15 June, 2000

OECD ROUND TABLE ON SUSTAINABLE DEVELOPMENT

Fourth Meeting

Paris, 27-28 June 2000

Agenda Item 3

FOREIGN DIRECT INVESTMENT AND SUSTAINABLE DEVELOPMENT

Background paper

Introduction

The objective of the OECD's work on investment is to contribute to the achievement of sustainable development.

Investment can impact on the three constituent parts of sustainable development: the environment, the economy, and the social framework. This background note focuses mainly on foreign direct investment (FDI) and the environment. In this context, OECD work on FDI and environment has focussed around three central issues. *First*, the environmental effects of FDI; *second*, technological development associated with FDI and the role of technology diffusion in shaping the natural environment; and *third*, the impact of environmental standards and government regulation on the direction and type of FDI.

In open and properly functioning markets, foreign investment will flow towards the highest returns relative to risk. However, potential investments in developing countries with very high returns are often not made because of perceptions of risk, including risks related to environmental management. This suggests that markets would benefit from the development of appropriate institutional frameworks that would reduce these risks. The OECD, through its work on harmful policy competition, non-discrimination and investor protection, investment climate, corporate responsibility, and such instruments as the Principles of Corporate Governance and the Guidelines for Multinational Enterprises, contributes to the development of such frameworks.

Investments, both public and private, are critical for sustainable development. FDI in particular can be a powerful and positive force for both economic development and environmental improvements under certain circumstances. Different from trade in goods and services, direct investment represents a long-term economic activity through which an efficient allocation of resources (including environmental resources), technological development, and sustainable economic growth can occur. Multinational enterprises (MNEs) increasingly play a role in the restructuring and technology development of domestic enterprises. The growth in FDI means that a country's development is increasingly influenced by multinational enterprises since these firms are the main drivers of FDI.

At the same time, international investment and MNE activity raise various concerns regarding resource management and pollution control. This relates to both cross-border investments and to the performance of established enterprises under foreign control. Issues may also arise at the interface of policies or rules designed to encourage inward investment and those designed to further environmental objectives. These issues are explored in more detail in the following sections.

The environmental effects of FDI

FDI may generate both costs ...

FDI is highly diversified in terms of its location, sectors and type of investors. Depending on the circumstances, FDI can have significant effects, both negative and positive, for the environment. On the one hand, in the absence of adequate environmental policies, FDI may lead to increased production and consumption of polluting goods, or to a non-sustainable use of natural resources, both of which would exacerbate the negative (scale) effects of economic activity for the environment. For example, FDI that goes into power stations, mines, and plants, may pose problems for pollution control, ecological protection, resource consumption, and public health issues, unless local environmental rules and their enforcement are set at appropriate levels.

and benefits for the environment.

On the positive side, FDI can improve resource allocation (including natural resources), making new investments in environmental protection possible, thereby encouraging conservation and the wise use of natural resources. FDI-induced economic growth may also have positive impacts on the environment and contribute to mitigating the negative impacts associated with FDI. Under the "inverted U-curve hypothesis", the demand for products that are environmentally sustainable increases with income. This may result in increased demand for environmental quality. This hypothesis suggests that after a certain point, pollution and resource waste may level off, and eventually decline.

However, it is noted that this relationship may not hold for all pollutants, or in all countries, at all times. Also the turning point may be at quite high levels of income so that, even as income increases, environmental problems never actually decline in absolute terms. The end result is that growth cannot be relied upon to deliver the kind of environmental improvements that may eventually be necessary.

Investment subsidies and barriers to FDI can distort resource values, input costs and market prices. Provided effective policies are implemented, so that prices reflect their true social costs, investment liberalisation and the removal of such distortions

will lead to improved resource allocation (including environmental resources), economic growth and, ultimately, welfare.

Although privatisation is a major channel for FDI, governments still have a strong regulatory role to play with regard to environmental issues.

