foreign direct investment: A lead driver for sustainable development?

“Trade and investment are only a means to an end not an end in themselves” (Sims & Lake, 2000)

The most Heavily Indebted Poor Countries and low income countries of the world remain largely dependent on bilateral and multilateral aid for their development strategies. However, since 1990 total Overseas Development Assistance (ODA) has dropped by more than half. Much greater importance is now being placed on alternative sources of capital to finance national development (ECOSOC 2000) and Foreign Direct Investment (FDI)\(^1\) is now the largest source of foreign private capital reaching developing countries (Figure 1). Global flows of FDI have grown phenomenally over the last ten years. Total inflows rose by nearly four times, from US $174 billion in 1992 to US$ 644 billion in 1998. However, total flows to developing economies fell between 1997 and 1998 (UNCTAD 1999). Regionally, prospects look least good for Africa (Table 1.). Of the middle to low income countries, Asia has experienced the fastest rate of growth in FDI but also the greatest volatility (World Bank 1999).

The Secretary General’s report “Financial Resources and Mechanisms” to the eighth UN Commission on Sustainable Development indicates increased international dialogue about whether FDI is a significant source of development finance. For all its potential, there is far greater awareness of the complex nature of FDI and the possible negative impacts of rapid and large growth for least developed countries. A crucial question is how FDI might be better applied to support more sustainable forms of development, particularly in those countries with burgeoning debts and widening income disparity to the rest of the world. This briefing paper seeks to review some of the pros and cons of FDI, to broadly consider possible roles and responsibilities of institutions in order to utilise FDI in a more effective manner and suggest some key questions that will need to be faced.

The pros and cons of FDI as a source of development

Attraction of FDI is becoming increasingly important for developing countries. However this is often based on the implicit assumption that greater inflows of FDI will bring certain benefits to the country’s economy. FDI, like ODA or any other flow of capital, is simply that, a source of capital. However the impact of FDI is dependant on what form it takes.
This includes the type of FDI, sector, scale, duration and location of business and secondary effects. A refocusing of perspective, from merely enhancing the availability of FDI, to the better application of FDI for sustainable objectives is crucial to push the debate forward. Various international fora and discussion have outlined a range of positive and negative aspects of FDI as a source of development for developing countries, some of which are discussed below.
1. Stimulation of national economy

FDI is thought to bring certain benefits to national economies. It can contribute to Gross Domestic Product (GDP), Gross Fixed Capital Formation (total investment in a host economy) and balance of payments. There have been empirical studies indicating a positive link between higher GDP and FDI inflows (OECD a.), however the link does not hold for all regions, e.g. over the last ten years FDI has increased in Central Europe whilst GDP has dropped. FDI can also contribute toward debt servicing repayments, stimulate export markets and produce foreign exchange revenue. Subsidiaries of Trans-National Corporations (TNCs), which bring the vast portion of FDI, are estimated to produce around a third of total global exports. However, levels of FDI do not necessarily give any indication of the domestic gain (UNCTAD 1999). Corporate strategies e.g. protective tariffs and transfer pricing can reduce the level of corporate tax received by host governments. Also, importation of intermediate goods, management fees, royalties, profit repatriation, capital flight and interest repayments on loans can limit the economic gain to host economy. Therefore the impact of FDI will largely depend on the conditions of the host economy, e.g. the level of domestic investment/savings, the mode of entry (merger & acquisitions or Greenfield (new) investments) and the sector involved, as well as a country’s ability to regulate foreign investment (UNCTAD 1999).

2. Stability of FDI

FDI inflows can be less affected by change in national exchange rates as compared to other private sources (portfolio investments or loans). This is partly because currency devaluation means a drop in the relative cost of production and assets (capital, goods and services) for foreign companies and thereby increases the relative attraction of a “host” country. FDI can stimulate product diversification through investments into new businesses, so reducing market reliance on a limited number of sectors/products (UNCTAD 1999). However, if international flows of trade and investment fall globally and for lengthy periods, then stability is less certain. New inflows of FDI are especially affected by these global trends, because it is harder for a foreign company to de-invest or reverse from foreign affiliates as compared to portfolio investment. Companies are therefore more likely to be careful to ensure they will accrue benefits before making any new investments. Examples of regional stability are mixed, whilst FDI growth continued in some Asian countries e.g. Korea and Thailand, during the 1996/97 crisis, it fell in others e.g. Indonesia. During Latin America’s financial crisis in the 80’s many Latin American countries experienced a sharp fall in FDI (UNGA 1999), suggesting that investment sensitivity varies according to a country’s particular circumstances.

