UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

UNCTAD

WORLD INVESTMENT REPORT 2022

INTERNATIONAL TAX REFORMS AND SUSTAINABLE INVESTMENT

OVERVIEW

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PREFACE

Global flows of foreign direct investment recovered to pre-pandemic levels last year, reaching $1.6 trillion. Cross-border deals and international project finance wereparticularly strong, encouraged by loose financing conditions and infrastructure stimulus. However, the recovery of greenfield investment in industry remains fragile, especially in developing countries.

This fragile growth of real productive investment is likely to persist in 2022. The fallout of the war in Ukraine with the triple food, fuel and finance crises, along with the ongoing COVID-19 pandemic and climate disruption, are adding stresses, particularly in developing countries. Global growth estimates for the year are alreadydown by a full percentage point. There is significant risk that the momentum forrecovery in international investment will stall prematurely, hampering efforts to boost finance for sustainable development.

The *World Investment Report* supports policymakers by monitoring global and regional investment trends and national and international investment policy developments. The report reviews investment in the Sustainable Development Goals and in climate change mitigation and adaptation. It also looks at sustainable finance trends in capital markets and among institutional investors.

The coming years will see the implementation of fundamental reforms in international taxation. These reforms are expected to have major implications for investment policy, especially in countries that make use of fiscal incentives and special economic zones. The report of this year provides a guide for policymakers to navigate the complex new tax rules and to adjust their investment strategies. I commend this report to all engaged in promoting investment in sustainable development.

António Guterres
Secretary-General of the United Nations

FOREWORD

The global environment for international investment changed dramatically with the onset of the war in Ukraine, which occurred while the world was still reeling from the impact of the pandemic. The war is having effects well beyond its immediate vicinity, causing a cost-of-living crisis affecting billions of people around the world, with rising prices for energy and food reducing real incomes and aggravating debt stress. Investor uncertainty and risk aversity could put significant downward pressure on global FDI this year.

The effects on investment flows to developing countries in 2022 and beyond are difficult to anticipate. Apart from direct effects on countries in Central Asia with close investment ties in the region, the impact on others will be mostly indirect and depend on the extent of their exposure to the triple crisis caused by the conflict and their consequent economic and political instability – key determinants of international private investment. If the past is an indication, the last time food prices were this high – during the 2007–2008 food crisis – there were riots in more than 60 countries.

The outcome will be of enormous significance for development prospects. The need for investment in productive capacity, in the Sustainable Development Goals (SDGs) and in climate change mitigation and adaptation is enormous. Current investment trends in these areas are not unanimously positive. Although global FDI flows rebounded strongly in 2021, industrial investment remains weak and well below pre-pandemic levels, especially in the poorest countries; SDG investment – project finance in infrastructure, food security, water and sanitation, and health – is growing but not enough to reach the goals by 2030; and investment in climate change mitigation, especially renewables, is booming but most of it remains in developed countries and adaptation investment continues to lag well behind.

Worryingly, some emerging indicators suggest that the war in Ukraine could become a setback in the energy transition, with increased fossil fuel production in countries previously committed to reducing emissions. In the first quarter of 2022, most of the 5,000 largest multinational enterprises revised downward their earnings forecasts for 2022. Alarmingly, while extractive industries revised upwards their expected earnings, with oil and gas at +22 per cent and coal at +32 per cent of expected earnings, renewable energy companies released downward revisions of an average of -22 per cent of expected earnings, lending credence to the intuition that current conditions risk reversing years of progress towards investing in sustainable energy. This is especially worrying as global CO_2 emissions from energy combustion and industrial processes rebounded in 2021 to reach their highest ever annual level.

To achieve the SDGs it is imperative that more funds are channeled to where they are most needed, on the ground, in developing countries. But also an important effort will have to come from domestic resource mobilization. From that perspective, the ongoing international tax reforms led by the G20 and the OECD, which we study extensively in this report, are a major step forward. They aim to ensure that multinationals pay their fair share of taxes where they operate, and they have the potential to give a significant boost to tax revenues in developing countries.

However, the war in Ukraine has further complicated domestic resource mobilization in developing countries, already worsened by the COVID-19 pandemic and the increased frequency of natural disasters in the context of climate change. In the midst of rising and unsustainable debt levels, without adequate multilateral mechanisms for restructuring, countries are being forced to reduce their fiscal space at a time when they should be increasing it.

The International Labour Organization suggests that the social protection financing gap stands at $1.2 trillion per year in developing countries, part of the $4.3 trillion we at UNCTAD estimate as the yearly gap in SDG financing.

And even with food and energy import bills, and worsening costs of borrowing due to higher interest rates, developing countries' primary fiscal balance has shrunk by $315 billion since the start of the war.

That is why international investment plays a critical complementary role to domestic public investment. And the new tax rules will affect how countries have traditionally promoted – and often competed – for international investment, through low tax rates, fiscal incentives and special economic zones.

The tax reforms are an opportunity for developing countries, not only from a revenue perspective, but also from an investment attraction perspective. Strategically, tax competition will decrease. Practically, the need to review the investment promotion toolkit is a chance to make costly incentives more sustainable.

There will be challenges. Developing countries face constraints in their responses to the reforms, because of a lack of technical capacity to deal with the complexity of the tax changes, and because of investment treaty commitments that could hinder effective fiscal policy action. The international community has the obligation to help. It can do so through technical assistance, by agreeing a solution to problems caused by international investment agreements, and by putting in place safeguards that protect the tax revenues of the poorest countries. These efforts should be part of a broader multilateral endeavor towards reining in illicit financial flows, especially in the developing world. This report points the way.

It is important that we act now. Even though countries face very alarming immediate problems stemming from the cost-of-living crisis, it is important we are able to invest in the long term. Because the short term and long term start at the same time. And the time is now.

Rebeca Grynspan
Secretary-General of UNCTAD

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TABLE OF CONTENTS

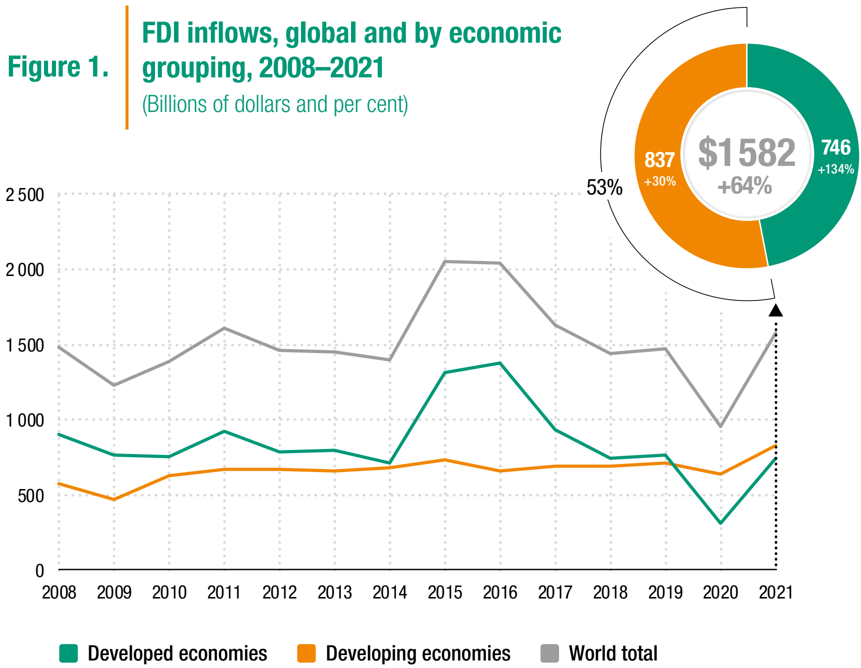
OVERVIEW

GLOBAL INVESTMENT TRENDS AND PROSPECTS

FDI recovered strongly in 2021, but prospects are bleak

Global foreign direct investment (FDI) flows in 2021 were $1.58 trillion, up 64 per cent from the exceptionally low level in 2020 (figure 1). 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.

