Foreign Direct Investment and Sustainable Development*

I. Introduction

The notion of sustainable development presents a challenge for policy makers and goes beyond the traditional concerns for economic growth. It argues that present growth should not be at the expense of future generations or of social equity both within and across countries worldwide. It raises environmental concerns about renewable resources and degradation of the ecosystem, as well as social ones regarding the marginalisation of the poorest countries and of unskilled workers, a respect for core labour standards, and of increasing income inequality.

The concerns raised by the concept of sustainable development become even more pronounced in the light of globalisation processes. Globalisation, in economic terms, can be thought of as a process in which business decisions, production processes and markets gradually come to exhibit more "global" characteristics and less "national" ones. Globalisation is characterised by structural reforms – especially trade and investment liberalisation – and increased trade and international investment flows. International trade and investment promote growth, alter the composition and geographical distribution of economic activities, stimulate competition and facilitate the international diffusion of technologies. Depending on the circumstances, trade and investment can have significant effects, both positive and negative, for sustainable development.

In general, trade and investment are not the root causes of environmental and social problems, which rather reflect market and intervention failures. However, the ongoing process of liberalising trade and investment regimes offers both challenges and opportunities in implementing sustainable development policies. For example, issues may arise at the interface of policies or rules designed to encourage trade and inward investment and those designed to further environmental or

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social objectives. Because of the long-term focus inherent to the notion of sustainability, the most important influence of investment may well be its indirect influence on environmental and social performance, both nationally and globally.

The growth in international investment also means that a country's sustainable development outlook is increasingly influenced by multinational enterprises (MNEs). This increased internationalisation of firm activities raises concerns regarding the reach of regulatory control in environmental areas such as resource management and pollution control, and social issues like income distribution and labour standards. On the other hand, increasingly more MNEs are responding to public concerns regarding environmental and social issues, as can be seen in the recent rise in corporate voluntary initiatives. This rise in corporate responsibility (CR) also impacts on sustainable development.

In section II we discuss recent trends in foreign direct investment (FDI) in the 1980s and 1990s and policy developments that have accompanied and contributed to these trends. The impact of FDI on the three pillars of sustainable development – economic growth, environmental protection and social development – is discussed in section III. The response of firms to increased public concerns regarding sustainability and how these responses can contribute to sustainable development is discussed in section IV. Section V discusses what role governments can play in promoting this trend in increased corporate responsibility and section VI concludes.

II. Recent trends and policy developments concerning international investment

a) Trends in foreign direct investment

The last two decades have seen the worldwide production and consumption of goods and services become increasingly internationalised. Whereas in 1980, FDI stock abroad accounted for only five per cent of world GDP, by 1998 this number had almost tripled to 14 per cent. In the six year period 1993-1999, world FDI flows have increased from just over US $200 billion to around $800 billion in 1999, and are expected to have passed the US $1 trillion mark in 2000 (UNCTAD, 2000). A distinguishing characteristic of world investment is that the vast majority is amongst OECD countries. More than 90 per cent of FDI world outflows originates in OECD counties, and in recent years the OECD has accounted for around three-quarters of FDI inflows as well (Table 1).

Outside the OECD region, foreign direct investment had not been evenly spread among regions. Table 2 shows that FDI has been highly concentrated in Latin America and Asia. Together these two regions comprise two-thirds of total OECD FDI flow to developing countries. Furthermore, in 1998 all the non-OECD countries listed in the top ten recipients of OECD FDI outflows are located in these

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Table 1. **Total world FDI flows, US$ million**

	1993	1994	1995	1996	1997	1998	1999
Total outflows							
World	247 425	284 915	358 573	379 872	475 125	648 920	799 928
OECD	207 824	245 055	305 515	324 146	410 037	599 464	734 589
(OECD *as % of world*)	(84%)	(86%)	(85%)	(85%)	(86%)	(92%)	(92%)
Total inflows							
World	219 421	253 506	328 862	358 869	464 341	643 879	865 487
OECD	146 044	163 360	228 932	229 114	294 888	484 012	669 719
(OECD *as % of world*)	(67%)	(64%)	(70%)	(64%)	(64%)	(75%)	(77%)

Source: UNCTAD World Investment Report 1999 and 2000. Since statistical definitions differ from the ones applied by the OECD International Direct Investment Statistics, the data in this table is not directly comparable with Tables 2, 3 and 4.

two regions (Table 3). Throughout the 1990s, these ten countries received between 40 and 50 percent of total OECD FDI outflows to developing countries and changes in the composition of the top ten countries have been minor. While for OECD countries FDI outflows to developing countries have accounted for only a small part of their GDP and total outflows, however, from the developing countries' perspective FDI has been of great importance.[1]

Not only is foreign direct investment becoming more important for developing countries in relation to GDP, it is also overshadowing other capital flows such as official development assistance (ODA) or export credits. While ODA has decreased in absolute terms over the 1992-1999 period, FDI flows have experienced a near

Table 2. **OECD FDI outflows by region**

	In US$ million				Percentage of total			
	1985	1990	1995	1999	1985	1990	1995	1999
WORLD	61 280	237 824	316 810	767 814	100	100	100	100
of which:								
OECD countries	42 058	181 964	256 988	692 996	68.6	76.5	81.1	90.3
NON-OECD countries	19 222	55 860	59 822	74 818	31.4	23.5	18.9	9.7
of which:								
Africa	404	823	2 972	. .	0.7	0.3	0.9	. .
Asia*	2 171	12 651	25 371	. .	3.5	5.3	8.0	. .
Europe*	8	410	2 221	. .	0.0	0.2	0.7	. .
Latin America and Caribbean*	9 102	18 948	22 622	. .	14.9	8.0	7.1	. .
Middle East	212	1 056	1 365	. .	0.3	0.4	0.4	. .
Unallocated	7 325	21 972	5 271	. .	12.0	9.2	1.7	. .

