KEY MESSAGES

INVESTMENT TRENDS AND PROSPECTS

Global foreign direct investment (FDI) flows in 2021 were $1.58 trillion, up 64 per cent from the exceptionally low level in 2020. The recovery showed significant rebound momentum, with booming merger and acquisition (M&A) markets and rapid growth in international project finance because of loose financing conditions and major infrastructure stimulus packages.

However, the global environment for international business and cross-border investment changed dramatically in 2022. The war in Ukraine – on top of the lingering effects of the pandemic – is causing a triple food, fuel and finance crisis in many countries around the world. Investor uncertainty could put significant downward pressure on global FDI in 2022.

The 2021 growth momentum is unlikely to be sustained. Global FDI flows in 2022 will likely move on a downward trajectory, at best remaining flat. New project activity is already showing signs of increased risk aversion among investors: preliminary data for Q1 2022 show greenfield project numbers down 21 per cent and international project finance deals down 4 per cent.

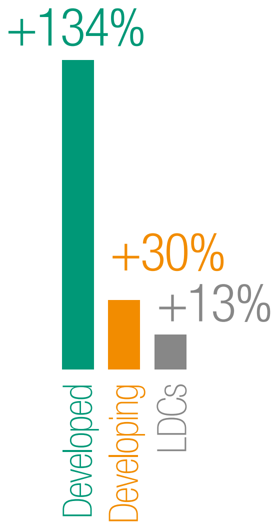
The 2021 FDI recovery brought growth in all regions. However, almost three quarters of the global increase was due to the upswing in developed countries, where FDI reached $746 billion – more than double the 2020 level. The increase was mostly caused by M&A transactions and high levels of retained earnings of multinational enterprises (MNEs). Those, in turn, led to sizeable intrafirm financial flows and major FDI fluctuations in large investment hubs.

The high levels of retained earnings in 2021 were the result of record MNE profits. The profitability of the largest 5,000 MNEs doubled to more than 8 per cent of sales. Profits were high especially in developed countries, because of the release of pent-up demand, low financing costs and significant government support.

Despite high profits, the appetite of MNEs for investing in new productive assets overseas remained weak. While infrastructure-oriented international project finance was up 68 per cent and cross-border M&As were up 43 per cent, greenfield investment numbers increased by only 11 per cent, still one fifth below pre-pandemic levels. The value of greenfield announcements overall rose by 15 per cent, to $659 billion, but remained flat in developing countries at $259 billion – stagnating at the lowest level ever recorded. This is a concern, as new investments in industry are crucial for economic growth and development prospects.

FDI flows to developing economies grew more slowly than those to developed regions but still increased by 30 per cent, to $837 billion. The increase was mainly the result of strong growth performance in Asia, a partial recovery in Latin America and the Caribbean, and an upswing in Africa. The share of developing countries in global flows remained just above 50 per cent.

- FDI flows to Africa reached $83 billion, from $39 billion in 2020. Most recipients saw a moderate rise in FDI. The total for the continent was inflated by a single large intrafirm financial transaction. Greenfield announcements remained depressed, but international project finance deals were up 26 per cent, with strong growth in extractive industries.



- In *developing Asia*, despite successive waves of COVID-19, FDI rose to an all-time high for the third consecutive year, reaching $619 billion. Asia is the largest recipient region, accounting for 40 per cent of global FDI. However, inflows remain highly concentrated; six economies account for more than 80 per cent of FDI to the region.
- FDI in *Latin America and the Caribbean* rose by 56 per cent to $134 billion. Most economies saw inflows rebound, with only a few experiencing further declines, caused by pandemic-induced economic crises. Total inflows remained about 15 per cent below the pre-pandemic level.
- FDI flows to the structurally weak, *vulnerable and small economies* rose by 15 per cent to $39 billion. Inflows to the least developed countries (LDCs), landlocked developing countries (LLDCs) and small island developing States (SIDS) combined accounted for only 2.5 per cent of the world total in 2021, down from 3.5 per cent in 2020.