Figure 1. **FDI inflows, global and by economic grouping, 2008–2021**
(Billions of dollars and per cent)



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

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. The resulting investor uncertainty could put significant downward pressure on global FDI in 2022.

Other factors will affect FDI negatively in 2022. The flare-up of COVID-19 in China, with renewed lockdowns in areas that play a major role in global value chains (GVCs), could further depress new greenfield investment in GVC-intensive industries. The expected interest rate increases in major economies that are seeing significant rises in inflation will slow down M&A markets and dampen the growth of international project finance. Negative financial market sentiment and signs of a looming recession could accelerate an FDI downturn.

There are several stabilizing factors as well. The large public support packages adopted for infrastructure investment, with multiple-year implementation periods, could provide a floor under international project finance. Cross-border M&As and MNE financial transactions of multinational enterprises (MNEs) have not yet lost their strength. And, looking at the composition of 2021 FDI flows, some large recipient regions, notably Europe, were still at relatively low levels, historically.

However, overall, 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 recovery was partly driven by record MNE profits

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 (figure 2), where inflows 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 MNEs. Those, in turn, led to sizable 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.

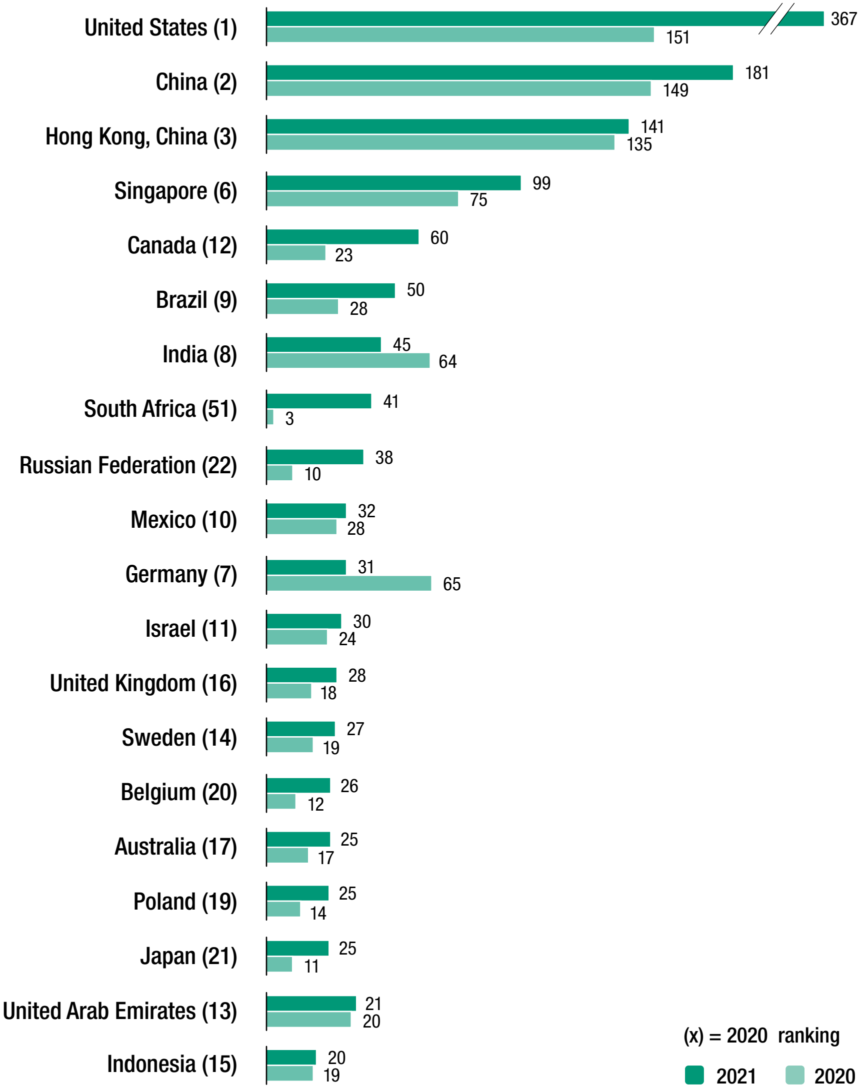
Despite high profits, the appetite of MNEs for investing in new productive assets overseas remained weak. While infrastructure-oriented international project finance was up 68 per cent and cross-border M&As were up 43 per cent in 2021, greenfield investment numbers increased by only 11 per cent, still 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 growth in developing countries slower

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.

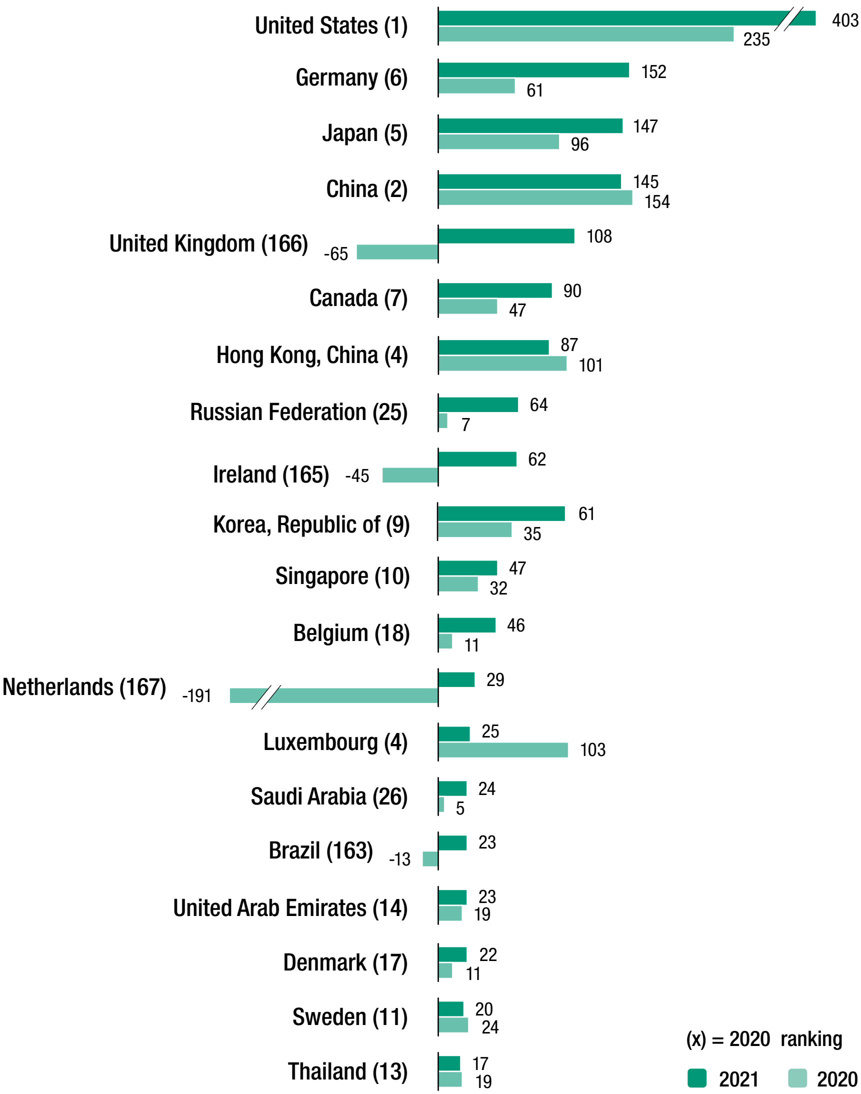
- FDI flows to Africa reached $83 billion, from $39 billion in 2020. Most recipients saw a moderate rise in FDI.
- In developing Asia, despite successive waves of COVID-19, FDI rose to an all-time high for the third consecutive year, reaching $619 billion.
- FDI in Latin America and the Caribbean rose by 56 per cent to $134 billion. Most economies saw inflows rebound, with only a few experiencing further declines.
- 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.

