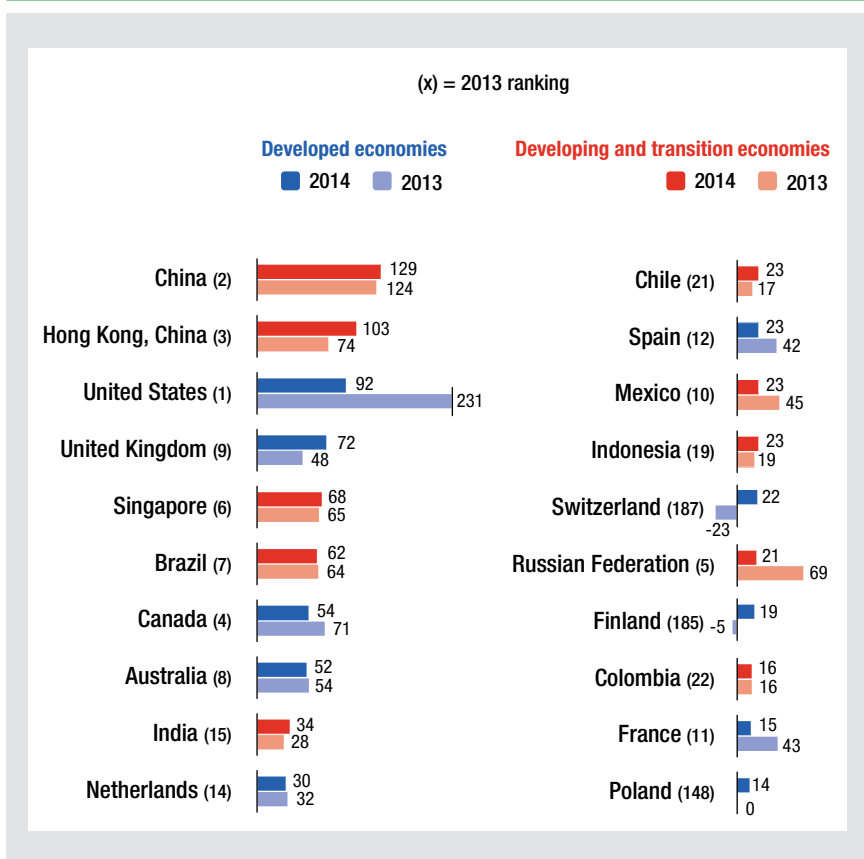
Although the outlook for FDI remains uncertain, an upturn in FDI flows is anticipated in 2015. Strengthening economic growth in developed economies, the demand-stimulating effects of lower oil prices and accommodating monetary policy, and continued investment liberalization and promotion measures could favourably affect FDI flows. Both UNCTAD's FDI forecast model and its business survey of large MNEs show a rise of FDI flows in and after 2015.

Global FDI inflows are expected to grow by 11 per cent to \$1.4 trillion in 2015. Flows could increase further to \$1.5 trillion and \$1.7 trillion in 2016 and 2017, respectively. The share of MNEs intending to increase FDI expenditures over the years 2015 to 2017 rose from 24 to 32 per cent, according to UNCTAD's business survey. Data for the first few months of 2015 are consistent with this forecast. However, a number of economic and political risks, including ongoing uncertainties in the Eurozone, potential spillovers from geopolitical tensions and persistent vulnerabilities in emerging economies, may disrupt the projected recovery.

Developing-country FDI inflows reached a record level

Developing-economy inflows reached \$681 billion (table 2). This group now accounts for 55 per cent of global FDI inflows. Five of the top 10 FDI hosts are now developing economies (figure 2).

Figure 2. FDI inflows: top 20 host economies, 2013 and 2014
(Billions of dollars)



Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Note: Excludes Caribbean offshore financial centres.

Table 2. FDI flows, by region, 2012–2014 (Billions of dollars and per cent)

Region	FDI inflows			FDI outflows		
	2012	2013	2014	2012	2013	2014
World	1 403	1 467	1 228	1 284	1 306	1 354
Developed economies	679	697	499	873	834	823
Europe	401	326	289	376	317	316
North America	209	301	146	365	379	390
Developing economies	639	671	681	357	381	468
Africa	56	54	54	12	16	13
Asia	401	428	465	299	335	432
East and South-East Asia	321	348	381	266	292	383
South Asia	32	36	41	10	2	11
West Asia	48	45	43	23	41	38
Latin America and the Caribbean	178	186	159	44	28	23
Oceania	4	3	3	2	1	0
Transition economies	85	100	48	54	91	63
Structurally weak, vulnerable and small economies^a	58	51	52	10	13	10
LDCs	24	22	23	5	7	3
LLDCs	34	30	29	2	4	6
SIDS	7	6	7	2	1	1
Memorandum: percentage share in world FDI flows						
Developed economies	48.4	47.5	40.6	68.0	63.8	60.8
Europe	28.6	22.2	23.5	29.3	24.3	23.3
North America	14.9	20.5	11.9	28.5	29.0	28.8
Developing economies	45.6	45.7	55.5	27.8	29.2	34.6
Africa	4.0	3.7	4.4	1.0	1.2	1.0
Asia	28.6	29.2	37.9	23.3	25.7	31.9
East and South-East Asia	22.9	23.7	31.0	20.7	22.4	28.3
South Asia	2.3	2.4	3.4	0.8	0.2	0.8
West Asia	3.4	3.0	3.5	1.8	3.1	2.8
Latin America and the Caribbean	12.7	12.7	13.0	3.4	2.2	1.7
Oceania	0.3	0.2	0.2	0.1	0.1	0.0
Transition economies	6.1	6.8	3.9	4.2	7.0	4.7
Structurally weak, vulnerable and small economies^a	4.1	3.5	4.3	0.7	1.0	0.8
LDCs	1.7	1.5	1.9	0.4	0.6	0.2
LLDCs	2.5	2.0	2.4	0.2	0.3	0.4
SIDS	0.5	0.4	0.6	0.2	0.1	0.1

Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

^a Without double counting countries that are part of multiple groups.

However, the increase in developing-country inflows is primarily a developing Asia story. FDI inflows to that region grew by 9 per cent to almost \$465 billion, more than two thirds of the total for developing economies. This rise was visible in all subregions except West Asia, where inflows declined for the sixth consecutive year, in part because of a further deterioration in the regional security situation. FDI flows to Africa remained unchanged at \$54 billion, as the drop of flows to North Africa was offset by a rise in Sub-Saharan Africa. Inflows to Latin America and the Caribbean saw a 14 per cent decline to \$159 billion, after four consecutive increases.