* Excluding OECD countries.
Source: OECD International Direct Investment Statistics.

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Table 3. **Major recipients of OECD FDI outlows[1]**

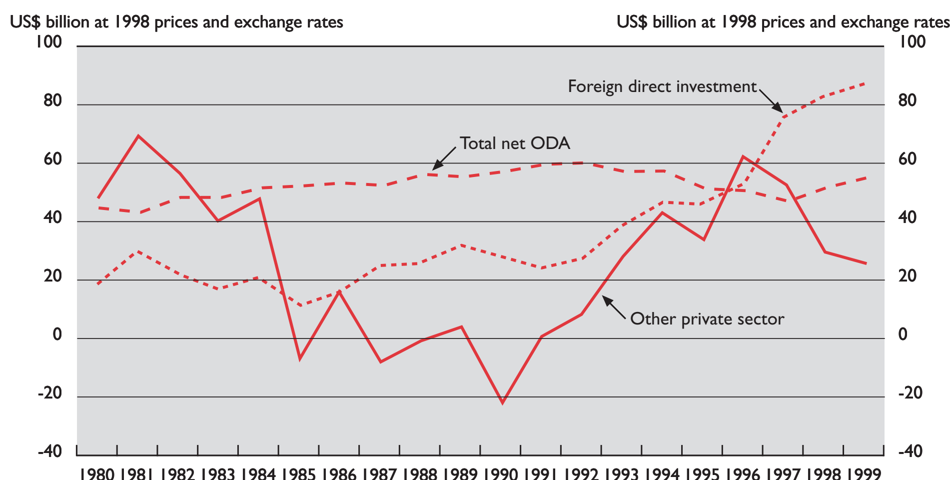
	1985		1990		1995		1998	
1	Brazil	785	Singapore	2 458	Brazil	8 342	Brazil	21 903
2	Indonesia	616	Brazil	2 118	China	7 005	Argentina	4 990
3	Singapore	562	Hong Kong	1 949	Hong Kong	3 812	Malaysia	4 899
4	Egypt	425	Indonesia	1 931	Indonesia	3 290	China[2]	4 198
5	Hong Kong	322	Thailand	1 645	Argentina	3 040	Singapore	3 749
6	China	319	Malaysia	1 272	Singapore	2 961	Thailand	3 534
7	Neth. Antilles	247	Chinese Taipei	816	Thailand	2 798	Colombia	2 851
8	Malaysia	182	Argentina	748	Chile	1 825	Venezuela	2 477
9	Chinese Taipei	137	Chile	646	Malaysia	1 756	Chile	2 464
10	Israel	128	Philippines	510	South Africa	1 437	Philippines	2 374
Top 10 as percentage of total non-OECD		19.4%		30.1%		52.8%		45.3%

1. US$ million
2. While China is fourth in the top ten recipients of FDI outflows from OECD countries, it is the largest recipient of worldwide FDI flows to non-OECD countries, due to large investments from non-OECD economies such as Singapore, Chinese Taipei and Hong Kong, China.

Source: Compiled from OECD (1999) *International Direct Investment Statistics Yearbook.*

quadrupling (Figure 1). Portfolio flows are also playing an increasingly larger role in the total financial flows towards developing countries. In 1999 they accounted for approximately ten percent of total resource flows to developing countries (World Bank, 2000). Box 1 describes the greening of portfolio flows – a trend that may contribute importantly to achieving sustainable development.

Figure 1. ***Selected long-term flows from OECD to developing countries, 1980-99***



Source: OECD, DAC.

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Box 1. **The Greening of Portfolio Investment**

Since the late 1980s an increasingly larger share of portfolio flows are oriented towards "green", "ethical", "socially responsible", and lately also "sustainable", investment funds and indexes. In the US alone, in 1999 more than $2 trillion was invested in social responsible funds, or roughly 13 per cent of the total amount of investment assets. This is up from 9 per cent in 1997 (Social Investment Forum, 1999).

These investment funds and indexes usually comprise a range of stocks which are screened to exclude particular firms operating in environmentally or socially harmful sectors or activities, or which do not meet other criteria the fund or index sets. For example, usually firms that manufacture alcohol, tobacco, or weapons, or engage in potentially environmentally damaging activities are excluded. Criteria are also sometimes set regarding the level of social, environmental, health and safety reporting, or the adherence to worldwide minimum social and environmental standards. Examples of these indexes are the Domini Social Equity Index, the Dow Jones Group Sustainability Index, and the entire Calvert 'family' of Socially Responsible Investment Funds.

The performance of these funds shows that social investing is profitable. Several social indexes outperform the S&P 500. A recent review of 70 studies that explored the link between environmental and financial performance found that companies with the best environmental management practices were rewarded with higher stock market returns than their peers, by up to 2 per cent (Earle, 1998). Moreover, positive environmental performance never translated into negative returns.

In recent years, an increasingly large part of FDI flows have been through mergers and acquisitions (M&As). While it is difficult to estimate the share of FDI that is accounted for by M&As,[2] the growth rate of M&As has outstripped that of FDI throughout the entire 1990s (Table 4). In recent years the value of OECD annual M&A deals almost equals that of FDI outflows from the OECD area.