3. Social development

FDI, where it generates and expands businesses, can help stimulate employment, raise wages and replace declining market sectors. However, the benefits may only be felt by small portion of the population, e.g. where employment and training is given to more educated, typically wealthy elites or there is an urban emphasis, wage differentials (or dual economies) between income groups will be exacerbated (OECD a). Cultural and social impacts may occur with investment directed at non-traditional goods. For example, if financial resources are diverted away from food and subsistence production towards more sophisticated products and encouraging a culture of consumerism can also have negative environmental impacts. Within local economies, small scale and rural businesses of FDI host countries there is less capacity to attract foreign investment and bank credit/loans, and as a result certain domestic businesses may either be forced out of business or to use more informal sources of finance (ECOSOC 2000).

4. Infrastructure development and technology transfer

Parent companies can support their foreign subsidiaries by ensuring adequate human resources and infrastructure are in place. In particular “Greenfield” investments into new business sectors can stimulate new infrastructure development and technologies to host economies. These developments can also result in social and environmental benefits, but only where they “spill over” into host communities and businesses (ECOSOC 2000). Investment in research & development (R&D) from parent companies can stimulate innovation in production and processing techniques in the host country. However, this assumes that in-house investment (in R&D, production, management, personnel training) will result in improvements. Foreign technology/organisational techniques may actually be inappropriate to local needs, capital intensive and have a negative affect on local competitors, especially smaller business who are less able to make equivalent adaptions. Similarly external changes in suppliers, customers and other competing firms are not necessarily an improvement on the original domestic-based approaches (UNCTAD 1999).
5. “Crowding in” or “Crowding out”?

“Crowding in” occurs where FDI companies can stimulate growth in up/down stream domestic businesses within the national economies. Whilst “Crowding out” is a scenario where parent companies dominate local markets, stifling local competition and entrepreneurship. One reason for crowding out is “policy chilling” or “regulatory arbitrage” where government regulations, such as labour and environmental standards, are kept artificially low to attract foreign investors, this is because lower standards can reduce the short term operative costs for businesses in that country. Exclusive production concessions and preferential treatment to TNCs by host governments can both restrict other foreign investors and encourage oligopolistic (quasi-monopoly) market structure (ECOSOC 2000, UNCTAD 1999). Empirical data for these scenarios is variable, but crowding out is thought to be more common in specific sectors. For example, in industries where demand or supply for a product or service is highly price elastic (market sensitive) and capital intensive. Hence regulation brings additional costs of compliance and is therefore much more likely to influence a company’s decision to invest in that country (OECD b).

6. Scale and pace of investment

It may be difficult for some governments, particularly low income countries, to regulate and absorb rapid and large FDI inflows, with regard to regulating the negative impacts of large-scale production growth on social and environment factors (WWF 1999). Also a high proportion of FDI inflows in developing economies are commonly aimed at primary sectors, such as petroleum, mining, agriculture, paper-production, chemicals and utilities. Primary sectors are typically capital and resource intensive, with a greater threshold in economies of scale and therefore slower to produce positive economic “spill over” effects (OECD a). Thus, in the short term, low income economies will have less capacity to mitigate environmental damages or take protective measures, imposing greater remediation costs in the long term, as well as potentially irreversible environmental losses (WWF 1999, OECD b).

7. Skewed distribution

FDI inflows are still highly concentrated in certain countries and regions (Figure 2.). TNCs are the largest source of FDI (about 95% of total inflows) and the majority of these are based in industrialised countries. The vast proportion of FDI flows go to other developed countries, especially the “Triad” of USA, UK, Japan, but also countries such as Germany, France, Canada, Netherlands.

In 1998, 92% of total FDI outflows came from developed countries and 72% of the total inflows returned to these economies (UNCTAD 1999). Of the proportion that went to low-middle income countries, the highest percentage went to Asia and Latin America (42% and 38% respectively), 14% to Central Europe & East Asia, whilst only 6% was invested in Africa (World Bank 1999). Over half of the FDI that does reach developing countries is concentrated in 5 countries. This is also true transitional countries, for example in Eastern Europe 75% of FDI inflows is directed toward 5 countries (WTO 1999, OECD b., ECOSOC 2000).
How can FDI be better applied to Sustainable Development?