International investment in sectors relevant for the Sustainable Development Goals (SDGs) in developing countries increased substantially in 2021, by 70 per cent. The combined value of greenfield announcements and international project finance deals in SDG sectors exceeded the pre-pandemic level by almost 20 per cent. Most of the growth went to renewable energy. Investment activity in other SDG-related sectors – including infrastructure, food and agriculture, health, and WASH – saw only a partial recovery.

Renewable energy and energy-efficiency projects represent the bulk of climate change investments. International private investment in climate change sectors is directed almost exclusively to mitigation; only 5 per cent goes to adaptation projects. More than 60 per cent is invested in developed countries, where 85 per cent of projects are purely privately financed. In contrast, almost half of the projects in developing countries require some form of public sector participation.

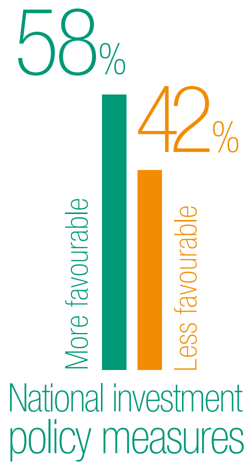
International project finance is increasingly important for SDG and climate change investment. The strong growth performance of international project finance can be explained by favourable financing conditions, infrastructure stimulus and significant interest on the part of financial market investors to participate in large-scale projects that require multiple financiers. The instrument also enables governments to leverage public investment through private finance participation.

Finally, comparing the largest, the smallest and the digital MNEs shows starkly contrasting investment trends. Sales of UNCTAD's top 100 digital MNEs grew five times faster than those of the traditional top 100 over the past five years, with the pandemic providing a huge boost. The largest MNEs engage more in greenfield investment, and digital MNEs more in M&As. Digital MNEs are FDI light, needing relatively little investment in physical assets to reach overseas markets. International production by both digital and large MNEs has grown continuously, albeit at different speeds. In contrast, FDI by SMEs is in decline. Over the past five years, the share of SMEs in greenfield investment projects declined from 5.7 to 1.3 per cent.

INVESTMENT POLICY DEVELOPMENTS

In 2021, the pace of investment policymaking returned to pre-pandemic levels, with 109 new measures, 28 per cent fewer than in 2020. That signalled an end to the emergency investment policymaking that characterized the first year of the pandemic; however, the crisis still affected the nature of the measures.

Developed countries expanded the protection of strategic companies from foreign takeovers, bringing the share of measures less favourable to investment to an all-time high (42 per cent). Four new countries adopted FDI screening mechanisms (including one developing country), and at least twice as many tightened existing mechanisms. Together, countries that conduct FDI screening account for 63 per cent of global FDI inflows and 70 per cent of stock (up from 52 and 67 per cent, respectively, in 2020).



Conversely, developing countries continued to adopt primarily measures to liberalize, promote or facilitate investment, confirming the important role that FDI plays in their economic recovery strategies. Investment facilitation measures constituted almost 40 per cent of all measures more favourable to investment, followed by the opening of new activities to FDI (30 per cent) and by new investment incentives (20 per cent).

The first quarter of 2022 registered a record number of new investment policy measures (75), mainly in response to the war in Ukraine. Sanctions and countersanctions affecting FDI to and from the Russian Federation, Belarus and the non-government-controlled areas of eastern Ukraine constituted 70 per cent of all measures adopted in Q1 2022.

Several notable developments accelerated the reform of the international investment agreement (IIA) regime in 2021. They included the conclusion of new-generation megaregional economic agreements and large-scale terminations of old-generation bilateral investment treaties (BITs). Greater policy attention to investment facilitation, climate change and human rights will also affect international investment governance.