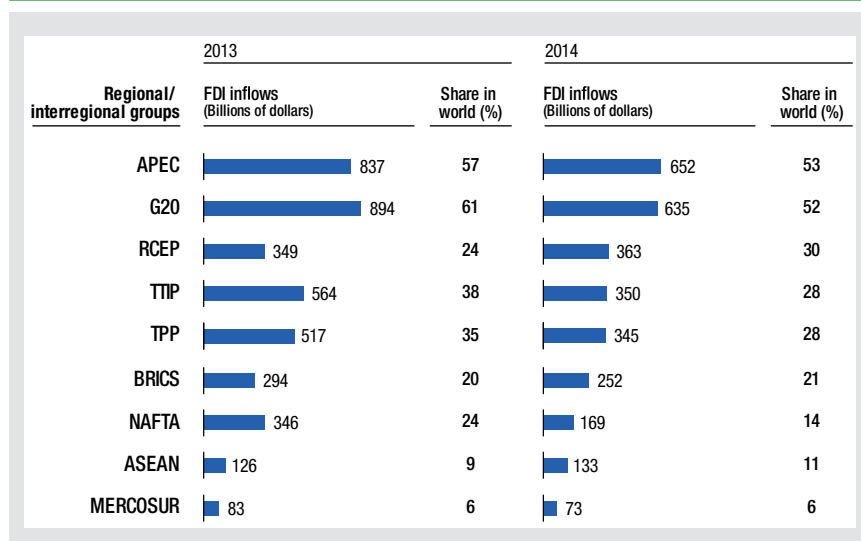
The Russian Federation dropped from 5th to 16th place as a recipient country, largely accounting for the 52 per cent decline in transition-economy FDI inflows to \$48 billion.

Despite a revival of cross-border merger and acquisitions (M&As), FDI flows to developed economies declined by 28 per cent to \$499 billion. FDI inflows to the United States fell to \$92 billion, significantly affected by a single large-scale divestment, without which the level of investment would have remained stable. FDI flows to Europe fell by 11 per cent to \$289 billion, one third of their 2007 peak.

Most regional groupings and initiatives experienced a fall in FDI inflows in 2014

The decline in global FDI flows also affected FDI to regional economic groups in 2014. For example, the groups of countries negotiating the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP) saw their respective shares of global FDI inflows decline (figure 3). Two Asian groups – ASEAN (up 5 per cent to \$133 billion) and RCEP (up 4 per cent to \$363 billion) – bucked the trend. Longer-term efforts will, for the most part, lead to increased FDI in regional groups by opening up sectors to investment and aligning policies for the treatment of investors.

Figure 3. FDI inflows to selected regional and interregional groups, 2013 and 2014
(Billions of dollars and per cent)



Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

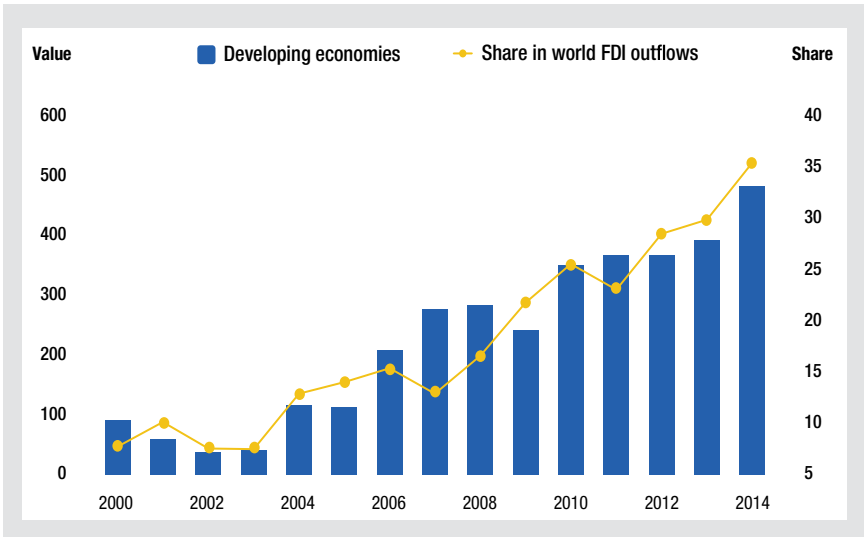
Note: Ranked in descending order of 2014 FDI flows. G20 = only the 19 member countries of the G20 (excludes the European Union); APEC = Asia-Pacific Economic Cooperation; TTIP = Transatlantic Trade and Investment Partnership; TPP = Trans-Pacific Partnership; RCEP = Regional Comprehensive Economic Partnership; BRICS = Brazil, Russian Federation, India, China and South Africa; NAFTA = North American Free Trade Agreement; ASEAN = Association of Southeast Asian Nations; MERCOSUR = Common Market of the South.

Developing-economy FDI outflows exceed one third of global total, led by Asian MNEs

In 2014, MNEs from developing economies invested almost \$468 billion abroad, a 23 per cent increase from the previous year. Developing economies now account for more than one third of global FDI outflows, up from 13 per cent in 2007 (figure 4). Developing and transition economies represent 9 of the 20 largest investor economies globally (figure 5).

Outward FDI stock from developing economies to other developing economies countries grew by two-thirds from \$1.7 trillion in 2009 to \$2.9

Figure 4. Developing economies: FDI outflows and their share in total world outflows, 2000–2014 (Billions of dollars and per cent)

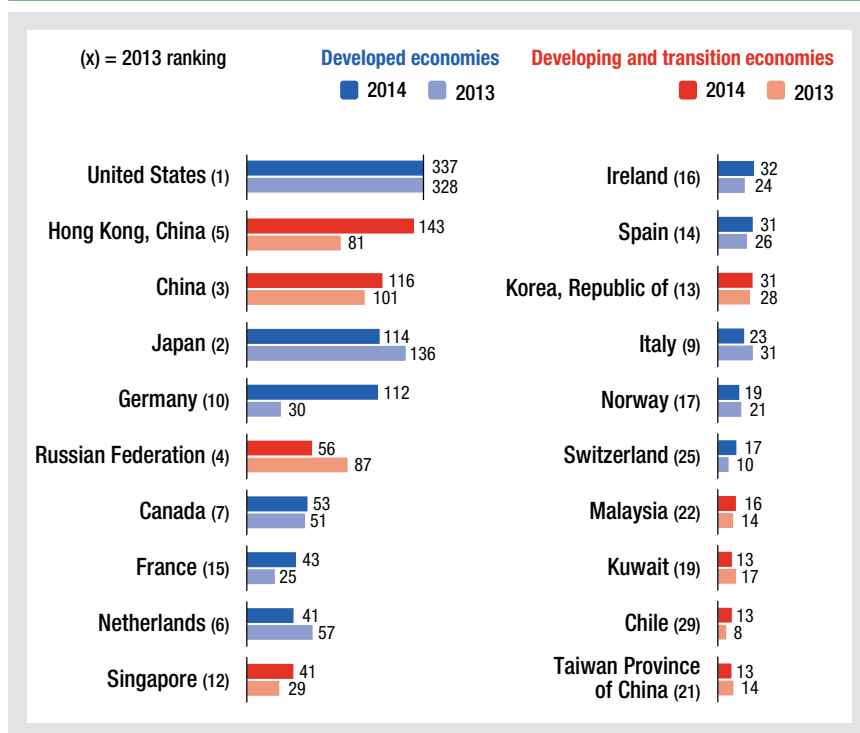


Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Note: Excludes Caribbean offshore financial centres.

trillion in 2013. East Asia and South-East Asia were the largest recipient developing regions. The share of the poorest developing regions in South-South FDI is still low, but it is growing. Much developing-economy FDI goes to each economy's immediate geographic region. Familiarity eases a company's early internationalization drive, and regional markets and value chains are a key driver. Specific patterns of South-South FDI are also determined by MNE investment motives, home government policies and historical connections. Developed- and developing-economy FDI outflows differ in their composition: while more than half of developing-country MNE outflows are in equity investment, developed-country outflows have a larger reinvested earnings component (now at 81 per cent) (figure 6). Equity outflows are more likely to result in new productive investment; reinvested earnings may also translate into increased cash holding.