Foreign direct investment flows from OECD countries are also more and more oriented towards the services sector. In 1998, more than half of OECD FDI outflows occurred in this sector, with financial intermediation accounting for the bulk of this. Also interesting to note are the increases in FDI in electricity, gas and water, and telecommunications, reflecting the massive privatisation and deregulation which have taken place in these sectors over the past two decades. While the primary sector showed a declining share in total FDI in the ten year period 1985-1995, large investments in the extraction of petroleum and gas reversed this trend in 1998 (Figure 2). Manufacturing, on the other hand increased steadily over the same 10-year period, but witnessed a relative drop in 1998 due to the surge in services related FDI.

b) *Policy developments*

The growth in international investment of the past decades has been due in large part to increased liberalisation brought about by reduced barriers to trade

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Table 4. **Value of OECD M&A purchases in comparison with total OECD FDI outlows, US$ billion**

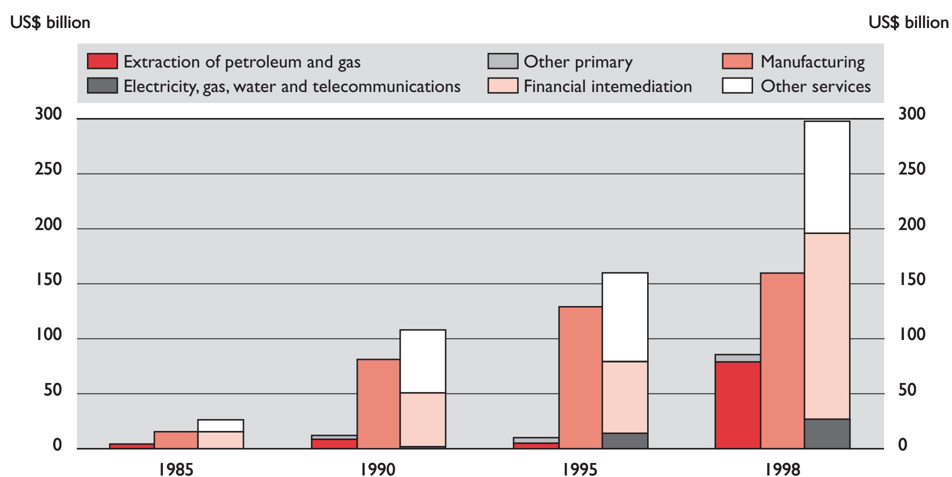
	1991	1992	1993	1994	1995	1996	1997	1998	1999
M&A[1]	80.0	101.2	134.1	165.7	217.7	244.8	303.1	516.7	772.8
Growth rate	–	26.4%	32.5%	23.6%	31.4%	12.5%	23.8%	70.5%	49.6%
Outward FDI[2]	196.3	183.7	210.9	247.0	316.8	341.0	414.1	636.5	767.8
Growth rate	–	–6.4%	14.8%	17.1%	28.2%	7.6%	21.4%	53.7%	20.6%

Sources:
1. KPMG DealWatch Database 2000; UNCTAD World Investment Report 1999.
2. OECD International Investment Statistics.

and investment and subsidy reform. This improvement in the investment climate in the 1990s was influenced in part by the recognition of the benefits of FDI. The 1990s also witness the removal of domestic impediments through widespread regulatory reform and privatisation.

Although there are no universal rules governing international investment, OECD member are committed to provide non-discriminatory treatment to inward direct investment and related financial flows by virtue of the legally binding OECD Codes of Liberalisation. The 33 countries that adhere to the OECD Declaration on International Investment and Multinational Enterprises[3] have also undertaken a

Figure 2. ***Total OECD FDI outlows to selected sectors***



Source: Compiled from OECD (1999), *International Direct Investment Statistics Yearbook.*

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political commitment to provide national treatment for established foreign controlled enterprises, to avoid conflicting requirements on those enterprises and to work together to improve the investment climate. These instruments have provided an effective framework for international co-operation and have served to underpin the liberalisation achieved in recent decades.

Besides removing barriers to trade and investment, harmonisation and mutual recognition of regulation is also important since the large variety of different legal systems and regulations – though intrinsically not restrictive – can also serve as a barrier to trade and investment. Regulatory reforms at the European Union level and the harmonising of European legislation, combined with a liberalised internal market, have been important drivers in the increase of intra-European investment and trade. Other regions have used regional integration schemes to liberalise trade and investment regulation. Examples include North America (NAFTA), Asia (ASEAN[4]), Australia and New Zealand (ANZCERTA), Latin America (Mercosur[5]) and sub-Saharan Africa (SADC[6]). Talks on the Free Trade Area of the Americas (FTAA), designed to set up a hemispheric-wide free trade zone by 2005, are currently underway.

Bilateral investment treaties (BITs) have become an increasingly important vehicle for promoting and protecting investment flows by providing legal security to foreign investors and their investments. They establish rules concerning the treatment of foreign investors and their investment by host countries, including national treatment and most-favoured nation treatment; prompt, adequate and effective compensation in the case of expropriation; and free movement of capital and other financial flows related to the investment. In addition, BITs include rules on dispute settlement, both with regard to state-to-state arbitration and investor-state arbitration. Most of the BITs have been signed in the 1990s and parallel the rise in investment flows. In the three decades leading up to 1990, only 500 BITs had been signed, whereas by the end of the decade this number has almost quadrupled; and in 1999 the vast majority were concluded between developing countries (UNCTAD, 2000).