For the second consecutive year, the number of terminations exceeded the number of newly concluded IIAs. In 2021, countries concluded 13 IIAs and effectively terminated at least 86 IIAs, bringing the size of the IIA universe to 3,288. In line with UNCTAD's IIA policy recommendations, IIAs signed in 2021 continue to feature many reform-oriented provisions aimed at preserving regulatory space while promoting investment for development.

The total count of investor–State dispute settlement (ISDS) cases reached 1,190 at the end of 2021, with at least 68 new arbitrations initiated during the year. Most of the cases initiated were brought under old-generation IIAs. In 2022, the war in Ukraine brought into the spotlight past and potential future ISDS claims related to armed conflict.

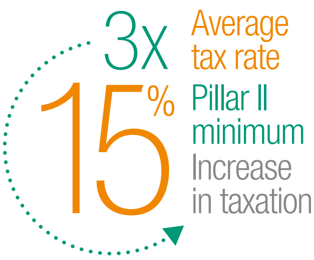
Trends in the taxation of investment

Tax policy is used around the world as an instrument to promote international investment. Countries rely on a variety of fiscal incentives to attract investors to priority sectors or regions. An analysis of tax-related investment policy measures adopted worldwide over the last decade shows that profit-based incentives, such as tax holidays and reduced corporate income tax (CIT), are among the most frequent and widespread.

Incentives are typically not time-bound, nor allocated on the basis of transparent criteria. Although the governance of incentives varies greatly across countries, on average, 70 per cent of incentives are allocated on the basis of discretion, criteria not available to the public or negotiation with individual investors. In addition, only about half of all tax incentives introduced worldwide over the last decade were time-bound, with lower shares in Africa (35 per cent) and Asia (40 per cent).

IIAs impose obligations on States that can create friction with tax measures undertaken at the national level. Most IIAs do not exclude taxation from their scope, which means that they cover a wide range of tax-related measures, whether of general or specific application. UNCTAD data suggest that investors have challenged tax-related measures in 165 ISDS cases based on IIAs. UNCTAD's guide for tax policymakers on IIAs, published in 2021, contains IIA reform options to minimize the risk of friction with tax policy.

THE IMPACT OF A GLOBAL MINIMUM TAX ON FDI



The introduction of a minimum tax of 15 per cent on the foreign profits of the largest MNEs proposed in the context of the G20/OECD Base Erosion and Profit Shifting (BEPS) project has important implications for international investment and investment policies. BEPS Pillar II is expected to discourage MNEs from shifting profits to low-tax countries and to reduce tax competition between countries. Further objectives are to stabilize international tax rules and reduce tax uncertainty, to create a more level playing field for companies and to prevent the proliferation of unilateral measures that would lead to a deterioration of the investment climate. In addition, increased tax revenues will support domestic resource mobilization for the SDGs.

Statutory rates of corporate income tax (CIT) have declined over the last three decades in a race to the bottom to attract international investment. They now hover at about 25 per cent in both developed and developing countries. Effective tax rates (ETRs) on the reported profits of foreign affiliates tend to be lower, less than 20 per cent on average, mainly because of fiscal incentives offered by host countries.

MNEs often pay significantly less tax on their foreign income because they can shift part of their profits to low-tax jurisdictions. As a result, the actual tax rates faced by MNEs on their foreign income are about 15 per cent, significantly lower than the headline rate. This is captured by a new metric introduced in this report, the FDI-level ETR, reflecting the average taxes paid by MNEs on their entire FDI income, including shifted profits.

Pillar II will increase the corporate income tax faced by MNEs on their foreign profits. First, MNEs will reduce profit shifting, as they will have less to gain from it, and will pay host-country tax rates. Second, foreign affiliates that pay an ETR below the minimum on profits reported in host countries will be subject to a top-up tax. The expected rise in the (FDI-level) ETR faced by MNEs is conservatively estimated at 2 percentage points. This corresponds to an increase in tax revenues paid by MNEs to host countries of about 15 per cent – more for large MNEs that are directly affected by the reform.