Figure 2. FDI inflows, top 20 host economies, 2020 and 2021 (Billions of dollars)



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

Figure 3. **FDI outflows, top 20 home economies, 2020 and 2021** (Billions of dollars)



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

Outward FDI increased sharply, with major swings in investment hubs

In 2021, MNEs from developed economies more than doubled their investment abroad to $1.3 trillion, from $483 billion. Their share in global outward FDI rose to three quarters of global outflows (figure 3). Much of the increase was driven by record reinvested earnings and high levels of M&A activity. The strong volatility of conduit countries continued in 2021.

Aggregate outward investment by European MNEs rebounded from the anomalously low level in 2020 of -$21 billion to $552 billion.

Outflows from North America reached a record $493 billion. MNEs from the United States increased their investment abroad by 72 per cent, to $403 billion. Flows to the European Union (EU) and the United Kingdom doubled, and those to Mexico almost tripled.

Outward FDI from other developed countries rose by 52 per cent to $225 billion, mainly because of increases from Japanese and Korean MNEs.

The value of investment activity abroad by MNEs from developing economies rose by 18 per cent, to $438 billion. Developing Asia remained a major source of investment even during the pandemic. Outward FDI from the region rose 4 per cent to $394 billion, contributing to almost a quarter of global outflows in 2021. Although overall outward investment from developing Asia increased, companies headquartered in the region made fewer acquisitions in 2021. Cross-border M&A purchases fell by 35 per cent to $45 billion. Acquisitions by MNEs headquartered in East Asia (mainly China) plummeted, from $44 billion in 2020 to just $6.3 billion.

Investment in the SDGs driven by a boom in renewables

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. However, most of the growth went to renewable energy. Investment activity – as measured by project numbers – in other SDG-related sectors, including infrastructure, food and agriculture, health, and WASH (water, sanitation and hygiene), saw only a partial recovery (table 1).

Table 1.	International private investment in the SDGs: 2021 project numbers compared to pre-pandemic levels (Per cent)

Infrastructure	Transport infrastructure, power generation and distribution (except renewables), telecommunication	-11	**Food and agriculture**	Investment in agriculture, research, rural development	-35
Renewable energy	Installations for renewable energy generation, all sources	+2	**Health**	Investment in health infrastructure, e.g. new hospitals	-25
WASH	Provision of water and sanitation to industry and households	-9	**Education**	Infrastructural investment, e.g. new schools	+17

Source: UNCTAD.

In LDCs, the SDG investment trend is less favourable than in other developing economies, and the detrimental impact of the pandemic persists. The share of total SDG investment in developing countries (both greenfield and international project finance values) that went to LDCs decreased from 19 per cent in 2020 to 15 per cent in 2021. Their share in the number of projects declined from 9 to 6 per cent.

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.

The largest, the smallest and the digital MNEs diverge

Comparing UNCTAD's traditional top 100 MNEs with an updated ranking of the top 100 digital MNEs and a new data set of investment projects by small and medium-sized enterprises (SMEs) reveals starkly contrasting investment trends.

Sales of the 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 traditional top 100 engage more in greenfield investment, and the 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 fell from 5.7 to 1.3 per cent.

Looking specifically at the investment behaviour of digital MNEs, although they invest relatively less through greenfield projects, when they do, the potential contribution to developing the digital economy can be significant. In addition to logistical and sales support points (accounting for 42 per cent of their greenfield investment projects), digital MNEs set up professional services offices (24 per cent), research and development (R&D) centres (14 per cent) and infrastructure for the internet (10 per cent). Just over one third of projects by digital MNEs are in developing countries.

Looking instead at the smallest MNEs, the fall in their investment abroad during 2020 and 2021 can be explained by the economic fallout from the COVID-19 pandemic, which hit small businesses disproportionally. However, the decline set in well before the pandemic, which indicates that longer-term factors hinder SME internationalization. These factors include unequal access to finance, the growing digital gap between SMEs and larger companies, continued concentration in international business and, from a policy perspective, a lack of investment promotion and facilitation measures targeted at SMEs. The deteriorating international policy environment for trade and investment, especially the trade tensions after 2017, are also likely to have discouraged SMEs more than large MNEs.

REGIONAL FDI TRENDS

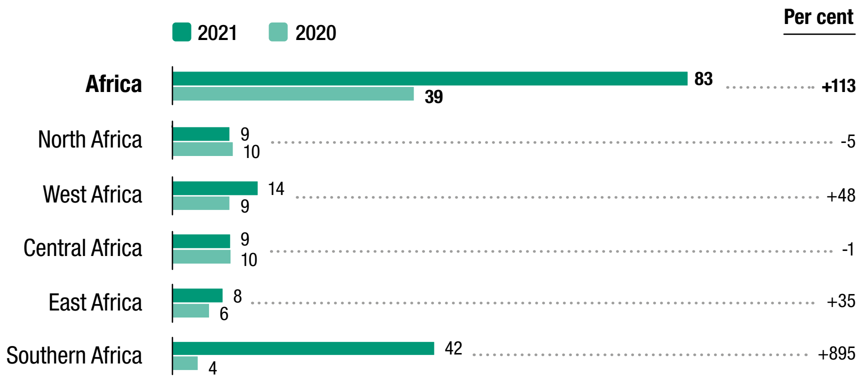
Moderate FDI rises across most of Africa

FDI flows to Africa reached $83 billion – a record level – from $39 billion in 2020, accounting for 5.2 per cent of global FDI. However, most recipients saw a moderate rise in FDI after the fall in 2020 caused by the pandemic. The total for the continent was inflated by a single intrafirm financial transaction in South Africa in the second half of 2021. Excluding that transaction, the increase in Africa is still significant, but more in line with other developing regions. Southern Africa, East Africa and West Africa saw their flows rise; Central Africa remained flat and North Africa declined (figure 4).

Despite the overall positive FDI trend on the continent, total greenfield announcements remained depressed, at $39 billion, showing only a modest recovery from the low of $32 billion in 2020. In contrast, international project finance deals targeting Africa showed a rise of 26 per cent in number (to 116) and a resurgence in value to $121 billion (after $36 billion in 2020). The rise was concentrated in power ($56 billion) and renewables ($26 billion).

European investors remain the largest holders of foreign assets in Africa, led by the United Kingdom ($65 billion) and France ($60 billion).

Figure 4. **Africa: FDI inflows by subregion, 2020–2021** (Billions of dollars)



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

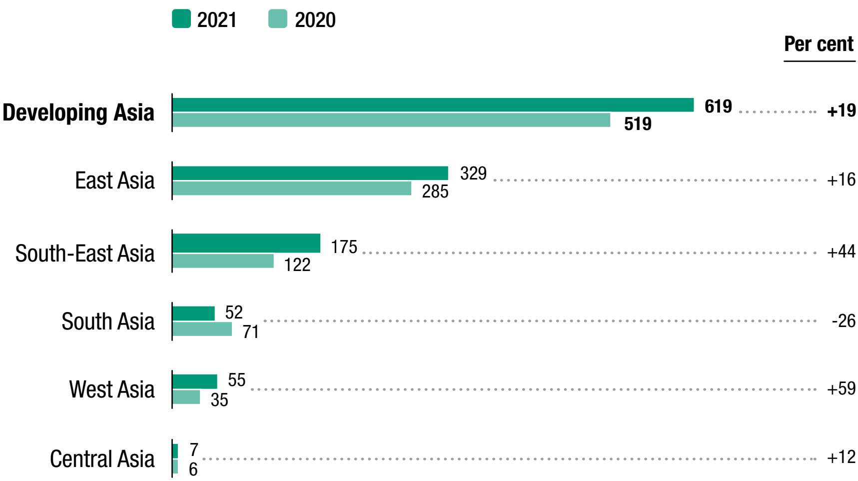
Record inflows in developing Asia

Despite successive waves of COVID-19, FDI in developing Asia rose for the third consecutive year to an all-time high of $619 billion, underscoring the resilience of the region. It is the largest recipient region of FDI, accounting for 40 per cent of global inflows.