Privatisation is a major channel for FDI in many countries and can yield significant environmental benefits in some circumstances. Privatised companies generally attract better management, which in turn may result in reduced waste and lower pollution. Compared with public owners, private investors, and foreign investors in particular, usually insist on greater efficiency in the operations in which they invest. On the other hand, privatisation can also mean less government control over environmental practices, which may result in reduced environmental performance in some circumstances. Although there are many benefits generated by market liberalisation and privatisation, there will remain a strong role for governments to play as regards the provision of public goods, and the development of institutional frameworks, associated with environmental protection.

Environmental effects of FDI-induced technology development and diffusion

FDI may bring technologies that are newer, 'better' and more environmentally friendly into host countries.

International investment flows may result in less environmentally damaging technologies being used when MNEs use technologies that represent environmental improvements over those currently available in the country in which they are investing. FDI undertaken by multinationals may also result in some standardisation across countries of technologies at higher levels, as MNEs generally apply common environmental standard to all of their operations.[1]

FDI by MNEs can also have positive spillover effects on the technological characteristics of national firms. Local firms may imitate multinationals' technological practices to improve their own production practices. Spillovers also arise when local firms employ staff previously employed by the multinationals, thereby gaining access to expertise that may not be readily available locally. On the other hand, FDI may not lead to the introduction of more environmentally friendly technologies if firms use "dirtier" technologies than they use in the home country.

Open capital markets, by providing access to foreign savings, can increase the use of 'cleaner' technologies.

While the role of FDI is important, international portfolio flows are also an important determinant of the technologies of production. The internationalisation of capital markets, by giving firms access to foreign sources of savings, can ease financial constraints which prevent firms from investing in more environmentally friendly technology. Studies undertaken by the OECD have shown that financial constraints are among the most important barriers to investment in cleaner technologies. In some cases, these constraints have arisen from national policies towards foreign capital, such as foreign exchange restrictions, capital controls and ownership restrictions.

By subjecting firms to foreign shareholder pressure, cross-border portfolio flows may also give foreign investors some influence over the characteristics of production. This would have positive environmental consequences if foreign

1. For example, it may be more efficient to run a single set of environmental practices worldwide than to scale back environmental practices at a single overseas location. MNEs also need to be especially conscious of their potential overseas environmental liabilities. The high visibility of MNEs can make them particularly attractive targets for local enforcement officials.

shareholders tended to demand a higher set of environmental standards. However, relative to more long-term forms of investment such as FDI, portfolio flows may be speculative in nature, with higher returns demanded and shorter planning horizons. This may result in an investment bias towards projects that do not take into account the long-run economic effects of environmentally damaging production practices.

The impact of 'higher' environmental standards and government regulation on FDI

A key question is whether high environmental standards cause firms to move to 'pollution-havens'.

A key question in assessing the implications of investment flows for sustainable development is whether higher environmental standards causes firms to move from 'high-standard' countries to jurisdictions with 'lower' environmental standards i.e. 'pollution-havens'. However, plant relocation will reflect not only higher costs associated with more stringent environmental standards, but also other cost advantages or market opportunities offered by the host country. Operating costs, including environmental costs, are only one factor among many in location decisions, and the significance of environmental factors will vary by industry.

Rather than seeking to reduce environmental compliance costs, MNEs seek consistent, as opposed to lax, environmental enforcement.

Data on whether or not FDI actually flows to 'pollution-havens' is sparse. While some exceptions exist, available research finds, in general, little evidence to support the hypothesis of a positive relationship between lax environmental regulations and increased inflows of FDI in polluting industries. Although FDI flows to a wide range of industries and companies – some of which are careful environmental stewards, some of which are not – the average company investing overseas does not seek to reduce environmental compliance costs as its primary goal. Multinational enterprises generally seek consistent, rather than lax, environmental enforcement. While available data suggests that in the aggregate there is not a problem with pollution havens, in specific cases (e.g. sectoral, country, or regional), the environmental impact of FDI may indeed be problematic. There is evidence that some firms in the resource extraction and using sectors, are indeed motivated by environmental cost considerations.