Figure 5. FDI outflows: top 20 home economies, 2013 and 2014
(Billions of dollars)



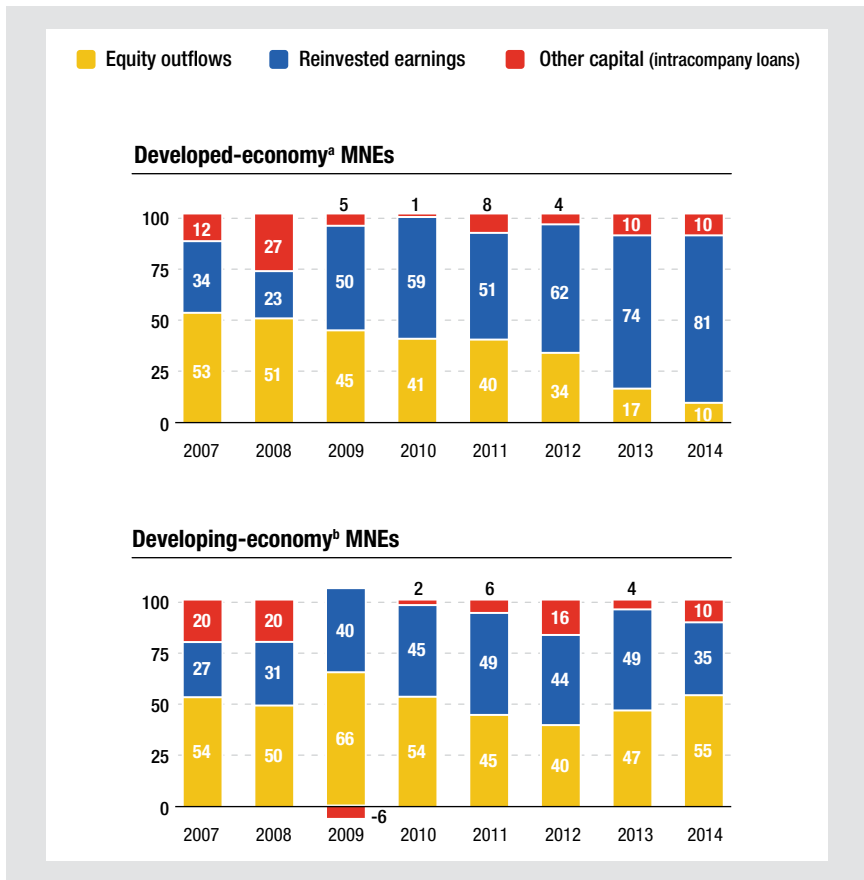
Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

Note: Excludes Caribbean offshore financial centres.

Cross-border M&A activity rebounded strongly in 2014; announced greenfield projects declined slightly

After two consecutive years of decline, cross-border M&A activity picked up in 2014. In net terms, the value of cross-border M&As increased by 28 per cent, reaching \$399 billion, facilitated by the availability of cheap debt coupled with considerable MNE cash reserves. Competitive pressure to find new pockets of growth and the need to cut costs through synergies and economies of scale were important deal drivers.

Figure 6. FDI outflows by component, by group of economies, 2007–2014
(Per cent)



Source: UNCTAD, FDI/MNE database (www.unctad.org/fdistatistics).

^a Economies included are Australia, Belgium, Bulgaria, Canada, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, Germany, Greece, Hungary, Iceland, Ireland, Israel, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States.

^b Economies included are Algeria, Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Bahrain, Bangladesh, Barbados, Belize, the Plurinational State of Bolivia, Botswana, Brazil, Cambodia, Cabo Verde, Chile, Costa Rica, Curaçao, Dominica, El Salvador, Fiji, Grenada, Guatemala, Honduras, Hong Kong (China), India, Indonesia, the Republic of Korea, Kuwait, Lesotho, Malawi, Mexico, Mongolia, Montserrat, Morocco, Namibia, Nicaragua, Nigeria, Pakistan, Panama, the Philippines, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, Sao Tome and Principe, Seychelles, Singapore, Sint Maarten, South Africa, Sri Lanka, the State of Palestine, Suriname, Swaziland, Taiwan Province of China, Thailand, Trinidad and Tobago, Turkey, Uganda, Uruguay, the Bolivarian Republic of Venezuela and Viet Nam.

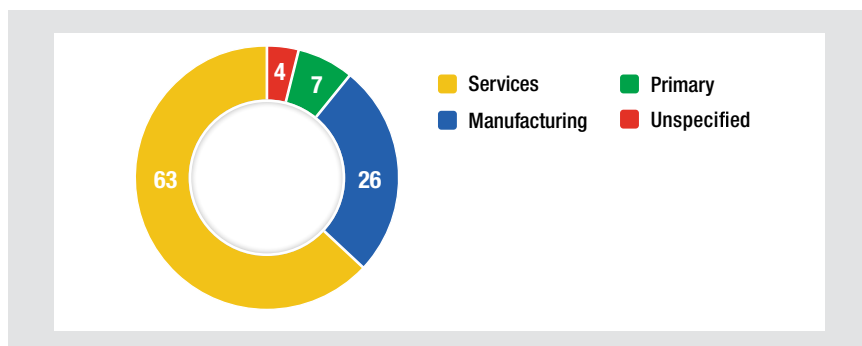
The re-emergence of large deals was a key factor in the increase in the value of cross-border deal activity. In 2014 the number of MNE acquisitions with values larger than \$1 billion jumped to 223, from 168 in 2013. At the same time, MNEs have made significant divestments, equivalent to half of the total value of acquisitions.

Announced greenfield investment remained sluggish, decreasing by 2 per cent to \$696 billion. Greenfield investment by developed-country MNEs rose marginally, while that by developing-country and transition-economy MNEs declined. Nevertheless, developing countries accounted for 30 per cent of total announced cross-border greenfield investments in 2014.

The long-term shift towards investment in services continues

In 2012, the latest year for which data are available, services accounted for 63 per cent of global FDI stock, almost two and a half times the share of manufacturing (26 per cent), and nine times the share of the primary sector (7 per cent) (figure 7). This share was up from 58 per cent in 2001, continuing a longer-term relative shift of global FDI towards services. Inasmuch as services account for 70 per cent of global value added, in principle the share of services FDI in global FDI could rise further.

Figure 7. Global inward FDI stock, by sector, 2012
(Per cent of total value)



Source: UNCTAD FDI/MNE database (www.unctad.org/fdistatistics).

Beyond secular trends in the structure of the world economy, a number of factors are behind the increase in the level and share of services FDI. These include increasing liberalization in the services sector in host economies; technological developments in information and communication technology that make services more tradable; and the rise of global value chains, which has given an impulse to the internationalization of services related to manufacturing.