The 2021 upward trend was widely shared in the region, with South Asia the only exception (figure 5). However, inflows remain highly concentrated. Six economies (China, Hong Kong (China), Singapore, India, the United Arab Emirates and Indonesia, in that order) accounted for more than 80 per cent of FDI to the region.

Across developing Asia, investment in sectors relevant for the SDGs rose significantly. International project finance values in these sectors increased by 74 per cent to $121 billion, primarily because of strong interest in renewable energy. Project values in this industry rose 123 per cent, to $77 billion, from $34 billion in 2020.

Figure 5. **Developing Asia: FDI inflows by subregion, 2020–2021** (Billions of dollars)



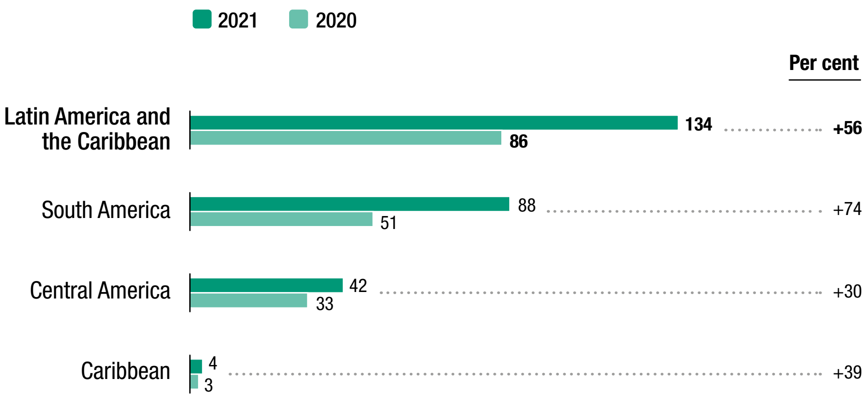
Source: UNCTAD, FDI/MNE database (https://unctad.org/fdistatistics).

Partial recovery in Latin America and the Caribbean

In 2021, FDI in Latin America and the Caribbean rose by 56 per cent to $134 billion, sustained by strong inflows in traditional target industries such as automotive manufacturing, financial and insurance services, and electricity provision, and pushed up by record high investments in information and communication services across the region. Most economies saw inflows rebound, with only a few experiencing further declines caused by pandemic-induced economic crises. Flows rose in all three subregions in Latin America and the Caribbean (excluding financial centres) (figure 6).

Cross-border M&A activity in the region increased, resulting in a higher number of deals, although the total value of net sales was virtually unchanged from 2020 at $8 billion. Announced greenfield investment increased by 16 per cent, with most commitments going to the automotive, information and communication, and extractive industries. The value of international project finance deals doubled, exceeding pre-pandemic levels, pushed by large projects in transportation infrastructure (especially in Brazil), mining (across the region) and renewable energy.

Figure 6. **Latin America and the Caribbean: FDI inflows by subregion,**
(Billions of dollars)



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

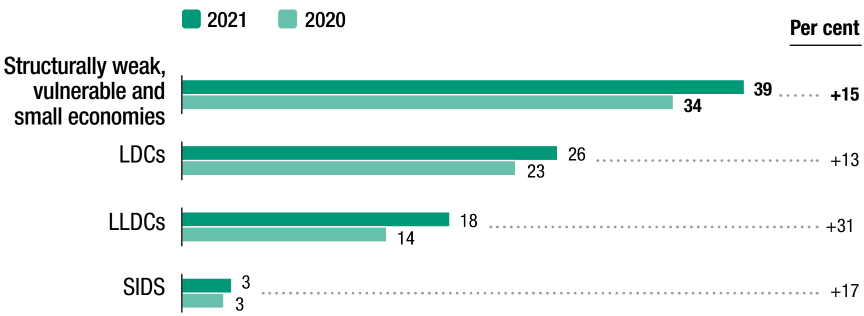
Hesitant growth in structurally weak, vulnerable and small economies

FDI flows to 82 structurally weak, vulnerable and small economies rose by 15 per cent to $39 billion (figure 7). 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 global total in 2021, down from 3.5 per cent in 2020. Investment in various sectors relevant for achieving the SDGs, especially in food, agriculture, health and education, continued to fall in 2021.

The number and value of greenfield project announcements in LDCs continued their downward trend in 2021. The number of projects fell to 158, the lowest number since 2008. This is a major concern as greenfield investments are crucial for building productive capacity and thus for prospects of sustainable growth. By value, the largest projects were announced in energy and gas supply and in information and communication.

Looking over a longer period, since 2011, FDI flows to LDCs as a group have increased only marginally. FDI remains an important external source of finance for LDCs, but the growth of FDI lags other sources; official development assistance and remittances are by far the largest external financial flow to LDCs.

Figure 7. **Structurally weak, vulnerable and small economies: FDI inflows by subgrouping, 2020–2021**
(Billions of dollars)



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

International project finance is an increasingly important source of investment in most countries and in a diverse set of industries, including SDG-relevant sectors. However, LDCs extractive industries continue to be the main target of project finance.

A few LDCs have seen some sectoral diversification. Looking at the types of investment that are most important for the development of productive capacities in LDCs, only investment in energy generation and distribution grew significantly during the decade, while investment in other infrastructure sectors and projects important for private sector development and structural change barely increased. During the pandemic, investment in several priority sectors for developing productive capacity almost completely dried up, making the next programme of action for LDCs – recently adopted – particularly challenging.

INVESTMENT POLICY DEVELOPMENTS

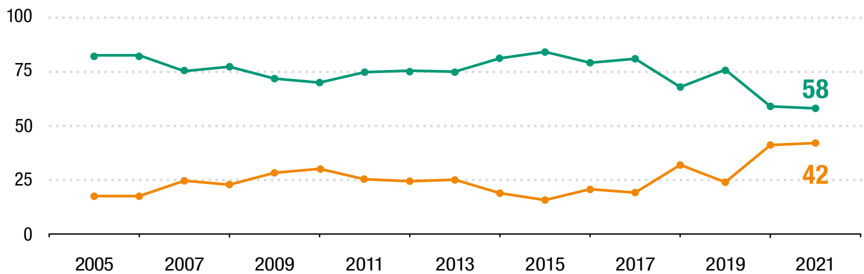
Investment policymaking slows down

The number of investment policy measures adopted in 2021 (109) decreased by 28 per cent compared with 2020, as the haste to adopt emergency pandemic-related measures subsided. However, the trend towards tighter regulation of investment continued, and the share of measures less favourable to investment was the highest on record (42 per cent, a point higher than in 2020) (figure 8). The number of M&A deals valued at over $50 million that were withdrawn because of regulatory or political concerns remained stable (14 deals), but their value quadrupled, to over $47 billion.

Developed countries mostly introduced or reinforced their screening regimes for investment based on national security criteria, or extended the temporary regimes adopted during the pandemic to protect strategic companies from foreign takeovers. This brought the total number of countries conducting FDI screening for national security to 36. Together, they 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

Figure 8. **Changes in national investment policies, 2005–2021** (Per cent)



Source: UNCTAD, Investment Policy Monitor.