Both developed economies and developing economies are expected to benefit substantially from increased revenue collection. Offshore financial centres stand to lose a substantial part of CIT revenues collected from MNEs' foreign affiliates. For smaller developing countries – which generally have lower ETRs – the application of the top-up tax could make a major difference in revenue collection.

The flipside of increased tax revenues is the potential downward pressure on the volume of investment that the increase in CIT on FDI activities will exert. The baseline scenario places the potential downward effect on global FDI at about -2 per cent.

At the same time, the reduction in tax rate differentials will result in the diversion of investment from low- to higher-tax jurisdictions, with developing countries benefiting relatively more because of their higher corporate tax rates.

The diversion effect could counterbalance investment losses caused by the volume effect. However, this will not occur automatically. In a world of smaller tax rate differentials, countries stand to gain more from improvements in other investment determinants – including those related to infrastructure and the regulatory and institutional environment.

No country can afford to ignore Pillar II. The mechanism that has been devised for implementation is such that it is sufficient for a relatively limited number of investor home countries (e.g. G20 and OECD members) to apply the top-up tax for the effects to become almost universal. Host countries, including many developing economies, then have the option to apply the top-up tax first – before home countries can do so – to protect tax revenues. But the effectiveness of competitive tax rates or traditional tax incentives to attract FDI will be diminished.

The Pillar II reforms will thus have major implications for national investment policymakers and investment promotion institutions, and for their standard toolkits. Fiscal incentives are widely used for investment promotion, including as part of the value proposition of most special economic zones. Looking specifically at the incentives most used to attract FDI:

- Accelerated depreciation and loss carry-forward provisions will remain effective.
- Tax holidays and exemptions will lose all or most of their attraction for investors.
- A range of other incentives will be affected to various degrees depending on their design.

Investment policymakers urgently need to review their incentives packages, for both existing and new investors. Some fiscal policy options to promote investment remain, including amplifying the benefit to investors of the so-called substance-based carve-out; shifting to incentives that are less affected by Pillar II; or reducing taxes that are not covered by Pillar II, to the extent that they have a bearing on investment decisions.

International investment policymakers and negotiators of IIAs need to consider the potential constraints that IIA commitments may place on the implementation of key provisions of Pillar II. If host countries are prevented by IIAs and their ISDS provisions from applying top-up taxes or removing incentives, the tax increase to the global minimum will accrue to home countries. Host countries would lose out on tax revenues without the compensating investment-attraction benefit. Existing old-generation IIAs, of the type predominantly in force in many developing countries, are likely to be particularly problematic.

IIAs

Pillar II

The strategic implications of the reforms for investment policy are also important. Reduced competition from low-tax locations could benefit developing economies. Nevertheless, as competition shifts from tax levers to alternative investment determinants, and from fiscal incentives to financial incentives, many could still find themselves at a disadvantage because they are unable to afford the substantial upfront financial commitments associated with infrastructure provision or subsidies.

Looking ahead, many important details of Pillar II still need to be defined. *Therefore, it will be key for developing countries to strengthen cooperation and technical capabilities to ensure effective participation in the process of negotiating the final shape of the reforms.*

Finally, the implementation of BEPS Pillar II by tax authorities will be highly complex, and so will the translation of the reforms into investment policies, incentives regimes, and the value propositions of investment promotion agencies and special economic zones. Moreover, the tax revenue implications for developing countries of constraints posed by IIAs are a major cause for concern. *The international community, in parallel with or as part of the Inclusive Framework discussions, should alleviate the constraints that are placing developing countries, and especially LDCs, at a disadvantage:*

- Vastly scale up technical assistance to developing countries to support BEPS implementation and investment policy adjustment.
- Adopt a multilateral solution to remove implementation constraints posed by IIAs and mitigate ISDS risks.
- As a stopgap measure, establish a mechanism to return any top-up revenues raised by developed home countries that should have accrued to developing host countries, but that they were unable to raise because of capacity or treaty constraints.