Private equity acquisitions up, but their share in global M&As fell

In 2014, cross-border gross M&As by private equity funds rose to \$200 billion. This amounted to about 17 per cent of the global M&A total, but was down 6 percentage points from the level in 2013, and 13 percentage points lower than in 2008. The upward trend in the value of private equity investments is likely to continue as a result of several factors: cash and commitments from investors are particularly high, estimated at about \$360 billion; low interest rates in developed countries are making leveraged debt more attractive; and volatile global financial markets are expected to generate more cross-border investment opportunities. North America and Europe continued to be the major target regions for cross-border M&As by private equity funds, although Asia reached a historically high share in total private equity deals in 2014.

FDI by SWFs remains a fraction of their assets under management; State-owned MNE purchases slow

There are more than 100 sovereign wealth funds (SWFs), managing over \$7 trillion worth of assets and accounting for about one tenth of the world's total assets under management, but FDI constitutes only a small proportion of those assets. The value of FDI by SWFs rose in 2014 to \$16 billion, ending a three-year decline. Some SWFs have been engaging in long-term investments through FDI, including through cross-border corporate

acquisitions and overseas real estate purchases. More than half of SWFs have started or expanded FDI in infrastructure, which represents an important asset class for them, because of both the sector's large-scale investment opportunities and its relatively stable returns.

In contrast, investment by State-owned MNEs (SO-MNEs) fell: cross-border M&As and greenfield projects in 2014 declined, by 39 and 18 per cent, respectively, to their lowest levels since the outbreak of the global financial crisis. The retreat of SO-MNEs is partly related to strategic decisions, such as the decision by a number of developed-country companies to consolidate their assets in some economies while selling them off in others. Policy factors have also affected SO-MNE internationalization; for example, stricter control of foreign ownership in extractive industries.

International production continues to expand: foreign sales and assets of MNEs grew faster than those of domestic firms

International production by MNEs' foreign affiliates expanded in 2014. Sales and value added rose by 7.6 per cent and 4.2 per cent, respectively. Employment of foreign affiliates reached 75 million (table 3). The financial performance of foreign affiliates in host economies improved, with the rate of return on inward FDI rising from 6.1 per cent in 2013 to 6.4 per cent in 2014. However, this level is still lower than that in the pre-crisis average (2005-2007).

At the end of 2014, some 5,000 MNEs had an estimated \$4.4 trillion in cash holdings, 40 per cent more than during the 2008–2009 crisis. However, there are signs that the largest 100 MNEs and companies in specific industries (e.g. utilities) are beginning to reduce their cash reserves (figure 8). In the last two years, MNEs in some industries (e.g. oil and gas, and utilities industries) have started to use cash holdings for more capital expenditures and acquisitions.

Table 3. Selected indicators of FDI and international production, 2014 and selected years

Item	Value at current prices (Billions of dollars)				
	1990	2005–2007 (pre-crisis average)	2012	2013	2014
FDI inflows	205	1 397	1 403	1 467	1 228
FDI outflows	244	1 423	1 284	1 306	1 354
FDI inward stock	2 198	13 894	22 073	26 035	26 039
FDI outward stock	2 254	14 883	22 527	25 975	25 875
Income on inward FDI ^a	82	1 024	1 467	1 517	1 575
Rate of return on inward FDI ^b	4.4	7.6	7.0	6.1	6.4
Income on outward FDI ^a	128	1 105	1 445	1 453	1 486
Rate of return on outward FDI ^b	5.9	7.6	6.6	5.8	5.9
Cross-border M&As	98	729	328	313	399
Sales of foreign affiliates	4 723	21 469	31 687	33 775 ^c	36 356 ^c
Value-added (product) of foreign affiliates	881	4 878	7 105	7 562 ^c	7 882 ^c
Total assets of foreign affiliates	3 893	42 179	88 536	95 230 ^c	102 040 ^c
Exports of foreign affiliates	1 444	4 976	7 469	7 688 ^d	7 803 ^d
Employment by foreign affiliates (thousands)	20 625	53 306	69 359	71 297 ^c	75 075 ^c
Memorandum					
GDP ^e	22 327	51 799	73 457	75 453	77 283
Gross fixed capital formation ^e	5 592	12 219	17 650	18 279	18 784
Royalties and licence fee receipts	31	172	277	298	310
Exports of goods and services ^e	4 332	14 927	22 407	23 063	23 409

Source: UNCTAD.

^a Based on data from 174 countries for income on inward FDI and 143 countries for income on outward FDI in 2014, in both cases representing more than 90 per cent of global inward and outward stocks.

^b Calculated only for countries with both FDI income and stock data.

^c Data for 2013 and 2014 are estimated based on a fixed effects panel regression of each variable against outward stock and a lagged dependent variable for the period 1980–2012.

^d For 1998–2014, the share of exports of foreign affiliates in world exports in 1998 (33.3%) was applied to obtain values. Data for 1995–1997 are based on a linear regression of exports of foreign affiliates against inward FDI stock for the period 1982–1994.

^e Data from IMF (2015).

Figure 8. Cash holdings of the largest 100 MNEs and their share of total assets, 2006–2014 (Billions of dollars and per cent)



Source: UNCTAD, based on data from Thomson ONE.

2. REGIONAL TRENDS IN FDI



REGIONAL TRENDS IN FDI

FDI remained stable in Africa

FDI flows to Africa overall remained flat at \$54 billion (table 2). **North Africa** saw its FDI flows decline by 15 per cent to \$11.5 billion. FDI fell overall in the region because of tension and conflict in some countries, despite significant inflows in others. FDI into Egypt grew by 14 per cent to \$4.8 billion, and flows into Morocco by 9 per cent to \$3.6 billion.

FDI flows to **West Africa** declined by 10 per cent to \$12.8 billion, as Ebola, security issues and falling commodity prices negatively affected several countries. **East Africa** saw its FDI flows increasing by 11 per cent, to \$6.8 billion. FDI rose in the gas sector in the United Republic of Tanzania, and Ethiopia is becoming a hub for MNEs in garments and textiles. **Central Africa** received \$12.1 billion of FDI in 2014, up 33 per cent from 2013. FDI flows in Congo almost doubled, reaching \$5.5 billion as foreign investors were undeterred, despite falling commodity prices. The Democratic Republic of the Congo continued to attract notable flows. **Southern Africa** received \$10.8 billion of FDI in 2014, down 2.4 per cent from 2013. While South Africa remained the largest host country in the region (\$5.7 billion, down 31 per cent from 2013), Mozambique played a significant role in attracting FDI (\$4.9 billion).

FDI inflows into Africa are increasingly due to the rise of developing-country MNEs. A number of developed countries (in particular France, the United States and the United Kingdom) were large net divestors from Africa during 2014. Demand from developing-economy investors for these divested assets was significant. As a result, African M&As increased by 32 per cent from \$3.8 billion in 2013 to \$5.1 billion in 2014, especially in oil and gas and in finance.

Services account for the largest portion of Africa's stock of inward FDI, although the share is lower than in other regions, and concentrated in a

relatively small number of countries, including Morocco, Nigeria and South Africa. Finance accounts for the largest portion of Africa's stock of services FDI; by 2012 more than half of Africa's services FDI stock was held in finance (56 per cent), followed by transport, storage and communications (21 per cent) and business activities (9 per cent).

Developing Asia now the largest recipient region of FDI

Following a 9 per cent rise in FDI inflows, **developing Asia** reached a historically high level of \$465 billion in 2014, consolidating the region's position as the largest recipient region in the world.

