T20 Policy Brief

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Task Force 04
TRADE AND INVESTMENT FOR SUSTAINABLE AND INCLUSIVE GROWTH

Investment Screening Mechanisms: Guidelines for Balancing Security with Development

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Abstract

A primary objective for the G20 is to coordinate the policies of its members towards greater stability and sustainable growth in the global economy. While the G20's Trade and Investment Working Group has in the past included investment screening mechanisms (ISMs) within its ambit, previous editions of the T20 engagement group have not covered the topic, despite the dramatic rise in quantity and scope of such unilateral policies witnessed in recent years and their potential negative impact on the achievement of SDGs. To fill this gap and to address a key element of the theme of neoprotectionism, this policy brief highlights the recent rise in, and the potential pitfalls brought on by, ISMs. While the authors acknowledge that going forward, given the complex vulnerabilities brought on by the prevalent geopolitical and technological environment, ISMs may remain a useful tool for many states towards fulfilling their economic security goals, they nonetheless also warn against a disproportionate compliance burden on MSMEs and the potential for abusive weaponization of such tools, particularly outbound ISMs, to the detriment of SDGs. To that end, based on qualitative evidence collected by interviewing practitioners and policymakers, the authors provide specific and actionable recommendations for the G20 towards ensuring a level-headed balance between security and inclusive growth.

Keywords: Investment screening. Geopolitics. Economic security. Development. G20.

Diagnosis: ISMs as an Alerting Trend to the G20

A primary objective for the G20 is to coordinate the policies of its members towards greater stability and sustainable growth in the global economy. While the G20's Trade and Investment Working Group has in the past included investment screening mechanisms (ISMs) within its ambit,[1] previous editions of the T20 engagement group have not covered the topic, despite the dramatic rise in quantity and scope of such unilateral policies witnessed in recent years and their potential negative impact on the achievement of SDGs. The surge in ISMs has caused disruptions in the global economic order (OECD 2020a; 2020b; 2021a; 2023; OECD/UNCTAD 2023; Sanchez-Badin et al. 2022; 2021a; 2021b).

ISMs are control and evaluation mechanisms overseeing the inflow of investments from foreign jurisdictions. The most recent monitoring carried out by the OECD records that, since 2016 there has been an increase of more than 50% in the implementation of ISMs – including an acceleration of the same in response to the COVID-19 pandemic (OECD 2021a). Notably, countries that have implemented these mechanisms have varying profiles, including both developed and developing countries, and both large exporters and importers of foreign capital (OECD 2019; Sanchez-Badin 2022). This movement is associated with a broader global shift in perspective towards international practices of investment regimes, from liberalization to one of state interventionism and restriction.

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[1] https://www.oecd.org/g20/topics/trade-and-investment/. Last access on March, 28, 2024.

Initially, ISMs were focused on what can be considered traditional national security interests, in that they applied foreign investment controls primarily in the military and defence sectors. However, in recent years, the notion of what encompasses national security for the purpose of ISMs has been significantly expanded. In addition to incorporating different themes and aspects of public policy under the umbrella of national security, geoeconomic tensions have led to the formulation of 'economic security' as a concept. These developments have had a direct impact on the regulations and state measures associated with foreign investment.

With such expanded notions of national security, the inclusion of new sectors under the purview of ISMs requires an assessment of its impact, both at the state level and importantly, in terms of the structuring of global value chains (GVCs). Sectors considered 'critical' or 'sensitive' for a national economy, which include many infrastructure sectors and domestic industries, have begun to be brought under the purview of ISMs and as a result, ISMs now have a much greater relevance towards the coordination of international economic policies of advanced nations (OECD 2019, p. 13).