In addition to liberalisation and regulatory reform, OECD countries further increased their reliance on market systems through privatisation. The OECD public enterprise sector is currently estimated to be less than half the size it was at the beginning of the 1980s (Gonenc *et al.*, 2001). The privatisation movement was in large part induced by dissatisfaction with the performance of state-owned enterprises, and the increased capital investment needed to upgrade infrastructure, especially in the public utility sector. Privatisation offered the opportunity to restructure and introduce competition in sectors previously dominated by state monopolies, to increase investment, and to improve productive and allocative efficiency, all of which benefit consumers and the economy as a whole.[7] However,

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in some economies in transition which have recently become OECD member countries, the benefits from the change in ownership have sometimes proved disappointing, due to weaknesses in the legal, institutional or market environment. In addition, the privatisation process needs to be open and transparent and allow foreign participation in a non-discriminatory manner.

With increasingly more countries acknowledging the benefits of FDI, barriers to international investment are gradually being removed. Of the almost one-thousand changes in FDI regulations undertaken worldwide in the 1990s, 94 percent were aimed at creating a more favourable environment for FDI (UNCTAD, 2000). Instead of barriers, many countries now employ *incentives* to attract FDI. Examples of such incentives include tax holidays, preferential access to (government) credit and the reduction of import duties for goods needed for production. Some measures are more specifically tailored towards a single goal, like subsidies for R&D activities, the hiring and training of workers or for technology transfer. These subsidies are meant to reap the maximum benefits associated with the activities of MNEs *e.g.* knowledge, management skills, technological advantages, etc.

However, barriers to investment have not disappeared, and many countries remain reluctant to undertake legal commitments to liberalisation, even where they are actively encouraging FDI. In order to maintain national"control" over the economy, restrictions on foreign ownership provide an important barrier to entry and prevent the market for corporate control from functioning efficiently. Though these barriers to FDI are being reduced,[8] many exceptions for 'strategic sectors' exist. Other examples of remaining restrictions include reciprocity and discretionary liberalisation *i.e.* where sectors are opened to FDI but on a case by case basis. Disincentives for investment include measures designed to align firm strategy with national development goals *e.g.* demands that firms live up to specific performance requirements. Finally, a lack of political and economic stability and predictability can also act as a barrier to investment, as can a lack of transparency of regulations, corruption, weak protection of intellectual property rights, and arbitrary application of regulations and laws.

III. Impact of FDI on sustainable development

This section analyses the main mechanisms by which international investment impacts upon the three constituent parts of sustainable development: the economy, the environment, and the social framework. It distinguishes between direct effects (for example economic growth, worldwide shifts in production and consumption patterns, and technology transfers) and the influence on, and the relevance of, the evolution of policies for sustainable development. In some cases, economic, environmental and social concerns are affected in the same way, in others there are significant differences. For this reason, these issues are discussed

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separately below. This approach should not obscure the fact that economic, environmental and social concerns are not separate and opposing aims of sustainable development. In some areas, progress on one front will have positive spillovers on the other two.

a) ***Economic growth***

Whether international investment stems from foreign or national sources, it has been shown that market openness – to both trade and investment – increases economic growth. Open markets allow resources to be used more efficiently and productively, may provide countries with technology not locally available, and by helping firms to tap into world markets, increases their sales potential and realises economies of scale. Efficiency, in turn, contributes to economic growth and rising incomes. Liberalisation can also benefit citizens in tangible ways, through lower prices and greater product diversity, and an increase in the purchasing power of their wages.

There is an increasing body of empirical-econometric evidence that countries with more open trade and investment regimes have had higher rates of growth. In the last decade countries that have had more open trade and investment regimes have achieved double the annual average growth rates of others, and have attracted more FDI (OECD, 1998). The observed average increase in trade exposure in OECD countries over the 1980s-90s period has been estimated to have resulted in about a 4% increase in output per capita (Bassanini *et al*, 2001). For developing countries, a study by Sachs and Warner (1995) finds that those countries with open economies grew by 4.5% a year in the 1970s and 1980's, while those with closed economies grew by 0.7% a year. And a recent study by Ben-David, Nordstrom and Winters (1999) finds that major trade liberalisation events have coincided with movements to higher – and in the majority of cases, steeper – growth paths that lie above the lower, and flatter, pre-liberalisation paths. These results concur with a World Bank study by Dollar and Kraay (2000) which confirms that openness boosts economic growth, and that the incomes of the poor rise one-for-one with overall growth.

Benefits associated with the inflow of FDI include an increase in the production base, the introduction of new skills and technologies and the creation of employment. MNEs are a powerful and effective means to disseminate technology from developed to developing countries, and are often the only source of new and innovative technologies that are usually not available through the market. Technology disseminated through FDI generally includes the 'entire package' including experts, skills and the financial resources to exploit the technology appropriately.

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Looking at the impact of FDI on capital accumulation and productivity growth, de Mello (1999) finds that foreign investors increase productivity in host countries and that FDI is often a catalyst for domestic investment and technological progress. Markusen and Venables (1999) find that FDI has a positive effect on domestic firms' productivity. They claim that increased competition associated with the entry of an MNE upgrades the efficiency and product quality in national firms, and opens up possibilities for export. Empirical evidence on OECD countries also shows that foreign affiliates of MNEs have a higher labour productivity compared to local firms.[9] Foreign investment plays an important role in the dissemination of gains from innovations, especially for developing countries (Ahn and Hemmings, 2000). And studies by Borensztein *et al.* (1999) and OECD (1998) find that not only does foreign direct investment stimulate growth but that it has a larger impact than investment by domestic firms. Recent literature, however, shows that developing countries need to have reached a certain threshold of development (*e.g.* education or infrastructure) before being able to capture the benefits associated with FDI (Saggi, 2000).