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).

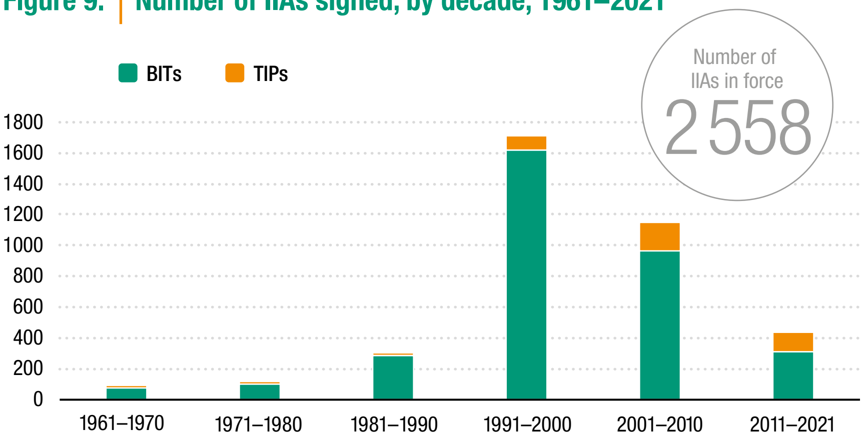
Sanctions are causing a new surge in investment measures

The first quarter of 2022 saw a dramatic increase in the adoption of investment policy measures (75 – a record for a single quarter), largely because of 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. They included outright prohibitions or limitations on FDI, but also measures that affect a broad range of foreign transactions and, indirectly, investment activities. Among them are sanctions targeting financial institutions; trade and transport restrictions; and travel bans and asset freezes affecting hundreds of individuals and entities.

Reform of the investment treaty regime is accelerating

In 2021, the trend towards reform of international investment agreements (IIA) accelerated. The number of effective treaty terminations (86) exceeded that of new IIAs (13), bringing the IIA universe to 3,288 (including 2,558 IIAs in force; figure 9).

Figure 9. Number of IIAs signed, by decade, 1961–2021



Source: UNCTAD, IIA Navigator.

Of the 86 terminations, 74 were based on the agreement to terminate intra-EU bilateral investment treaties (BITs). Newly concluded IIAs feature many reformed provisions in line with UNCTAD's IIA policy recommendations, aimed at preserving regulatory space while promoting investment for development. Other factors will also affect international investment governance, including greater attention to investment facilitation, climate change, anti-corruption, due diligence and human rights.

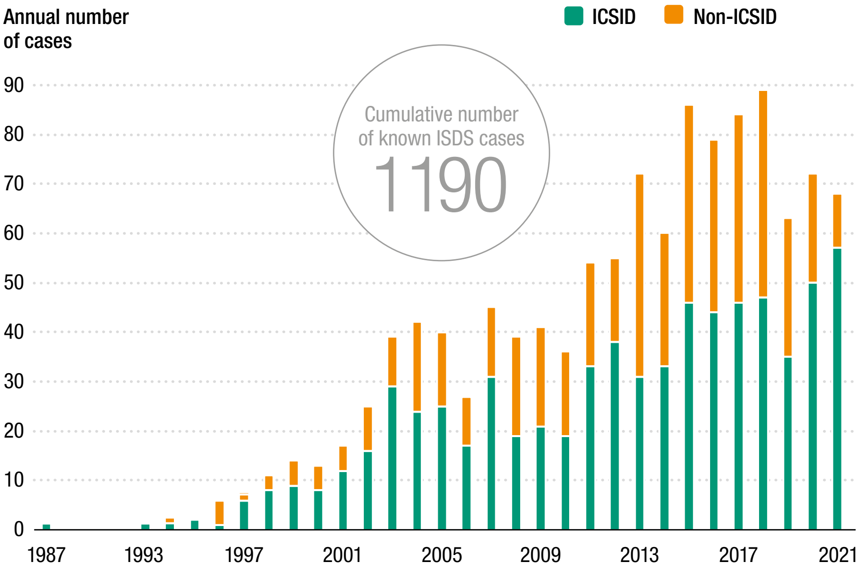
Megaregional agreements are increasingly shaping international investment rules

The number of new-generation megaregional economic agreements is growing. The comprehensive nature and geostrategic relevance of these agreements makes them highly influential to international investment policy. In addition to investment issues, these agreements can cover trade in goods and rules of origin, trade in services, competition, e-commerce, intellectual property, public procurement, regulation of State-owned enterprises and policies related to SMEs. Megaregional agreements liberalize market access and foster regional integration among the contracting parties, stimulating additional investment flows. Because of their broad scope, they can have a more substantial positive impact on FDI than BITs.

ISDS cases are up to 1,200

In 2021, investors initiated 68 new arbitrations pursuant to IIAs, bringing the total count of investor–State dispute settlement (ISDS) cases to 1,190 (figure 10). Two IIAs signed in the 1990s – the Energy Charter Treaty (ECT) and NAFTA – continued to be the instruments invoked most frequently. To date, 130 countries and one economic grouping are known to have been respondents to one or more ISDS claims. ISDS tribunals rendered at least 54 substantive decisions in investor–State disputes, 31 of which are in the public domain. Of the public decisions, 11 principally addressed jurisdictional issues (including preliminary objections), with 4 upholding the tribunal's jurisdiction and 7 declining jurisdiction. The remaining 20 public decisions were rendered on the merits, with 12 holding the State liable for IIA breaches and 8 dismissing all investor claims. By the end of 2021, at least 807 ISDS proceedings had been concluded. In 2022, the war in Ukraine brought into the spotlight past and potential future ISDS claims relating to armed conflict.

Figure 10. | Trends in known treaty-based ISDS cases, 1987–2021



Source: UNCTAD, ISDS Navigator.

Tax policy is used around the world to promote international investment

The worldwide corporate income tax (CIT) rate, which averaged almost 40 per cent in 1980, has decreased gradually over the past three decades, to about 25 per cent in 2021. Competition for international investment has been a key driver of the decline, which occurred in all regions, regardless of country size or level of development. LDCs, which rely relatively more on CIT for fiscal revenues than other countries, had the highest CIT rate in 2021 (28 per cent).

Most tax incentives reward profits, not new investment

National investment policy measures adopted in the past decade reveal widespread use of tax incentives for investment across all regions. Of 100 countries that adopted investment measures related to taxation, 90 lowered taxes, introduced new tax incentives or made existing incentives more generous. More than one third of the fiscal incentives introduced (39 per cent) were profit-based (mainly tax holidays and reduced CIT). Conversely, just over 1 in 10 new tax incentives (13 per cent) were expenditure-based, i.e., rewarding investment or reinvestment by reducing the after-tax cost of capital expenditures through allowances, accelerated depreciation or tax credits.