The ability of firms to move to new locations may also be limited by other financial conditions. For example, home governments may impose environmental restrictions on companies doing business abroad if export finance programmes are involved. Another type of environmental performance requirement relates to the conditions laid down by the International Finance Corporation (IFC), the World Bank (WB), and other multilateral development banks for the projects they finance. Although these standards apply only to funds provided by the multilateral agency, they can become a de facto requirement for all participants in a project. How effective these requirements are is not yet clear, because the track record is not yet very long.

There is little evidence to suggest that there is a general 'race to the bottom' in environmental standards.

A related fear is that some jurisdictions will use lower environmental standards as a way of attracting new FDI. The argument here is that countries could either lower their standards intentionally, or they could resist increasing them, in order to gain a competitive advantage. However, most empirical research suggests that efforts by national governments to compete for FDI by relying on lower environmental standards are unlikely to be successful in the long-term. Countries that operate transparent and efficient environmental programmes have not generally experienced lower FDI. Once again, this conclusion may only hold in the aggregate – specific competitive actions by host governments may indeed be profitable.

However, concerns for international competitiveness may be preventing a 'race to the top'.

There are fears that better environmental performance implies increased costs and reduced competitiveness. The opposite view is that better environmental performance reduces costs and improves product quality, thereby improving competitiveness. While there is little evidence that governments are lowering environmental standards to compete for FDI in the aggregate, concerns about international competitiveness may prevent governments from raising these standards. Enhanced international co-operation is therefore likely to be part of the optimum policy response to this problem.

Private sector responses to environmental concerns

Firms are increasingly responding to environmental concerns via ...

The responses of MNEs to government regulations and to broader pressures from the societies in which they operate are important in understanding the relationship between FDI and sustainable development. Preliminary evidence suggests that in response to government regulation, consumer pressure, a pro-active stance of top management or the concerns of staff motivated by ethical and environmental questions, firms are trying to respond to environmental issues. For example, at least 65 per cent of the FTSE 350 companies report on environmental issues in some form.

...voluntary standards ...

The private sector, often acting in partnership with governments, has begun establishing general industry-wide codes or guidelines that firms can use as reference points for their environmental management and reporting practices. Some of the more renowned voluntary initiatives include model codes (e.g. the Business Charter for Sustainable Development and CERES Principles), standardised environmental management systems (e.g. ISO 14001) and reporting standards (e.g. the Global Reporting Initiative). The advantage of voluntary initiatives is that they can be designed and implemented in accordance with firms' specific requirements. Thus, they sometimes allow environmental objectives to be achieved more efficiently than alternative approaches to influencing business conduct such as command-and-control regulation. On the other hand, a major weakness is the effectiveness and credibility of self-regulation – which will depend on the arrangements for internal and external monitoring and on supporting institutions.

...corporate codes of conduct...

Increasingly firms, and MNEs in particular, are committing themselves through corporate codes of conduct to behave as responsible environmental stewards. Though the type, form, and content of these codes of conduct vary widely, they are increasingly more frequent and explicit in terms of firms' commitments to environmental and social responsibilities. A recent OECD study on corporate codes of conduct suggests that more than 70 per cent of the firms surveyed explicitly addressed environmental stewardship, in addition to labour issues, as the most common theme within their codes.

...environmental management practices ...

To implement the strategies and commitments found in corporate codes of conduct firms are increasingly relying on environmental management systems (EMS). EMS identify the practices, procedures, and resources needed to implement and maintain environmental management, control risks related to the environment, and increase cost-savings through more efficient use of resources and energy. As implementation of EMS requires considerable know-how, international standards have been developed to formalise this knowledge, e.g. ISO 14001. The past few years have seen a rapid growth in the number of firms with an ISO 14001 certification. By February 2000, for example, more than 3000 Japanese companies, 1900 German, and more than 1000 UK firms were certified.