FDI also brings other tangible and intangible assets that have large impacts on development. For example, the inflow of FDI through mergers and acquisitions can bring improved corporate governance, including better organisational and managerial skills. The degree to which corporations observe basic principles of good corporate governance is an increasingly important factor for international investment decisions. Corporate governance programmes – which establish rules to protect shareholders and encourage clarity and transparency in financial reporting – play an important role in economic growth, and the development of equity markets, which enable companies to access financing from a larger pool of investors (Maher and Andersson, 2001). Corporate governance mechanisms facilitate the efficient functioning of capital markets (including the market for corporate control) and promote the efficient allocation of resources. This is particularly relevant for international investment given the increase in FDI via mergers and acquisitions. A good corporate governance regime helps to maintain the confidence of investors – both foreign and domestic – and to attract patient longer-term capital, which is particularly important for developing countries. Bribery and corruption are also critical impediments to economic growth. Corruption is not only a serious obstacle to investment, but also acts as a brake on social improvement (*e.g.* education or health) since it diverts funds away from development (Box 2).

Available evidence suggests that many of the poorest developing countries have not been able to integrate successfully into global markets and to participate in the growth-inducing benefits of openness to trade and investment. The failure of the majority of the least developed countries (LDCs) to grow and to integrate into the global economy as rapidly as other developing countries has occurred despite multiple efforts at reform. Market openness clearly is not a sufficient

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Box 2. Bribery, Corruption and Sustainable Development

Bribery and corruption – stemming from lax economic, political and institutional systems – have a strong impact on sustainable development. For example, the latest report on Transparency International's (2000) Corruption Perception Index (CPI) shows a striking correlation between the CPI and national environmental performance. In contrast to the idea that corruption and bribery can "grease the machinery of commerce", empirical evidence has shown that countries with high levels of corruption have poor economic performance and lower rates of investment, both domestic and foreign (Mauro, 1995; World Bank 1997; and Wei, 1998).

The mechanisms through which corruption hinders economic growth are straightforward. First of all, bribery and corruption distort economic decision-making, and increase transaction costs and uncertainty in the economy. Once corruption has spread, a vicious circle is established whereby economic actors continue to operate illegally without trying to revert to the rule of law. Moreover, corruption inflates government expenditure and distorts the composition of this expenditure away from investment in sectors such as health and education towards large public infrastructure projects. Hence, development is slowed as crony capitalism is promoted at the expense of economic efficiency. Similarly, corruption misallocates talents to rent-seeking activities and distorts sectoral priorities and technology choices. Last, but not least, corruption undermines the state's legitimacy and its ability to raise revenues, reducing the provision of public goods.

Enterprises have responded to these concerns by adapting management techniques commonly used in many other areas such as quality and environment. OECD research on corporate codes of conduct shows bribery and corruption are amongst the most commonly cited issues in codes, but that definitions used, and the scope of commitments, vary widely. This suggests that the international business community still struggles to come to grips with the complex ethical questions that arise in defining appropriate business conduct in this area.

condition for economic growth, but sound macro-economic policies and institutional stability are also necessary, as is social stability (Rodrik, 1999). With weak institutions, poor governance (both public and private) and unsound policies, market reforms can fail with great costs, especially to vulnerable groups in society.

Indeed, during the 1990s, output growth in low-income countries was less than the developing country average, largely as a result of conflict and macroeconomic instability.[10] Since 1980 more than half of all low-income countries, including 15 of the world's 20 poorest countries, have been involved in external or civil wars. However, low-income countries that had both macroeconomic stability and avoided conflict achieved annual per capita growth rates of 2.9 percent and real export growth rates of 11.6 percent. Though hardly conclusive, the performance of these countries during the 1990s suggests they can achieve rapid growth while increasing their integration with the global economy (despite limited capacity and weak institutions) provided they exhibit minimal social and macroeconomic stability. Good regulatory reforms to encourage competition and foster consumer protection are also elements crucial for ensuring the rewards from liberalisation are realised.

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***b*) Environmental protection**

In general, while foreign investment is not the cause of environmental problems, it can have significant effects, both positive and negative, on the environment. The consequences of investment liberalisation on the environment are likely to be the result of an expansion of world economic output (scale effects), a reallocation of production and consumption worldwide and between sectors (structural effects), and the stimulation of technological development and diffusion (technology effects).

On the one hand, investment liberalisation may lead to increased production and consumption of polluting goods or to an expansion in industrial activity. This can lead to growing pressures on the environment such as increased pollution and use of resources, rapid urbanisation, or damage to protected areas, etc. – posing problems for pollution control, ecological protection and public health issues. On the other hand, investment liberalisation – when paired with the implementation of strong regulatory frameworks to protect the environment – can have a beneficial impact on the environment. For example, FDI can improve structural efficiencies and make new investments in environmental protection possible. Furthermore, by contributing to an economy's economic growth, investment also increase society's demand for a healthier environment, since wealthier societies are more willing – and able – to pay for protection of the environment. Some evidence supporting this relationship has been found – the amount of environmental regulation, as well as many indicators of environmental quality, increase steadily with the growth in per capita income (Furtado *et al.*, 2000).

However, there are several reasons for not relying exclusively on this "market solution" to protect the environment. Not all measures of environmental quality fit this pattern *e.g.* growth contributes monotonically to global emissions of carbon dioxide, levels of waste disposal and urban congestion. Also, it might take years of growth before environmental quality begins to improve, at the risk of possibly irreversible environmental damage in the short term. While income growth may well be necessary it may not be sufficient for environmental improvements. Instead of relying solely on economic growth and market mechanisms, policy coherence and the implementation and enforcement of adequate environmental regulations will become increasingly important in limiting damages to the environment caused by FDI.