Inflows to **East Asia** rose by 12 per cent to \$248 billion. China, now the largest FDI host economy in the world, accounted for more than half of this figure. Hong Kong (China) witnessed a 39 per cent increase in inflows to \$103 billion. In **South-East Asia**, FDI inflows rose by 5 per cent to \$133 billion. This increase was driven mainly by Singapore, now the world's fifth largest recipient economy, where inflows reached \$68 billion. Other South-East Asian economies also saw strong FDI growth: inflows to Indonesia went up by 20 per cent to \$23 billion.

Policy efforts to deepen regional integration are driving greater connectivity between economies in East and South-East Asia. This is especially so in infrastructure, where MNEs are major investors across the region. Hong Kong (China), China, Japan and Singapore are among the most important regional sources of equity investment in the sector. They are also active through non-equity modalities. Regional infrastructure investment is set to grow further, supported by policies to boost connectivity, such as China's "One Belt, One Road" strategy and the opening up of transport industries to foreign participation by ASEAN member countries. FDI inflows to **South Asia** rose to \$41 billion in 2014. India, accounting for more than three quarters of this figure, saw inflows increase by 22 per cent to \$34 billion. The country also dominated FDI outflows, with a five-fold increase to \$10

billion, recovering from a sharp decline the year before. A number of other South Asian countries, such as Pakistan and Sri Lanka, saw rising FDI from China. In attracting manufacturing FDI, especially in capital-intensive industries, South Asia lags behind East and South-East Asian economies. However, some success stories have emerged, such as the automotive industry, with Automakers now expanding beyond India to locate production activities in other countries in the region, including Bangladesh and Nepal.

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 GCC economies, State-led investment in construction focused on infrastructure and oil and gas development has opened up opportunities for foreign contractors to engage in new projects in the region through non-equity modes. FDI outflows from the region decreased by 6 per cent to \$38 billion, due to the fall of flows from Kuwait and Qatar – the two largest investors in the region. FDI flows from Turkey almost doubled to \$6.7 billion.

FDI flows declined after four years of increases in Latin America and the Caribbean

FDI flows to Latin America and the Caribbean, excluding the Caribbean offshore financial centres, decreased by 14 per cent to \$159 billion in 2014. This was mainly the consequence of a 78 per cent decline in cross-border M&As in Central America and of lower commodity prices, which reduced investment in the extractive industries in South America. Flows to South America declined for the second consecutive year, down 4 per cent to \$121 billion, with all the main recipient countries, except Chile, registering negative FDI growth. In Central America and the Caribbean, FDI declined 36 per cent to \$39 billion, partly because of unusually high levels in 2013 due to a cross-border megadeal in Mexico.

There were two main waves of FDI in the past few decades. The first wave began in the mid-1990s as a result of liberalization and privatization policies that encouraged FDI into sectors such as services and extractive industries, which had previously been closed to private and/or foreign capital. The second wave began in the mid-2000s in response to a surge in commodity prices, leading to increased FDI in extractive industries in the region (especially South America). After more than a decade of strong growth driven by South America, the FDI outlook in Latin America and the Caribbean is now less optimistic. For the region, this is an occasion for a reflection on the experience of the two FDI waves across the region. In the context of the post-2015 development agenda, policymakers may consider potential policy options on the role of FDI for the region's development path.

FDI flows in transition economies more than halved in 2014

FDI inflows to the transition economies fell by 52 per cent to reach \$48 billion in 2014 – a value last seen in 2005. In the **Commonwealth of Independent States** (CIS), regional conflict coupled with falling oil prices and international sanctions reduced foreign investors' confidence in the strength of local economies. The Russian Federation – the largest host country in the region – saw its FDI flows fall by 70 per cent due to the country's negative growth prospects, and as an adjustment after the level reached in 2013 due to the exceptional Rosneft–BP transaction. In **South-East Europe**, FDI flows remained stable at \$4.7 billion. Foreign investors mostly targeted manufacturing because of competitive production costs and access to EU markets.

FDI outflows from the transition economies fell by 31 per cent to \$63 billion as natural-resource-based MNEs, mainly from the Russian Federation, reduced their investment abroad, particularly due to constraints in international financial markets and low commodity prices.

In the Russian Federation, sanctions, coupled with a weak economy and

other factors, began affecting inward FDI in the second half of 2014, and this is expected to continue in 2015 and beyond. Market-seeking foreign investors – for example, in the automotive and consumer industries – are gradually cutting production in the country. Volkswagen (Germany) will reduce its production in Kaluga, and PepsiCo (United States) has announced it will halt production at some plants. The geographical profile of investors in the country is changing. As new investment from developed-country MNEs is slowing down, some of the losses are being offset by other countries. In 2014, China became the fifth largest investor in the Russian Federation.

Inflows to developed economies down for the third successive year

FDI inflows to developed countries lost ground for the third successive year, falling by 28 per cent to \$499 billion, the lowest level since 2004. Inflows to Europe continued the downward trend since 2012 to \$289 billion. Inflows to North America halved to \$146 billion, mainly due to Vodafone's \$130 billion divestment of Verizon, without which they would have remained stable.

European countries that made the largest gains in 2014 were those that had received a negative level of inflows in 2013, such as Finland and Switzerland. FDI to the United Kingdom jumped to \$72 billion, leaving it in its position as the largest recipient country in Europe. In contrast, large recipients of FDI in 2013 saw their inflows fall sharply, such as Belgium, France and Ireland. Inward FDI to Australia and to Japan both contracted.

FDI outflows from developed countries held steady at \$823 billion. Outflows from Europe were virtually unchanged at \$316 billion. Outflows from Germany almost trebled, making it the largest European direct investor. France also saw its outflows increase sharply. In contrast, FDI from other major investor countries plummeted. In North America, both Canada and the United States saw a modest increase of outflows. Outflows from Japan declined by 16 per cent, ending a three-year run of expansion.

The impact of MNE operations on the balance of payments has increased, not only through FDI, but also through intra-firm trade and FDI income. The recent experience of the United States and Japan shows that growing investment income from outward FDI provides a counterbalance to the trade deficit. Furthermore, outward FDI has helped create avenues for exports of knowledge-intensive goods and services.

FDI to structurally weak, vulnerable and small economies witnessed divergent trends

FDI flows to the **least developed countries** (LDCs) increased by 4 per cent to \$23 billion, mainly due to increases in Ethiopia, Zambia, Myanmar and the Lao People's Democratic Republic. Announced greenfield investments into the group reached a six-year high, led by a \$16 billion oil and gas project in Angola. In contrast, a large reduction of FDI flows took place in Mozambique, and other recipients, including Bangladesh, Cambodia, the Democratic Republic of Congo and the United Republic of Tanzania, also saw weak or negative FDI growth.

FDI flows to the **landlocked developing countries** (LLDCs) fell by 3 per cent to \$29 billion. The Asian countries in the group experienced the largest fall, mainly due to a drop in investment in Mongolia which saw its inflows decline for a third successive year. In Central Asian LLDCs, investors from developing and transition economies are increasingly important in terms of the value of FDI stock, led by China, Russia, Turkey, the United Arab Emirates, the Republic of Korea and the Islamic Republic of Iran. FDI remains the largest source of external finance for LLDCs, having overtaken official development assistance after the global financial crisis.