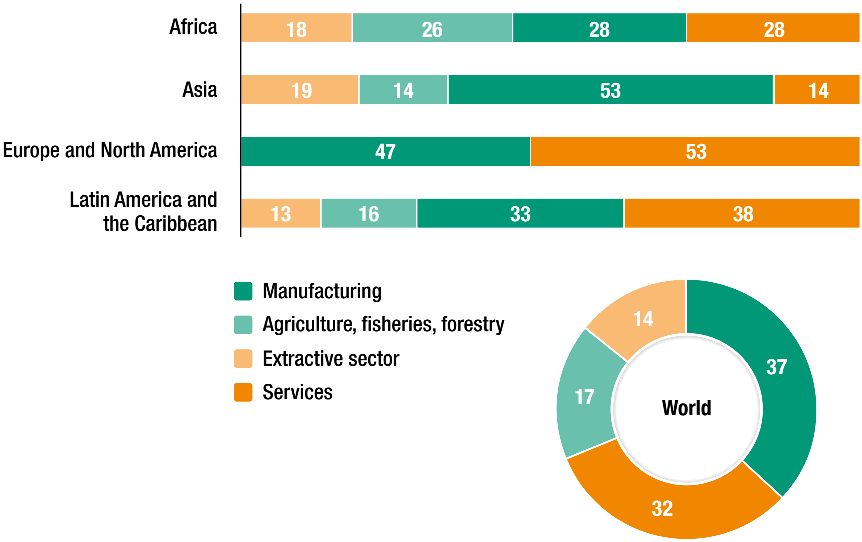
Both profit- and expenditure-based incentives are often combined with additional fiscal incentives. Tax breaks for indirect taxes and duties, such as VAT or import tariffs, accounted for about 30 per cent of all tax incentives introduced in Asia and in Latin America and the Caribbean. They were also frequently utilized in Africa (24 per cent of all tax incentives), but far less commonly in Europe and North America (13 per cent). Business facilitation measures such as simplified import and export procedures, single-window mechanisms for permits and licenses, or streamlined procedures for employment visas represented the most significant non-tax promotion instrument adopted in every region in conjuncture with fiscal promotion schemes.

Globally, most new incentives targeted manufacturing and services investments, although regional differences are significant (figure 11). Tax incentives specifically targeting the agricultural and extractive sectors were concentrated in developing countries and LDCs. The development of specific regions within a country was the most recurrent policy objective associated with the introduction of new tax incentives globally (24 per cent), in Africa (33 per cent) and in Asia (27 per cent).

Governance of fiscal incentives can be improved

In only about 30 per cent of cases, incentives are granted on the basis of automatic criteria (such as the invested amount, the volume of employment generated or the location of the investment), while the rest are allocated on the basis of discretion, criteria not available to the public or negotiation with investors. In addition, only about half of all tax incentives for investment introduced worldwide over the last decade were time-bound, with lower shares in Africa (35 per cent) and in Asia (40 per cent). This has important implications for forgone revenues, the possibility to conduct impact assessments and the potential for market distortions.

Figure 11. **Sectoral distribution of new tax incentives for investment, by region and world, 2011–2021** (Per cent)



Source: UNCTAD, Investment Policy Monitor.

IIA obligations can interact with tax measures

IIAs impose obligations on States that can create friction with tax measures taken at the national level. The actions of tax authorities, as organs of the State, and tax policymaking more generally can engage the international responsibility of a State under an IIA when they adversely affect foreign investors and investments. They can expose States to tax-related claims brought under the ISDS mechanism. UNCTAD data shows that investors have challenged tax-related measures in 165 ISDS cases based on IIAs.

It is important to enhance cooperation between investment and tax policymakers to improve the coherence between the two policy areas. UNCTAD's guide for tax policymakers on IIAs, published in 2021, contains IIA reform options to minimize the risk of friction with tax policy. Equally important is the need to minimize the risk of friction between investment policy measures and the global tax treaty network which, like the IIA regime, is also made up of more than 3,000 agreements.

THE IMPACT OF A GLOBAL MINIMUM TAX ON FDI

BEPS Pillar II will fundamentally change the international tax architecture

Within the context of the G20/OECD Base Erosion and Profit Shifting (BEPS) project and through discussions in its Inclusive Framework with the participation of 141 jurisdictions, agreement has been reached in principle on the introduction of a global minimum tax for MNEs. The reform, known as BEPS Pillar II, will introduce a minimum tax of 15 per cent on the foreign profits of large MNEs – those with revenues above €750 million. Through a set of complex mechanisms, top-up taxes will be added to domestic taxes to ensure that, in each country, MNEs pay taxes equal to at least 15 per cent of "excess" profits of foreign affiliates; that is, profits that exceed an amount – known as the carve-out – that is related to real economic activity in the host country (assets and employees). The implementation of Pillar II is planned for 2023, although the timeframe is widely seen as ambitious.

BEPS Pillar II aims 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.

The introduction of a minimum tax on MNE profits has major implications for international investment and investment policies. Tax is an important determinant of FDI; tax rates enter the calculation of MNE investment decisions, and differences between countries affect MNE locational choices. Therefore, tax rates and preferential schemes (fiscal incentives) are an important part of the investment policy toolkit.

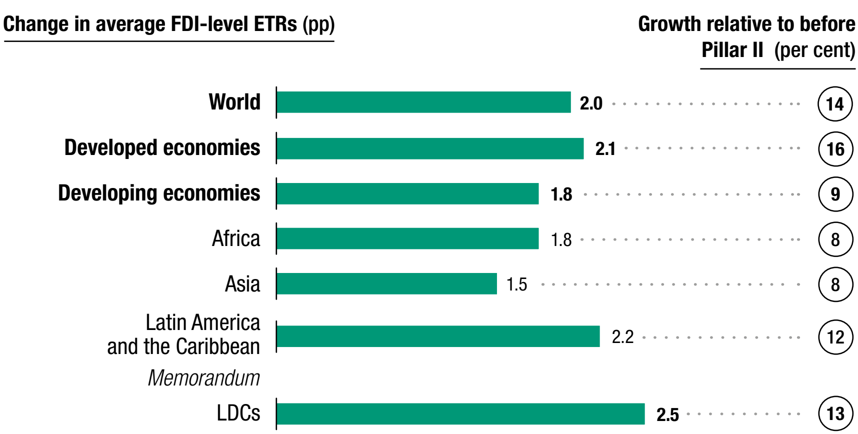
Real effective tax rates on FDI are well below headline rates and will be affected by the minimum

Statutory rates of 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.

However, MNEs often pay significantly less than the standard ETRs 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 on average, 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. Two distinct mechanisms are at play. 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, with some variations by region (figure 12). 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.

Figure 12. **Impact of Pillar II on average FDI-level effective tax rates with a carve-out, by economic grouping and region**
(Percentage points and per cent)



Source: UNCTAD estimates.

The analysis of the FDI-level ETR pre- and post-Pillar II shows that the reforms work mainly through the reduction in profit shifting caused by the application of the minimum rate to offshore financial centres (OFCs), rather than through the application of the minimum elsewhere. This is particularly true for developing countries which, on average, have higher ETRs and a greater exposure to profit shifting.

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 MNE 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.

Increased taxes could have a volume and a distribution effect on FDI

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. This estimate, which appears moderate, refers to productive investment only; it cannot be directly compared with historical trends in standard FDI flows, which are characterized by large variations caused by the financial component of FDI.

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 the reforms

The mechanism that has been devised for the implementation of Pillar II 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.

IPAs and SEZs should urgently review investment incentives

The Pillar II reforms will thus have major implications for national investment policymakers and institutions, and for their standard toolkits. Worryingly, the current awareness of the reforms among investment promotion agencies (IPAs) and operators of special economic zones (SEZs) is still very low. More than one third of respondents to UNCTAD's annual IPA survey indicated they were not yet aware of the reforms, and only about a quarter had begun an assessment of the implications. They will need to act soon. At a minimum, they should review their current use of incentives, evaluate the implications for their portfolio of existing investors and identify the best approach for both investment retention and promotion.

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.

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. The report provides a detailed guide on the implications of Pillar II for the most common types of fiscal incentives for investment (table 2).

The need to review the portfolio of incentives on offer to foreign investors provides an opportunity to rethink them wholesale. In recent years, UNCTAD has urged countries to engage in such an evaluation, with a view to shifting incentives towards the promotion of investments with better performance in terms of sustainable development – specifically linking incentives to the SDGs. The shift from reduced-rate incentives and exemptions towards incentives linked to real capital expenditures – which are affected less by Pillar II – fits well with this objective, because investment in SDG sectors is often capital intensive.