Foreign direct investment flows can also assist in abating pollution, or have other positive environmental impacts, through the worldwide dissemination of technologies. With tighter regulations at home, MNEs have a strong incentive to innovate in areas that improve resource efficiency or reduce industrial waste. Once developed, new technologies can be applied on a worldwide basis by the firm, in order to benefit from economies of scale. FDI by MNEs can also have positive

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spill-over effects on the technological characteristics of national firms since local firms may imitate multinationals' technological practices in order to improve their own production practices. However, even if industrial production plants use advanced technologies, FDI can increase the total environmental burden on a country if before that investment no such plants existed.

While FDI is an important vehicle for both technological change and diffusion, international capital 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 that prevent firms from investing in potentially more efficient and environmentally friendly technology. Financial constraints are often among the most important barriers to investment in environmentally preferable technologies. In some cases, these constraints have arisen from national policies towards foreign capital, such as foreign exchange restrictions, international credit controls, and ownership restrictions.

Long term environmental impacts of international investment will depend in large part on how government environmental policies respond to their pressures and opportunities. For example, the so-called "*pollution haven*" hypothesis implies that competitive forces would move foreign direct investment away from countries with high environmental standards, or attract it towards those with low environmental standards. Closely related to this hypothesis is that of the "*regulatory chill*", which would reflect resistance to enacting or upgrading home country environmental standards on competitiveness grounds.

It is possible that some countries could be attracted by the idea of relaxing environmental standards or refraining from upgrading low standards in order to attract certain types of investments, and individual firms may be sensitive to the costs of complying with more stringent environmental standards. FDI flows to a wide range of industries and companies – some of which are careful environmental stewards, some of which are not. However, empirical research shows that the risk of redeployment of productive resources towards low standard countries is rather small. Environmental costs are only one of a broad number of factors, including quality of infrastructure, access to inputs, wage costs, labour productivity, political risk, the size and growth potential of markets, that investors take into account in location decisions. The costs of adhering to environmental regulations are also typically a small part (on average 2-3%) of total production costs for most firms (OECD, 1998; Adams, 1997; UNEP, 2000). Instead, multinational enterprises generally seek *consistent* environmental enforcement, rather than *lax* environmental enforcement (OECD, 1997). In spite of the strength of empirical findings concerning the relative unimportance of pollution havens there is some evidence that competitiveness concerns have dampened governments' enthusiasm to raise environmental standards.[11]

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c) ***Social development***

The social effects associated with investment, and its liberalisation, are examined in two areas. First, FDI can impact upon the labour market. Though foreign firms have been shown to create employment, the quality of that employment is sometimes questioned. Especially where governments compete to attract FDI, some may be tempted to be less vigilant in enforcing their national laws that promote core labour standards. Secondly, investment and its liberalisation can exacerbate differences in income distribution and inequality that in general result from inadequate national policies regarding wealth distribution (*e.g.* tax policies). The benefits of the changes in global production and trade patterns, therefore, will be distributed differently amongst nations and amongst different groups within nations.

With respect to the definition and recognition of *core* labour standards, the international community has made significant progress in developing consensus. According to the ILO D*eclaration on* F*undamental* P*rinciples and* R*ights at* W*ork*, adopted in 1998, these principles and rights include freedom of association and the effective recognition of the right to collective bargaining; the elimination of all forms of forced or compulsory labour; the effective abolition of child labour; and the elimination of discrimination in respect of employment and occupation.

The interplay between investment, and employment and core labour standards is complex. Countries that strengthen their core labour standards can increase economic efficiency by raising skill levels in the work force and by creating an environment which encourages innovation and higher productivity. In general, the absence of core labour standards does not change the location decisions of OECD investors in favour of less strictly regulated countries. In the majority of cases, core labour standards are not important determinants for investment location decisions, thereby making policy competition between governments in core labour standards unnecessary and even harmful for society (OECD, 1998).

Besides its impact on labour markets, international investment can also impact upon the distribution of wealth within and across nations and contribute to poverty alleviation. Economic growth, driven by investment, helps to alleviate poverty and the social and environmental damage which poverty engenders, but may not by itself be sufficient for poverty reduction. Poverty can also foster political and social instability, as well as encourage practices that result in environmental degradation (e.g. deforestation to increase farmland or provide firewood, and soil erosion from over-intensive farming).

In the last fifty years, investment led integration has been accompanied with a rise in prosperity and living standards, and a substantial reduction in poverty in many parts of the world. The share of the world's population living in extreme

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economic poverty – defined as living on less than $1 per day – has fallen from 29 per cent in 1990 to 24 percent in 1998 (World Bank, 2000). That still leaves a total of more than one billion people in poverty. In Asia, where most of the world's poor live, poverty has declined significantly over the past two decades, although the recent crisis has slowed progress. In contrast, the incidence of poverty is rising rapidly in countries with economies in transition in Europe and Central Asia, and continuing to rise in Latin America and Sub-Saharan Africa.

Though people are poor for a variety of reasons, empirical studies show a growing consensus that market openness has a positive impact on per capita incomes.[12] However, while liberalisation policies are likely to be beneficial in most circumstances, for the less developed countries enhancing their integration into the global economy involves more than the opening of markets and a welcoming environment for international investment. Policies concerning macroeconomic stability, good governance and capacity building are also of crucial significance. So too are the right environmental and social policies to ensure that development is sustainable, and that the benefits of openness are widely shared.