FDI inflows to **small island developing States** (SIDS) increased by 22 per cent to \$7 billion in 2014, mostly due to a rise in cross-border M&A sales. Trinidad and Tobago, the Bahamas, Jamaica and Mauritius were the largest destinations of FDI flows to SIDS, accounting for more than 72 per cent of the

total. Flows to Trinidad and Tobago were lifted by a \$1.2 billion acquisition in the petrochemical industry; cross-border acquisitions also drove the increased FDI flows in Mauritius. A number of cross-border megadeals took place in Papua New Guinea's oil and gas industry. In contrast, flows to Jamaica – the group's second largest recipient – decreased by 7 per cent to \$551 million.

A stock-taking of external finance flows to structurally weak, small and vulnerable economies since the First Conference on Financing for Development in Monterrey in 2002 demonstrates the potential of FDI in pursuit of sustainable development and in the context of the post-2015 development agenda. Because of the size, stability and diverse development impact of FDI compared with other sources of finance, it remains an important component in external development finance. In particular, given its contribution to productive and export capacities, FDI plays a catalytic role for development in these economies, including in partnership with other sources of finance. A holistic approach – encompassing all sources, public and private, domestic and foreign – is essential for mobilizing development finance effectively into all three economic groups; a perspective to be discussed at the Third Financing for Development Conference in Addis Ababa in July 2015, and subsequently.

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 these structurally weak economies quadruple by 2030. More important, further efforts are needed to harness financing for economic diversification to foster greater resilience and sustainability in these countries.

3. REFORMING THE INTERNATIONAL INVESTMENT REGIME: AN ACTION MENU



REFORMING THE INTERNATIONAL INVESTMENT REGIME: AN ACTION MENU

The IIA regime is at a crossroads; there is a pressing need for reform

Growing unease with the current functioning of the global IIA regime, together with today's sustainable development imperative, the greater role of governments in the economy and the evolution of the investment landscape, have triggered a move towards reforming international investment rule making to make it better suited to today's policy challenges. As a result, the IIA regime is going through a period of reflection, review and revision.

As evident from UNCTAD's October 2014 World Investment Forum (WIF), from the heated public debate taking place in many countries, and from various parliamentary hearing processes, including at the regional level, a shared view is emerging on the need for reform of the IIA regime to make it work for all stakeholders. The question is not about *whether* to reform or not, but about the *what, how* and *extent* of such reform.

WIR 2015 offers an action menu for such reform

WIR15 responds to this call for reform by offering an action menu. Based on lessons learned, it identifies reform challenges, analyses policy options, and offers guidelines and suggestions for action at different levels of policymaking.

IIA reform can benefit from six decades of experience with IIA rule making. Key lessons learned include (i) IIAs "bite" and may have unforeseen risks, therefore safeguards need to be put in place; (ii) IIAs have limitations as an investment promotion and facilitation tool, but also underused potential; and (iii) IIAs have wider implications for policy and systemic coherence, as well as for capacity-building.

IIA reform should address five main challenges:

- *Safeguarding the right to regulate for pursuing sustainable development objectives.* IIAs can limit contracting parties' sovereignty in domestic policymaking. IIA reform therefore needs to ensure that such limits do not unduly constrain legitimate public policymaking and the pursuit of sustainable development objectives. IIA reform options include refining and circumscribing IIA standards of protection (e.g. FET, indirect expropriation, MFN treatment) and strengthening "safety valves" (e.g. exceptions for public policies, national security, balance-of-payments crises).
 - *Reforming investment dispute settlement.* Today's system of investor-State arbitration suffers from a legitimacy crisis. Reform options include improving the existing system of investment arbitration (refining the arbitral process, circumscribing access to ISDS), adding new elements to the existing system (e.g. an appeals facility, dispute prevention mechanism) or replacing it (e.g. with a permanent international court, State-State dispute settlement, and/or domestic judicial proceedings).
 - *Promoting and facilitating investment.* The majority of IIAs lack effective investment promotion and facilitation provisions and promote investment only indirectly, through the protection they offer. IIA reform options include expanding the investment promotion and facilitation dimension of IIAs together with domestic policy tools, and targeting promotion measures towards sustainable development objectives. These options address home- and host-country measures, cooperation between them, and regional initiatives.
 - *Ensuring responsible investment.* Foreign investment can make a range of positive contributions to a host country's development, but it can also negatively impact the environment, health, labour rights, human rights or other public interests. Typically, IIAs do not set out responsibilities on the part of investors in return for the protection that they receive. IIA reform options include adding clauses that prevent
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the lowering of environmental or social standards, that stipulate that investors must comply with domestic laws and that strengthen corporate social responsibility.

- *Enhancing systemic consistency.* In the absence of multilateral rules for investment, the atomised, multifaceted and multilayered nature of the IIA regime gives rise to gaps, overlaps and inconsistencies between IIAs, between IIAs and other international law instruments, and between IIAs and domestic policies. IIA reform options aim at better managing interactions between IIAs and other bodies of law as well as interactions within the IIA regime, with a view to consolidating and streamlining it. They also aim at linking IIA reform to the domestic policy agenda and implementation.

WIR 2015 offers a number of policy options to address these challenges. These policy options relate to different areas of IIA reform (substantive IIA clauses, investment dispute settlement) and to different levels of reform-oriented policymaking (national, bilateral, regional and multilateral). By and large, these policy options for reform address the standard elements covered in an IIA and match the typical clauses found in an IIA.

A number of strategic choices precede any action on IIA reform. This includes whether to conclude new IIAs; whether to disengage from existing IIAs; or whether to engage in IIA reform. Strategic choices are also required for determining the nature of IIA reform, notably the substance of reform and the reform process. Regarding the substance of IIA reform, questions arise about the extent and depth of the reform agenda; the balance between investment protection and the need to safeguard the right to regulate; the reflection of home and host countries' strategic interests; and how to synchronize IIA reform with domestic investment policy adjustments. Regarding the reform process, questions arise about whether to consolidate the IIA network instead of continuing its fragmentation and where to set priorities as regards the reform of individual IIAs.

When implementing IIA reform and choosing the best possible options for designing *treaty elements*, policymakers have to consider the compound effect of these options. Some combinations of reform options may “overshoot” and result in a treaty that is largely deprived of its basic investment protection *raison d’être*. For each of the reform actions, as well as their combinations, policymakers need to determine the best possible way to safeguard the right to regulate while providing protection and facilitation of investment.

Reform calls for a global approach to synchronize actions at national, bilateral and regional levels

In terms of process, IIA reform actions need to be undertaken at the national, bilateral, regional and multilateral levels. In each case, the reform process includes (1) taking stock and identifying the problems, (2) developing a strategic approach and an action plan for reform, and (3) implementing actions and achieving the outcomes.

While reform steps at the national level (e.g. new model IIAs) or bilateral level (e.g. renegotiation of “old” IIAs) can play an important role in countries’ reform strategies, they risk perpetuating, if not exacerbating, the fragmentation and incoherence of the global IIA regime. Reform initiatives at the multilateral or regional level, although more challenging and time-consuming, offer a means to consolidate IIA reform by finding common solutions to widely shared concerns. Regional reform processes could span from a collective review of the underlying regional (and bilateral) treaty network to its consolidation. At the multilateral level, a global review and identification of the systemic risks and emerging issues could lead to consensus-building on key IIA reform issues that ultimately could feed into more coordinated approaches, including for future international investment rule making. Such efforts would be in the interest of consolidating and streamlining the IIA network and making it work for sustainable development.