Table 2. Summary assessment of the impact of Pillar II on incentives to attract FDI

Incentive type	Pillar II impact	Incentive type	Pillar II impact
a. Reduced rates		**b. Deductions**	
Zero-rated	High impact	Accelerated depreciation and immediate expensing	Little/no impact
Below 15 per cent	High impact	Loss carry-forward	Little/no impact
Above 15 per cent	Little/no impact	Deductible qualified expenses	Variable/unclear impact
c. Exemptions		**d. Other incentives on income-related taxes**	
Tax holidays	High impact	Incentives on withholding taxes	Little/no impact
Specific exemptions: location, sector, entity	Variable/unclear impact	IP box	Variable/unclear impact
Participation exemptions	Little/no impact	Tax credits	Variable/unclear impact
		Incentives on capital gains taxes	Variable/unclear impact

Source: UNCTAD.

Little/no impact · High impact · Variable/unclear impact

IIA negotiators should be aware of increased risks

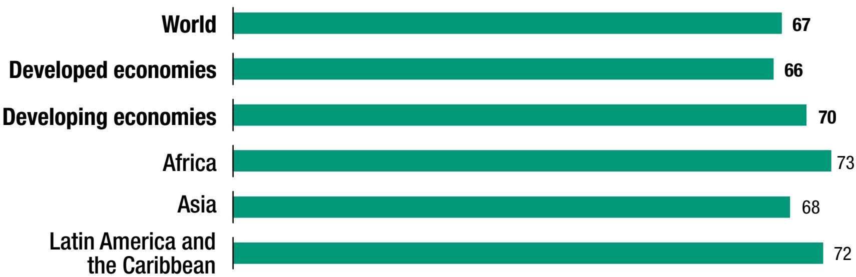
The tax reforms also have important implications for *international investment policymakers* and negotiators of IIAs. They need to consider the potential constraints that IIA commitments may place on the implementation of key provisions of Pillar II. If host countries are prevented by IIAs and their 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.

More than two thirds of new investments are "in scope" of the reforms

The strategic implications of the reforms for investment policy are also important. The global minimum tax will initially apply only to MNEs with consolidated revenues over €750 million. It may appear that this leaves out a substantial part of potential investors for which countries can continue to compete through fiscal measures, unaffected by the new rules. However, the threshold captures more than two thirds of new investment projects carried out over the past five years, with even higher shares in developing regions (figure 13). Moreover, even if initially many firms will remain out of scope, the fact that more and more FDI is carried out by the largest MNEs (overseas investment by SMEs is in decline), combined with the expected gradual reduction of the threshold, will mean that over time almost all FDI will be subject to the minimum.

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.

Figure 13. **Share of greenfield investment projects by MNEs with annual revenues of more than €750 million, 2015–2021** (Per cent)



Source: UNCTAD, based on information from the Financial Times Ltd. fDI Markets (www.fDImarkets.com).

There is no time to waste

Looking ahead, many important details of Pillar II still need to be defined. Moreover, significant political hurdles to final adoption remain. Many countries may therefore be inclined to take a "wait and see" approach. However, the potential impact of the reforms is so great that it would be prudent not to delay in reviewing the proposals, evaluating policy options, and preparing responses. For developing countries, it is important to strengthen cooperation and technical capabilities to ensure effective participation in the process of negotiating the final shape of the reforms.

Early engagement and preparedness for the reforms will also help reduce tax uncertainty for MNEs, which can act as a barrier to investment. Furthermore, in this period of adjustment, it is important for policymakers to avoid extending long-lasting legal commitments to provide advantageous tax treatment or incentives.

Developing countries need support: 3 key actions

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.

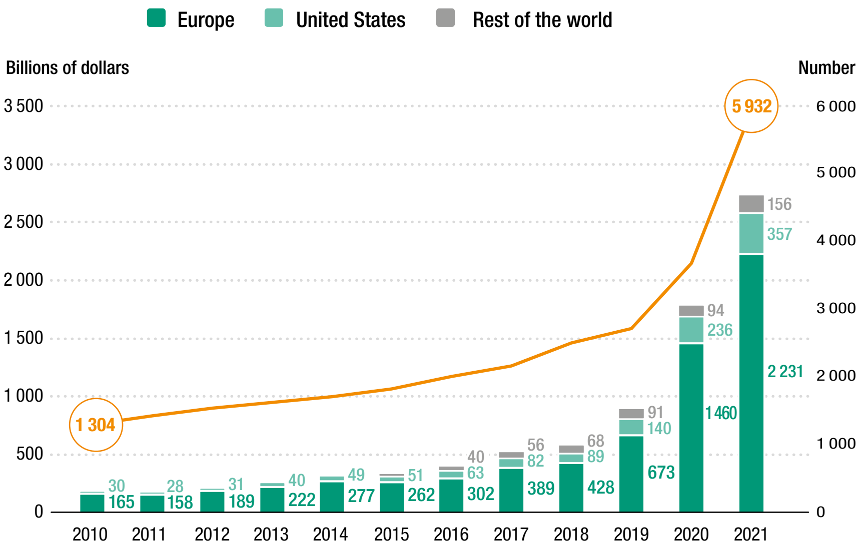
CAPITAL MARKETS AND SUSTAINABLE FINANCE

Sustainability-themed investment products are booming

Throughout the pandemic, sustainable finance in global capital markets has seen strong growth. 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 *(i) sustainable funds* and *(ii) sustainable bonds,* including green, social and mixed-sustainability bonds.

The number of *sustainable funds* reached 5,932 by the end of 2021, up 61 per cent from 2020. The total assets under management (AUM) of these funds reached a record $2.7 trillion, an increase of 53 per cent from the previous year (figure 14).

Figure 14. **Sustainable funds and assets under management, 2010–2021** (Billions of dollars and number)



Source: UNCTAD, based on Morningstar data.
Note: The numbers for 2020 were updated based on the latest data.

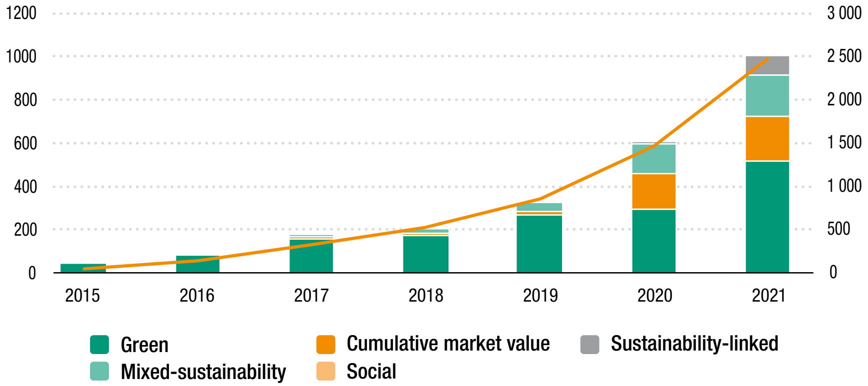
Much of the growth of sustainable funds remains concentrated in developed markets. Europe is by far the largest market, with a share of 81 per cent of AUM. Sustainable funds account for 18 per cent of the assets of the European fund market, showing the relative maturity of the market and the catalytic impact of sustainable finance regulation in Europe. The United States is the second largest market. However, sustainable funds represent only 1 per cent of its total fund market. China is the third largest sustainable fund market worldwide, with AUM of nearly $50 billion.

It is important to highlight several concerns. First, despite the rapid growth in recent years, sustainable funds still account for only about 4 per cent of the global fund market. Second, most of the existing funds are self-labelled, and a lack of consistent standards and high-quality data to assess their sustainability credentials and impact has given rise to green-washing concerns. Third, developing countries are mostly absent from the sustainable fund market. Developing economies, especially LDCs, face tremendous barriers to developing their own sustainable fund markets or benefiting from the international market, because of their limited market size and the higher risks perceived in their capital markets.