Even though experience shows that properly sequenced market-friendly reforms do produce economic growth and increased welfare, these effects might not be distributed equally among different groups in society. Liberalisation can lead to transitional disturbances in the markets on which the poor operate. Extreme adverse poverty shocks are often associated with the disappearance of a market, while strong poverty alleviation arises when markets are introduced for previously non-traded goods. Where markets do exist, liberalisation is likely to have major effects on the price of factors of production – of which wages are the most important for poverty purposes. If the reform boosts the demand for labour-intensive products, it will increase the demand for labour and then either wages or employment, or both, will increase. Whether this will reduce poverty depends on whether the poor are strongly represented in the type of labour for which demand has risen (Ben-David *et al*., 1999). Policymakers, therefore, need to complement policies stimulating economic growth with policies intended to broaden access to income opportunities, and which are needed in order to stimulate welfare gains overall.

IV. Firm level responses

As the above overview has shown, much of the overall impact of FDI on sustainable development depends on government policies in the host and the home country, and on the behaviour of the multinational enterprise itself. With respect to the latter, a particular interesting feature of the last decade has been the focus on responsible corporate behaviour. Companies – especially large, visible firms – have increasingly undertaken voluntary initiatives to advance the sustainable development agenda. These initiatives include the issuance of codes of conduct,

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the implementation of associated management systems and, more recently, public reporting on the non-financial performance of companies. Firms have undertaken these initiatives for a variety of reasons – to improve compliance with law and regulation, to manage litigation and reputation risks, to improve relations with customers and business partners, and to improve relationships with the societies in which they operate.

a) ***Corporate codes of conduct***

Codes of conduct are voluntary expressions of commitment that set forth standards and principles for business conduct (Kolk *et al.*, 1999). They cover a broad range of issues and address each of the economic, social and environmental "pillars" of the sustainable development agenda. Examples of those issues are environmental management, human rights, labour standards, the fight against corruption, consumer protection, information disclosure, competition, and science and technology. 'Compliance with law' is the most common commitment made in the codes, and environment and labour relations are the most common issue areas. However, significant divergences exist among companies in the nature of commitments they make, even in narrowly defined business ethics contexts (*e.g.* commitments on core labour standards in the branded apparel industry – OECD, 2001).

Voluntary commitments issued in the form of codes of conduct have an advantage in that they can be tailored to firm-specific requirements. On the other hand, they can suffer from credibility problems, especially by people who suspect that companies cannot be trusted to monitor their own behaviour. Firms are aware of this problem and they are attempting to communicate the steps that they take to make good on their commitments in day-to-day operations. Examination of public statements on their implementation efforts suggests that firms try to tailor implementation to the issue at hand – that is, they use different management tools for anti-bribery commitments than they do when trying to implement core labour standards (OECD, 2001). Various private consulting firms and auditing services have emerged to assist firms in developing appropriate management and communication strategies. However, in many of these areas there are still significant differences of opinion on what should be done and how it should be reported.

b) ***Management systems***

Management systems have been developed by firms to implement the strategies and commitments found in corporate codes of conduct. In particular, many firms are introducing *environmental management systems* (EMSs). An effective EMS identifies and controls risks related to the environment, and increases cost-savings through more efficient use of resources and energy. Firms often seek to increase

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the credibility of their environmental commitments by publishing the details of their EMS. Since the implementation of an EMS requires considerable know-how, international standards have been developed to formalise this procedure. The most common standardised EMSs are the Eco-Management and Audit Scheme (EMAS); the EU supported management system and certification scheme introduced in 1993; and ISO 14001, an international environmental management standard published in 1996. As regards labour relations, standardised management systems have also become available, of which Social Accountability 8000 (SA8000) – focusing *inter alia* on child labour, forced labour, health and safety, and free association and collective bargaining – is a well-known example.

The past few years have seen a rapid growth in the number of certified firms. Some tension, however, may exist between tailor-made management systems and standardised systems. Standardised systems provide quick and relatively inexpensive access to advanced management techniques – and avoid "re-invention of the wheel". On the other hand, standardised systems may not be tailored to individual company needs.

c) E*nvironmental reporting practices*

Environmental performance reporting is used by an increasing number of firms to report the results of their efforts to the public. Companies are facing ever-greater pressure to publish a thorough report on their environmental performance, including quantitative information going back several years and references to negative experiences. In economies where environmental management practices have been widespread, the demand for high quality environmental reports is mounting as the next step in advanced environmental corporate practice. Sill, environmental performance reporting is relatively uncommon and high environmental impact firms differ markedly in how they publish their information and the data they include (OECD, 2001). Unlike other areas of business reporting, there are few widely accepted standards to help firms decide what information should be included in their environmental performance report. The Global Reporting Initiative, supported by major businesses, NGOs and the United Nations, has developed standards for business reporting in the area of sustainable development.

V. Promotion of responsible corporate behaviour

The private sector plays a vital role in generating economic growth and in ensuring the sustainability of that growth. Therefore, the way private enterprises are governed and their behaviour, both domestically and internationally, is important for sustainable development. The private initiatives discussed above often complement government-orchestrated initiatives, and recent trends of regulatory

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or public enforcement strategy have tended to integrate these private initiatives. OECD countries have launched several initiatives to promote responsible corporate behaviour more in line with the sustainable development agenda. Among these instruments are the OECD Principles of Corporate Governance, the OECD Guidelines for Multinational Enterprises, and the OECD Bribery Convention. This may eventually lead to the accumulation of greater consensus among businesses and other parts of civil society about the appropriate scope and nature of commitments in the various areas of business conduct, and about the management and reporting practices that are needed to support these commitments. Although none of these initiatives represents the last word on the issues they address, they do represent important steps in the ongoing process of developing a meaningful framework for promoting appropriate conduct in international business.