With regard to strategic industries, there are particular concerns about acquisitions made by foreign players of "key enabling technologies" (Chiarini 2016; Kowalski et al. 2017; Botton and Lee-Makiyama 2018). More recently, access by foreign investors to confidential data of companies and national citizens was added to the same conceptual key (Wehrlé and Pohl 2016). Additionally, recent crises, such as the COVID-19 pandemic and the War in Ukraine, have raised concerns about how to guarantee the supply and resilience of certain sectors related to the healthcare and pharmaceutical production chains, along with services considered essential (OECD 2020a).

According to monitoring reports published by UNCTAD (2019; 2020) and OECD (2020b; 2021b), such IAIEs present a huge institutional variety, with newer mechanisms generally containing more detailed rules, such as evaluation criteria, rules of procedure and responsibilities (OECD 2021a; Sanchez-Badin et al. 2022). Their differences range from the scope of competence, institutional structure, procedures and allocated budget to a variation in the results achieved, considering the number of cases and the content evaluated. In this diversity of models and results, there are different perceptions about whether, where and under what conditions the risk of external investment in a given sector, activity or project is concentrated and, also, about how the management of this risk is classified to other objectives of domestic policies (UNCTAD 2019; OECD 2020b; 2021b; Sanchez-Badin et al. 2022).

While the authors acknowledge that going forward, given the complex vulnerabilities brought on by the prevalent geopolitical and technological environment, ISMs will remain a useful tool for many states towards fulfilling their economic security goals, they nonetheless also warn against a disproportionate compliance burden on MSMEs and the abusive weaponization of such tools, particularly outbound ISMs, to the detriment of SDGs.

Recommendations Based on Trends Observed In ISMs

There are multiple challenges for ISMs, whether related to the way investment screening is practised or objections as to how legitimate the need for the screening itself is. The first challenge observed arises from the **expansion of the concept of national security**, including the expansion of the scope of **sectoral coverage**. Cross-sectoral screening, which makes the definition of national security increasingly vague, governments do not need to update sectoral lists as views about which sectors may generate risks evolve. There is also a tendency for review limits for external investments to be lower, both in terms of absolute evaluation and as a percentage of the size of the business.

Some convergence is observed, but it is worth noting that the convergence identified is happening mainly in the economies of Europe, North America, the Far East and Oceania. And, even in the group of "convergent" countries, they have a great **institutional variety** between the investment analysis systems of different countries. This variety ranges from the history of the foundation and organization of the organizational structures that deal with ISMs to the very composition of these structures and even the administrative procedures in each of them. It is also observed that, in terms of procedural performance and transparency, the performance of many ISMs is still poorly developed. **Its procedures are still opaque and not very predictable**.

As a result, we have identified that in most cases, foreign investment screening decisions are not public and such mechanisms end up being a "black hole in national security"; ISM evaluation criteria and procedural design are often perceived as vague, open-ended, subjectively assessed, and ad hoc; and the lack of accountability and transparency of the authorities involved in the process end up constituting an arbitrary exercise of executive power and not a properly regulated procedure. This favours the criticism that ISMs are **harmful to predictability and legal certainty** in the domestic environment of the country receiving the investment.

Considering the diverse array of criteria, procedures, and institutional designs, alongside the prevailing lack of transparency and predictability, **the primary recommendation is to enhance the transparency, predictability, and oversight of ISMs**. The G20 stands out as a pivotal forum capable of fostering coordinated action on ISM practices globally. Specifically, requiring countries to include reports on ISM practices in the "Trade and Investment Measures Report" would be immensely beneficial. Furthermore, there should be a particular focus on assessing the impacts of ISMs on developing economies and MSMEs, as they warrant special attention.

The ISMs procedures involve both responsibilities for the investor and the bodies and commissions of the state bureaucracy involved in the external investment evaluation process. Regarding the investor's responsibility, their main role is to inform the public administration and provide the information requested by them, filling out a form with information on the main characteristics of the investment: origin, value, percentage acquired, sector, planning environmental, societal and aspects related to employability and work. The notification in almost all countries is placed as an investor obligation. It can be mandatory or voluntary. If this notification is not made, some countries indicate the possibility of applying sanctions to the investor.