UNCTAD has been monitoring more than 800 sustainable equity mutual funds since 2020. Overall, these funds exhibit a better sustainability profile than their conventional peers. However, their sustainability ratings vary widely, and the low-performing funds fall short of their self-claimed sustainability credentials. For example, with respect to climate ratings, both thematic funds with a green investment focus and sustainable funds in general tend to perform better than the overall fund market. But about 25 per cent of self-declared green funds have a net exposure to fossil fuels of more than 5 per cent (with some cases up to 20 per cent), calling their “greenness” into question.

The *sustainable bonds* market also continued its strong growth in 2021 (figure 15). For the first time, new sustainable bond issuance exceeded $1 trillion (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. Cumulatively, the total value of outstanding sustainable bonds is now estimated at close to $2.5 trillion. The European Union and the corporate sector continue to push social and mixed-sustainability bond issuance to new heights.

Figure 15. | **Growth in the sustainable bond market, in 2021** (Billions of dollars)



Source: UNCTAD, based on data from Environmental Finance and the Climate Bonds Initiative.

Institutional investors have some way to go in mainstreaming sustainability

In 2021, public pension funds (PPFs) held more than $22 trillion in assets, or almost 40 per cent of global pension fund assets. The assets of sovereign wealth funds (SWFs) 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. UNCTAD's analysis of the sustainability integration practices of the world's top 100 PPFs and SWFs shows that, although the number of institutional investors reporting on sustainability performance has increased since 2020, a majority (53 funds) still fails to report. SWFs remain relatively less transparent than PPFs. Many non-reporting funds are based in China, Japan, the United Arab Emirates, the United States and Saudi Arabia.

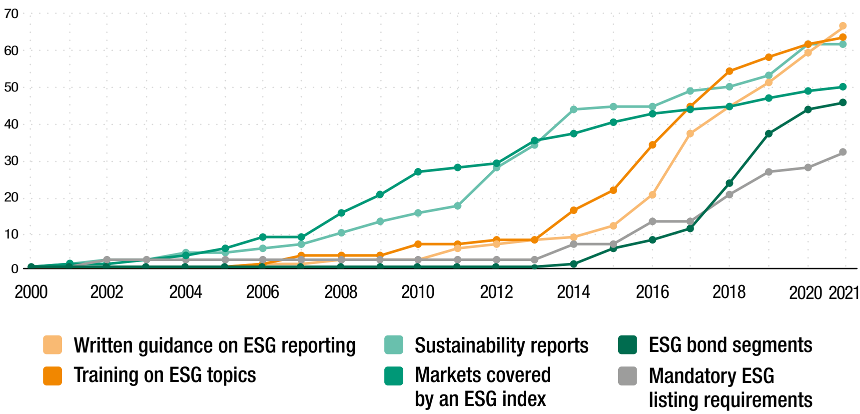
Among the 47 front-runner funds that do publish information on sustainability integration, many acknowledge the material risks posed by ESG issues, with funds changing their investment strategies and policies accordingly. A majority of these funds have made efforts to introduce internal policies and guidelines to support the integration of an ESG or SDG perspective in their investment strategies, often anticipating transition risks and targeting net zero in their portfolios by 2050, at the latest.

Stock exchanges play an important role in promoting sustainable finance

Stock exchanges and other market operators continue to integrate ESG considerations in market infrastructure (figure 16). The number of exchanges with written guidance on ESG disclosure for issuers continues to grow rapidly, from just 13 exchanges in 2015 to 63 at the end of 2021. The number of stock exchanges that provide training on ESG topics to issuers and investors continues to increase as well; more than half of stock exchanges now offer annual training. Mandatory ESG reporting has also been on the rise in recent years, supported by both exchanges and security market regulators. The number of exchanges covered by mandatory rules on ESG disclosure, currently 30, has more than doubled in the past five years.

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 boardrooms.

Figure 16. **Stock exchange sustainability trends, 2000–2021**
(Number of exchanges)



Source: UNCTAD, SSE database.

Policies, regulations and standards are rapidly evolving

The rise of sustainability-themed investment products has been accompanied by an increasing number of principles and standards. Many of these have been driven by the private sector or developed through international initiatives, as exemplified by the large number of voluntary standards for products, disclosure and sustainability integration. More recently, governments in both developed and developing economies have been stepping up their efforts to support the growth of sustainable finance by putting in place the necessary policies and regulatory frameworks.

UNCTAD's monitoring of sustainable finance measures and regulations reveals that 35 economies and country groupings, accounting for about 93 per cent of global GDP, had 316 policy measures and regulations in force at the end of 2021 (figure 17). More than 40 per cent of these measures were introduced in the last five years, and 41 new measures were adopted in 2021 alone. At least 45 measures are still in the pipeline. These regulatory trends illustrate the accelerating pace of sustainable finance policymaking.

Figure 17. **Sustainable finance policy measures and regulations in major developed and developing economies, 2010–2021** (Number)

Source: UNCTAD.

Almost half of the policies and regulations identified relate 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. However, many measures under development are concentrated in these areas. Most countries covered by UNCTAD's data set have a national sustainable finance strategy or framework in place.

At the international level, efforts to coordinate and consolidate sustainable finance regulations and standards gathered momentum in 2021. The International Organization of Securities Commissions (IOSCO) continues to develop its work on sustainable finance to provide guidance to securities regulators around the world, and international standards development for corporate ESG disclosure is accelerating. Between 2021 and 2022, the International Financial Reporting Standards (IFRS) Foundation launched its new International Sustainability Standards Board and signed an agreement with the Global Reporting Initiative. Combined, these developments aim to create a new global baseline for corporate sustainability reporting.

Climate action in capital markets is urgent

Global efforts to decarbonize the world's economies have important implications for business and the investment community. Mitigating climate change risk also offers opportunities that both investors and issuers can capitalize on.

Research into the scope 1 greenhouse gas emissions of the top 100 issuers by market capitalization listed on G20 exchanges shows that the emissions of publicly listed companies vary significantly from one market to another. Some markets are particularly exposed to systemic risks during the transition to net-zero economies. For example, among the companies analysed in the G20, over half of the scope 1 emissions are emitted by firms listed on just five exchanges. Exchanges, regulators and policymakers should monitor the emissions of companies listed on public markets to ensure an orderly transition to net-zero economies.

Stock exchanges are playing an important role in helping their markets navigate the low-carbon transition. Many exchanges are now hosting training on TCFD-aligned corporate climate disclosure. To help exchanges lead a transition to more climate-resilient markets, the UN Sustainable Stock Exchanges initiative, in collaboration with the UN Special Envoy on Climate Action and Finance, launched a voluntary Action Plan and an associated set of tools.

* * *

Much remains to be done to fully leverage the potential contribution of capital markets to sustainable development. The focus now is on strengthening the integrity of sustainability-themed investment products to address green- or sustainability-washing concerns, and on harmonizing corporate ESG disclosure.

Moving towards a more geographically balanced market will require more international cooperation. For countries with less developed markets and weaker regulatory and standard-setting capacities, technical assistance will be necessary to support market development and to strengthen sustainability reporting ecosystems.

Through the work of its Global Sustainable Finance Observatory and other sustainable investment-related programmes, such as the Sustainable Stock Exchanges initiative, the Sustainable Institutional Investment Programme and the International Standards of Accounting and Reporting programme, UNCTAD is committed to working together with key stakeholders from both the public and private sectors to increase the contribution of financial markets to the SDGs, as mandated by the UN General Assembly.

NOTE

The Overview is prepared based on the in-depth analysis contained in *World Investment Report 2022: International tax reforms and sustainable investment* (United Nations publication, Sales No. E.22.II.D.20).

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ISAR

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