...and environmental reporting.

In order to report the results of their efforts, firms are making use of environmental reporting. The level of environmental reporting can differ greatly between companies. Whereas some firms only briefly mention their results on environmental improvements, other firms may publish complete environmental reports or include a chapter on their environmental performance in the companies overall annual report, reporting on quantified results and targets and audited by environmental accountants.

For the moment, the corporate environmental movement seems to have taken off most seriously among OECD-based enterprises and it appears to be starting to take hold in non-OECD Asia. The effects of this trend on sustainable development are likely to be positive but not yet fully visible.

International co-ordination

The interface of international investment principles and the sustainable development agenda needs more analysis ...

In a report to the 1999 OECD Ministerial Council meeting, the Secretary-General of the OECD noted that the development of frameworks for international investment has much to contribute to promoting greater and more stable investment flows, higher quality investments, and a better distribution of their benefits.

A key issue in the establishment of principles for international investment and issues related to the environment is how universal principles, such as Non-discrimination and Most Favoured Nation, can be reconciled with the more site-specific needs of environmental policy. Questions concerning the environmental implications of inter-country competition for investment also arise, as do questions about the most environmentally appropriate dispute settlement mechanisms to use in any multilateral investment arrangements.

Preliminary OECD work on the theme of "non-discrimination and environment" suggests that there is no *a priori* reason why international investment rules could not be designed in such a way as to respect environmental needs, and vice versa. Investment liberalisation is increasingly likely to be scrutinised for the way in which it addresses environmental concerns. The opportunity to forge this reconciliation will become increasingly important over time.

...and dialogue with all interested parties.

The OECD plays a key role in developing dialogue between the investment and environment policy communities, and by involving stakeholders and civil society through workshops and consultations. For example, part of the work within the OECD on investment and the environment, and on corporate responsibility, bringing together policy makers, NGOs and other stakeholders, is conducted within the framework of the OECD Guidelines for MNE.

As a further example of how the OECD contributes to this debate, an objective of the Hague conference organised by the OECD in January 1999 on "FDI and the Environment" was to examine the empirical evidence and to deepen understanding of the key issues in the FDI – environment relationship. This conference also provided a platform for discussion amongst stakeholders in both OECD and non-OECD countries.[2]

Questions for discussion

Questions for discussion include:

- In an increasingly liberalised investment climate, what are the priorities (or obstacles) for action in order to enhance the potential benefits of foreign direct investment for sustainable development?
- What is the role of international co-operation and harmonisation of investment rules in this process?
- What is the role of voluntary regulations? Are they sufficient to take care of environmental concerns?
- What is the relationship between government regulations and voluntary standards in the transition to more sustainable environmental conditions?

2. The conference also identified key issues meriting further analysis and which guides OECD work in this area, see OECD (1999), *Foreign Direct Investment and the Environment.*

RELATED DOCUMENTS

OECD Guidelines for MNEs :
http://www.oecd.org/daf/investment/guidelines/index.htm

OECD (1999), *Trade, Investment and Development: Policy Coherence Matters.*

OECD (1999), *Foreign Direct Investment and Recovery in Southeast Asia.*

OECD (1999), *Principles of Corporate Governance.*

OECD (1999), *Foreign Direct Investment and the Environment.*

OECD (1999), *Trade Measures in Multilateral Environmental Agreements.*

OECD (1999), *Foreign Direct Investment, Development and Corporate Responsibility.*

OECD (1998), *Open Markets Matter: The Benefits of Trade and Investment Liberalisation.*

OECD (1997), *Economic Globalisation and the Environment.*

OECD (1997), *FDI and the Environment: Overview of the Literature*, December.

OECD (1996), *Trade, Employment and Labour Standards: A study of Core Workers' Rights and International Trade.*

OECD (1995), *Foreign Direct Investment, Trade and Employment.*