By presenting reform approaches, guidelines, tools, solutions, and a road map for the reform process, *WIR 2015* offers an action menu for IIA reform. It pulls together a variety of contributions that have been put forward in recent years, by UNCTAD and many others, on aspects of IIA reform. It invites countries to use this action menu and define their own road maps for IIA reform: countries can pick and choose the respective reform actions and options to formulate their own reform packages, in line with their individual reform objectives.

Table 4. Guidelines for IIA Reform

Description

1. Harness IIAs for sustainable development	The ultimate objective of IIA reform is to ensure that the IIA regime is better geared towards sustainable development objectives while protecting and promoting investment.
2. Focus on critical reform areas	The key areas for reform are (i) safeguarding the right to regulate for public interest, (ii) reforming investment dispute settlement, (iii) strengthening the investment promotion and facilitation function of IIAs, (iv) ensuring investor responsibility, and (v) enhancing systemic coherence.
3. Act at all levels	The reform process should follow a multilevel approach and take place at the national, bilateral, regional, and multilateral levels, with appropriate and mutually supportive action at each level.
4. Sequence properly for concrete solutions	At each level, the reform process should follow a gradual, step-by-step approach, with appropriately sequenced and timed actions based on identifying the facts and problems, formulating a strategic plan, and working towards concrete outcomes that embody the reform effort.
5. Ensure an inclusive and transparent reform process	The reform process should be transparent and inclusive, allowing all stakeholders to voice their opinion and to propose contributions.
6. Strengthen the multilateral supportive structure	The reform process should be supported by universal and inclusive structures that help coordinate reform actions at different levels by offering backstopping, including through policy analysis, technical cooperation, and a platform for exchange of experiences and consensus-building.

All of this should be guided by the goals of harnessing IIAs for sustainable and inclusive growth, and determining the most effective means to safeguard the right to regulate while providing protection and facilitation of investment. The reform should focus on critical areas, include actions at all levels, take a systematic and sequential approach, ensure inclusiveness and transparency, and make use of multilateral support structures (table 4).

In the absence of a multilateral system and given the huge number of existing IIAs, the best way to make the IIA regime work for sustainable development is to collectively reform it with a global support structure. Such a global support structure can provide the necessary backstopping for IIA reform, through policy analysis, coordination, 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.

4. INTERNATIONAL TAX AND INVESTMENT POLICY COHERENCE



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 for 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.

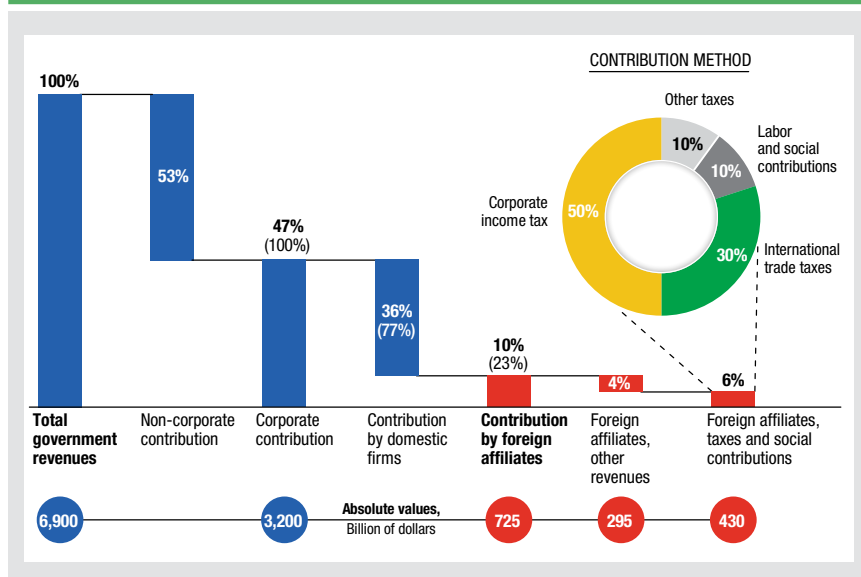
Foreign affiliates contribute about 10 per cent of government revenues in developing countries

Policymakers and experts at work in the BEPS process have so far not arrived at an overall quantification of the value at stake for government revenues. Various research institutes and NGOs have put forward estimates for the amount of taxes avoided by MNEs. To date, however, there is no consensus estimate, in no small part because of the absence of a baseline establishing the actual fiscal contribution of MNEs.

UNCTAD estimates the contribution of MNE foreign affiliates to government budgets in developing countries at about \$730 billion annually (figure 9). 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 governments of African countries depend on foreign corporate payments for 14 per cent of their budget funding.)

Furthermore, the lower a country is on the development ladder, the greater

Figure 9. Government revenues contributed by foreign affiliates of MNEs Share of government revenues, developing countries, reference year 2012 (Per cent and billions of dollars)



Source: UNCTAD.

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.

Some 30 per cent of global cross-border investment passes through offshore hubs

Notwithstanding their overall role as contributors to government revenues, MNEs, like all firms, aim to minimize 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

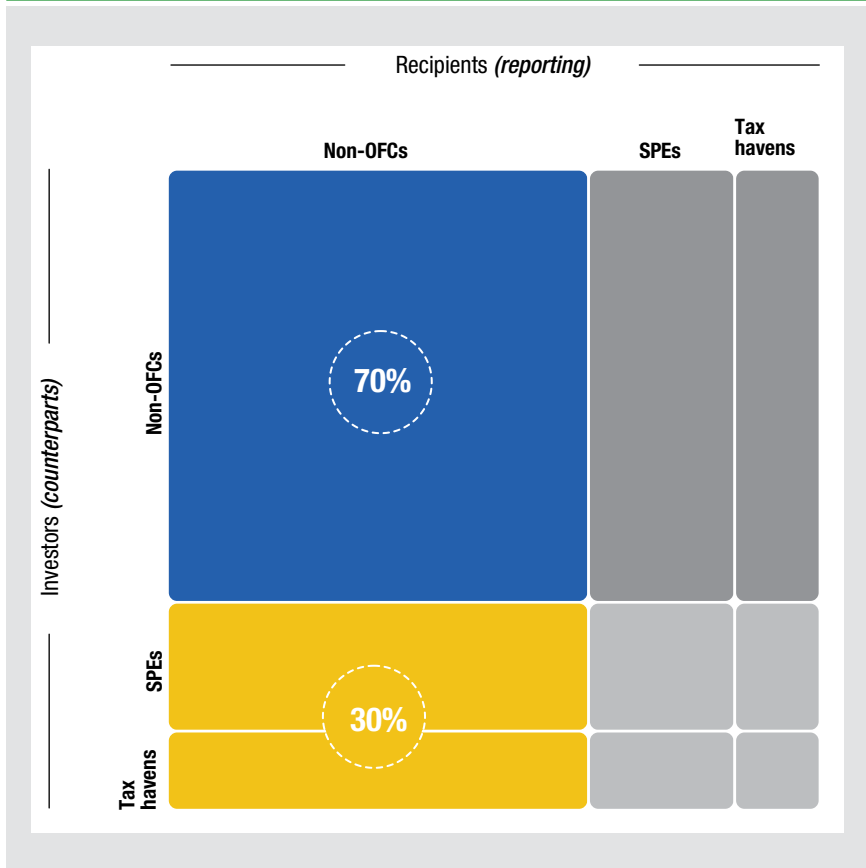
operational needs. The size and direction of FDI flows are thus often influenced by MNE tax considerations, because the structure and modality of initial investments enable tax avoidance opportunities on subsequent investment income. The attention of policymakers in tackling tax avoidance, most notably in the BEPS approach, focuses naturally on tax rules and transparency principles – i.e. on accounting for income. The fundamental role of cross-border investment as the enabler of tax avoidance warrants a complementary perspective.