CAPITAL MARKETS AND SUSTAINABILITY

sustainable finance
$5.2 trillion in 2021 up 63%

UNCTAD estimates that the value of sustainability-themed investment products in global financial markets amounted to $5.2 trillion in 2021, up 63 per cent from 2020. These products include sustainable funds ($2.7 trillion), green bonds (over $1.5 trillion outstanding), social bonds ($418 billion), mixed-sustainability bonds ($408 billion) and sustainability-linked bonds ($105 billion). Most are domiciled in developed countries and targeted at assets in developed markets.

The global market for sustainable funds experienced another year of exceptional growth in 2021. Net investment reached $557 billion, up 58 per cent from 2020 and more than three times the 2019 level. European funds attracted net inflows of $472 billion, or 85 per cent of the world's total. Sustainable funds now account for 18 per cent of the assets of the European fund market. Globally, however, sustainable funds still only account for about 4 per cent of total open-ended funds.

New global sustainable bond issuance surpassed $1 trillion in 2021, including green, social and mixed-sustainability bonds, as well as sustainability-linked bonds. The increase in sustainable bond issuance was especially visible in emerging markets. The European Union and the corporate sector continue to push social and mixed-sustainability bond issuance to new heights.

Concerns remain about greenwashing and the real impact of sustainability-themed investment products. That is because most of these products are self-labelled and there is a lack of consistent standards and high-quality data to assess sustainability credentials. Also, developing economies are largely bypassed by the sustainable fund market.

In 2021, public pension funds held more than $22 trillion in assets, or almost 40 per cent of global pension fund assets. The assets of sovereign wealth funds grew to $11 trillion. *Institutional investors can exert a significant influence over their investees and the sustainable investment market through asset allocation and active ownership.*

Currently, more than half of the 100 largest public pension and sovereign wealth funds do not disclose or report on sustainability issues. Making progress on ESG reporting by these funds will require strengthening national regulations.

Exchanges continue to play an important role in promoting sustainable finance, especially ESG disclosure. The number of exchanges with written guidance on ESG disclosure for issuers grew to 63 at the end of 2021. Mandatory ESG disclosure, supported by both exchanges and security market regulators, now exists in 30 markets.

Exchanges also have an important role in promoting gender equality. The number of exchanges engaged in annual "Ring the Bell for Gender Equality" events has grown from just 7 in 2015 to over 110 in 2022. Beyond raising awareness, exchanges support mobilizing finance for gender-equality-themed investment products, improving women's access to financial markets and promoting greater levels of female participation in corporate board rooms.

The climate emissions of publicly listed companies vary significantly from one market to another and can present systemic risks in some markets in a transition to net-zero emission economies. Exchanges, regulators and policymakers should monitor the emissions of companies listed on public markets to ensure an orderly transition.

Stock exchanges are playing an important role in helping listed companies take action on climate change, including through intensive training of their issuers on climate disclosure reporting.

With the rise of sustainability-themed financial products, governments around the world are stepping up their efforts to develop regulatory frameworks for sustainable finance. By the end of 2021, 35 countries and economic groupings – both developed and developing – had 316 sustainable finance-dedicated policy measures and regulations in force, more than 40 per cent of which were introduced in the last five years. Almost half of these policies are dedicated to sustainability disclosure. Sector-specific regulations with respect to asset management, sustainable banking and sustainable insurance are the second biggest policy area, representing about 20 per cent of all measures. Policy and regulatory gaps are more visible in three relatively new policy areas: taxonomies, product standards and carbon pricing.

In 2021, efforts to coordinate and consolidate sustainable finance regulations and standards at the international level gathered momentum. The International Organization of Securities Commissions (IOSCO) and the International Financial Reporting Standards (IFRS) Foundation are now leading a global effort in consolidating the major ESG reporting standards, effectively reducing the fragmentation that has persisted over the past decade.

Mandatory
ESG
disclosure in
30
markets