Regarding the procedure, there is also concern about whether the authorization of the authority responsible for the ISM must be made by express, public and substantiated act and whether conditions and responsibilities can be established. In the decision, there is also a provision that the authorities may present conditions for carrying out the investment. This may mean reducing the value, defining the corporate form and other conditions elected by the local authority. The application of conditionalities requires an ability to monitor the implementation of the decision by the authority. Thus, once the investment is approved and defined, ISM will monitor the investment (or even reinvestment) by the external investor.

Regarding the bureaucratic structure responsible for the ISMs, it is observed that, often, the ISM of each country is not limited to one body, with a set of competencies associated with the evaluation of foreign investment that is conducted in more than one area of the bureaucracy, as is the case of bureaucracies responsible for trade and capital transparency, competition control and national security analysis. Furthermore, there is a certain diversity in the performance given to ISMs, which can be structured around individual or collegial bodies or even have shared competencies.

Since the specific rules governing ISMs are generally underdeveloped, which constitutes one of the primary criticisms challenging ISMs, **a second recommendation for the G20 is to identify best practices**. This initiative aims to establish guidelines for ISMs, with a keen focus on balancing restrictive policies and practices with the promotion and facilitation of foreign investment.

In "convergent" economies, it has become common practice to create whitelists of countries whose investments are exempt from ISM scrutiny. However, these lists can exacerbate discrimination among foreign investments based on their origin, posing potential problems for developing countries. **The recommendation in this scenario is to amplify the debate within the G20 regarding the criteria supporting such exemptions and, ultimately, consider imposing limits on the use of whitelists within the ISM system.**

Lastly, it's crucial to underscore the argument that ISM practices have resulted in inefficiencies and increased transaction costs for investor compliance, potentially deterring or impeding external investors. **The G20 forum could advance the discussion on the feasibility of establishing compensation systems for blocked investors.** Such measures aim to mitigate the inhibition of global capital circulation.

Scenario of Outcomes from ISM in a Geoeconomic Context

Upon analyzing reports and decisions made by relevant authorities, it is notable that many countries have endorsed the 2009 OECD Guidelines for Investment Policies in Recipient Countries concerning National Security. These guidelines recommend, among other measures, transparent policy development that is well-tailored to identified risks and applied proportionally (OECD 2023). The OECD's involvement serves as evidence that international oversight and recommendations regarding ISM policies require further reinforcement. The G20 serves as a platform to bolster the prominence of such pivotal policy actions in contemporary foreign investment discussions. Furthermore, expanding the involvement in this discourse beyond the OECD to include a broader spectrum of economies is imperative. Otherwise, developing economies risk being marginalized in this discussion, particularly concerning investments originating from their regions.

If the suggested recommendations are taken on-board by G20 members, not only would the adverse impact of ISMs on investment flows be minimized within their own national economies, but also within the global economic landscape. The achievement of several SDGs within developing countries is in part dependent on flows of capital, both inward and outward. If G20 members can resist the temptation of abusing national security as a concept to pursue their technological and economic leadership goals and instead, elect to temper their adoption of ISMs, then global economic growth would be more inclusive and developing economies would be afforded a more level playing-field towards their advancement along global value chains.

This restraint on the part of G20 members would of course be challenging, chiefly due to the existence of multiple stakeholder groups with diverging policy preferences, who stand to directly gain from the indiscriminate usage of ISMs, either economically or politically. A value-based, multilateral approach could contribute towards overcoming this challenge, apart from a resolve towards favoring the common global good in the long-run, rather than short-term individual, ‘nation first’ focus.

If, on the other hand, these recommendations are not adopted and their need is underplayed, then not only would national economies lose opportunities for value creation domestically, but the global economic landscape would be rendered that much more unjust and non-inclusive towards developing economies.

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