The OECD Principles of Corporate Governance include the core elements of a good corporate governance regime. For example, they advocate *inter alia* that the rights' of shareholders, including minority and foreign shareholders, be protected, and that the markets for corporate control be allowed to function in an efficient and transparent manner. They recognise the role that stakeholders play in contributing to the sustainability of financially sound enterprises, and that factors such as business ethics and corporate awareness of environmental and societal concerns impact on the reputation and long-term success of a company. A good corporate governance regime helps to assure that corporations use their capital efficiently, while at the same time that they operate for the benefit of society as a whole. The Principles can be used both by national governments as a benchmark against which they can evaluate and improve their laws and regulations, and by private sector parties that have a role in developing corporate governance systems and best practices.

The OECD Guidelines for Multinational Enterprises provide a set of recommendations for worldwide responsible corporate behaviour consistent with existing legislation and both complement and reinforce efforts by the private sector to define and implement responsible business conduct. These voluntary Guidelines – specifically aimed at the behaviour of Multinational Enterprises – provide a government-backed set of principals and standards of good corporate behaviour and help to level the playing field between competitors in the international market place. Issues dealt with in the recently revised Guidelines include: disclosure and transparency (updated to encourage social and environmental accountability); employment (now covering all internationally recognised core labour standards), and; environment (encouraging MNEs to raise their environmental performance through improved internal environmental management and better contingency planning for environmental impacts). Also a new recommendation on human rights and new chapters on combating corruption and on consumer protection have been added.

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Though the role of firms is vital in the fight against bribery, governments also have an important role to play. T*he* OECD C*onvention on* C*ombating* B*ribery* addresses combating bribery of foreign public officials in international business transactions. The Convention *inter alia* requires countries to establish the criminal offence of bribing a foreign public official, and to have in place adequate sanctions and reliable means for detecting and enforcing the offence. The aim is to eliminate the 'supply' of bribes to foreign officials, with each country taking responsibility for the activities of its own companies. The new chaper on combating corruption in the OECD Guidelines for MNEs, and the disclosure and transparency chapter in the OECD Corporate Governance Principles, provide a framework that discourages firms engaging in acts of bribery.

VI. Conclusion

Driven by increases in international investment flows and by changes in government policies – liberalisation, regulatory reform and privatisation – national economies have become increasingly integrated into one global one, with the exception of a number of least developed countries. For both developed and developing countries the internationalisation of economic activities poses opportunities and challenges for sustainable development. Though investment is not the root cause of environmental and social problems – which in general result from market failures and inadequate policy frameworks – it does amplify and accelerate these difficulties.

International investment can stimulate competition, improve resource allocation, and facilitate the international distribution of technology. Indeed, countries with open investment regimes have generally shown higher growth rates than those countries that did not. However, while economic growth has increased overall world prosperity, inequality between and within both developed and developing countries has increased. With the large majority of the world's people living in developing countries, it is important to take into account their perspective on the issues of sustainable development as well. High international standards in employment and environment are clearly desirable in terms of sustainability, but these may be relatively and absolutely more difficult for developing countries to reach. OECD countries have a role to play in assisting developing countries in attaining the presently set goals of sustainable development.

Some have feared that recognition of the benefits of FDI might lead to a race to the bottom in environmental and social standards in order to attract more FDI. These concerns have in general proven to be unfounded – though on the other hand, there are no signs of a 'race to the top' either. At the same time, economic growth has increased pressure on the environment through scale effects, which can only partly be offset through more efficient use of resources, for example, due to

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better technology. MNEs however have generally preferred to reap the scale benefits of standardisation in environmental, health and safety management systems in their foreign affiliates rather than exploiting weaknesses in local legislation.

MNEs are the main vehicles of FDI, and their behaviour and strategies are crucial in attaining sustainable development. Within the OECD, several instruments – among which the OECD Guidelines for Multinational Enterprises – provide a benchmark to stimulate corporate behaviour more in line with the goals of sustainability. Firms are also responding to pressure from the public-at-large and civil society. The largest MNEs are increasingly committing themselves to voluntary principles and standards of corporate social responsibility, thereby, contributing to sustainable development.

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Notes

1. The ratio of foreign direct investment inward stock to GDP is around 20 percent for countries like Colombia and Venezuela, while Chile (40%), Malaysia (67.0%) and Singapore (85.8%) illustrate this point even more, especially when compared to the world average of 14 percent (UNCTAD, 1999).
2. This difficulty arises due to several problems in the measurement of FDI statistics. For example, not all M&As qualify as FDI (UNCTAD, 2000).
3. This includes all 30 OECD Member countries, as well as Argentina, Brazil, and Chile. The OECD encourages non-Members to adhere to this Declaration, which includes the Guidelines for Multinational Enterprises.
4. Consisting of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.
5. Consisting of Brazil, Argentina, Paraguay and Uruguay.
6. The Southern African Development Community comprises 14 countries consisting of Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Tanzania, Zambia, Zimbabwe, and Swaziland.
7. The available empirical evidence suggest that privatisation has had a positive effect on the profitability and performance of privatised industries, and that liberalisation has been beneficial for efficiency and consumer welfare in reforming countries.
8. For example, the OECD Principles of Corporate Governance advocate the equitable treatment of shareholders, including foreign shareholders.
9. The wages paid in the manufacturing industry by foreign affiliates of MNEs reflect the higher labour productivity and are higher than those paid by national firms (OECD, 1998).
10. See World Bank (2000). Low-income countries are defined as those countries with a GDP per capita in 1999 of less than US $755.
11. For example, see Mabey and McNally (1999), Oman (1999) and Nordstrom and Vaughan (1999).
12. See Sachs and Warner (1995). A critical review of this study is provided in Rodriguez and Rodrik (1999).

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