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. UNCTAD's Offshore Investment Matrix shows the pervasive role of offshore investment hubs in the international investment structures of MNEs (figure 10). In 2012, of an estimated \$21 trillion of international corporate investment stock in non-offshore recipient countries (coloured area in the figure), more than 30 per cent, or some \$6.5 trillion, was channeled through offshore hubs (yellow area). The largest offshore investment players are jurisdictions facilitating so-called special purpose entities (SPEs).

A mirror view of the matrix reveals that 28 per cent of the total amount of cross-border corporate investment stock from non-offshore investor countries is invested into intermediary entities based in hubs (dark grey area). In some cases these entities may undertake some economic activity on behalf of related companies in higher tax jurisdictions, such as management services, asset administration or financial services. Often they are equivalent to letterbox companies, legal constructions conceived for tax optimization purposes. The prominent transit role of these entities in financing MNE operations causes a degree of double-counting in global corporate investment figures. In UNCTAD FDI statistics, this double-counting effect is removed by subtracting the SPE component from reported FDI data.

MNEs employ a range of tax avoidance levers, enabled by tax rate differentials between jurisdictions, legislative mismatches and tax treaties.

Figure 10. Non-OFC inward investment stocks, by type of investor
Vertical view of the Offshore Investment Matrix (Per cent)



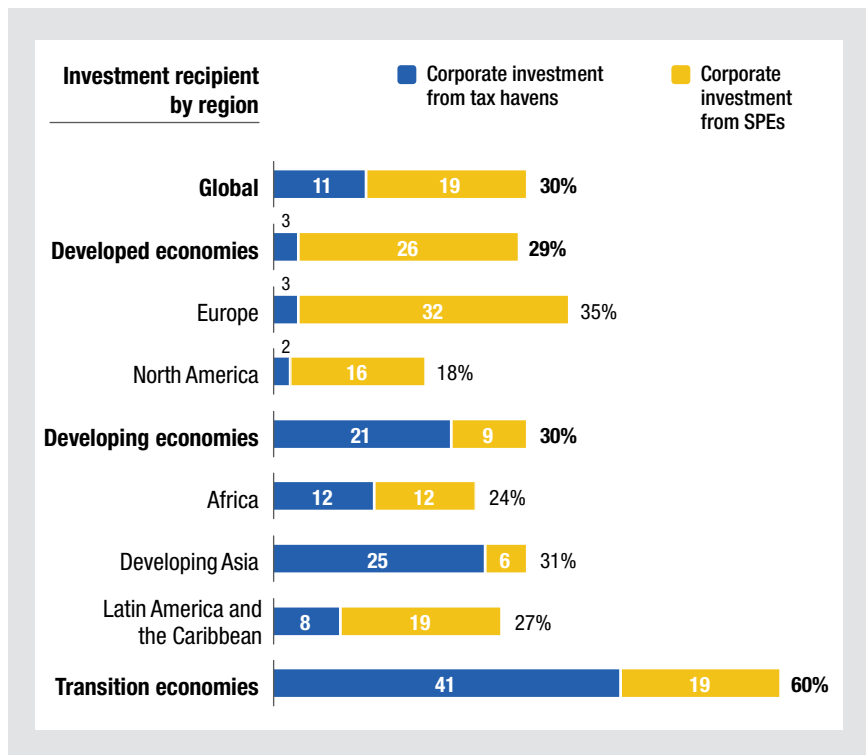
Source: UNCTAD.

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.

Revenue losses for developing countries from tax avoidance through offshore investment hubs amount to about \$100 billion

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 (figure 11). However, profit shifting out of developing countries can have a significant negative impact on their sustainable development prospects. Developing countries are often less equipped to deal with highly complex tax avoidance practices because of resource constraints or lack of technical expertise.

Figure 11. Exposure to investments from offshore investment hubs, by region, 2012
Share of corporate investment stock from offshore hubs (Per cent)



Source: UNCTAD.

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 off-shore 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. (The average effects disguise country-specific impacts.)

These results do not necessarily capture the full extent of MNE tax avoidance – they capture only schemes that exploit direct investment links through offshore hubs. Leaving aside the estimates for overall government revenue losses, the Offshore Indicator developed by UNCTAD provides intrinsic value to policymakers as a “signal indicator” for BEPS, and as a rule-of-thumb method for country-level BEPS impact.

Tax avoidance practices by MNEs and international investors 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.

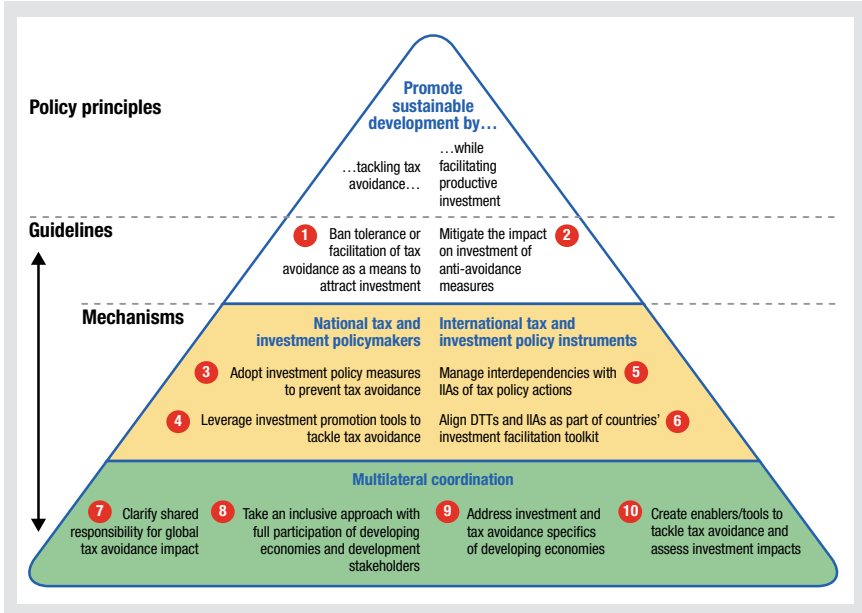
National and international tax and investment policies should work in synergy

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 role of these hubs or that might affect 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 cross-border investment in building the corporate structures that enable tax avoidance is fundamental. Therefore, investment policy should form an integral part of any solution.

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 (figure 12). Key objectives of the 10 guidelines proposed for discussion in the WIR 2015 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 investor host, home and transit 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.

Figure 12. Guidelines for Coherent International Tax and Investment Policies



Source: UNCTAD.