1. Accessibility and stability of FDI

If FDI is to take a greater role in building developing country economies, further assessment of the factors which influence and are influenced by FDI flows is necessary. Foreign companies are thought to be attracted to recipient countries for a whole range of factors, e.g. political stability, market potential & accessibility, repatriation of profits, infrastructure, ease of currency conversion. Privatisation and deregulation of markets are seen as central means to attract FDI, however this can leave the poorest or most indebted countries open to destabilising market speculation (ECOSOC 2000). National legislation can support better investment security for local markets, fair competition and corporate responsibility through defining equitable, secure, non-discriminatory, transparent investment practices (WSSD 1995, Habitat II 1996). Whilst there is concern that increased regulation could deter new foreign investors, there is evidence, such as in Eastern Europe, that tighter regulation of corporate, environmental and labour standards has not affected FDI growth (ECOSOC 2000).

Where low income and developing economies are successful in attracting FDI, they require considerable support to ensure that they can adapt to rapid and large inflows of FDI, and that these flows positively benefit domestic economic stability (WSSD 1995). This means developing strategies which encourage greater and longer term domestic investment and saving, as well as higher returns on investment capital. The development of an international multi-lateral rule-based trading and investment system has been advocated widely. However, whilst the abandoned Multilateral Agreement on Investment would have provided greater rights for companies and investors, it gave limited support for the social, economic and environmental concerns of host countries. Furthermore, regulation of investment is only as effective as a country’s ability to enforce it. The cost of implementation may be prohibitive for many countries, hence bilateral and multilateral support, along side multi-stakeholder participation, is vital for the formulation of such agreements (ECOSOC 2000, Habitat II 1996).

2. Socially Responsible Investment

Ethical and socially responsible FDI can be encouraged through national, bilateral and international investment guidelines and regulation e.g. consumer rights, information provision, commercial probity, labour standards and corporate culture (UNCTAD 1999). Several institutions have developed or are currently working on responsible practice. The ILO has 180 conventions referring to social responsibility and it also has more specific “Tripartite Declaration of Principles” (1977), concerning TNCs and social policy. UNCTAD has developed a “Code of Restrictive Business Practices”.

Eradication of poverty and reduction of gender inequality, where women make up nearly 70% of the world's poorest, should be prioritised. Whilst governments may seek FDI for labour intensive sectors, those sectors which require greater skills are likely to require investment in domestic training and education. Access to FDI for poorer communities and small to medium enterprises can be promoted by fostering credit/loans and capacity building programmes to improve their bargaining power (WCW 1995, WSSD 1995). Intellectual property right agreements between host countries and foreign investors can also be strengthened to ensure domestic technology transfer and skills development are better incorporated (UNCTAD 1999).

3. Environmental protection

Greater efforts need to be made to assess the linkages between environmental impacts and FDI, although it may be difficult to isolate FDI impacts from other activities. Authorities and businesses can apply Environmental Management Systems (EMS) to assess the potential impacts of FDI ventures, e.g. ISO 4001 which details techniques such as Life-Cycle-Analysis, Environmental Impact Assessments (EIA) and Environmental Audits. These all require investment in inspection, monitoring, regulation and enforcement to ensure effective implementation. The resources required to effectively adopt these approaches are often lacking in many developing countries, suggesting a vital need for targeted international assistance (UNCTAD 1999). Greater environmental commitment can also bring long term corporate gains e.g. greater efficiency and better quality of practice (OECD b).

Parent governments and businesses play a pivotal role in ensuring that the environmentally sustainable technology
filter out into host countries (UNCTAD 1999). In Agenda 21, WTO, GATT and TRIPS agreements governments are asked to take all practical steps to promote, facilitate and finance, as appropriate the transfer, diffusion, and access to environmental technology and know-how\(^3\). Looking at specific sectors, tourism has been identified as a key source of FDI. At CSD 7 member states were urged to develop policies which encourage tourism, attract FDI but also adopt environmentally appropriate practices (ECOSOC 1999). “Corporate environmentalism” has potential for considerable enhancement internationally. For example, in the energy sector, parent companies can support subsidiary use of renewable energy. This practice can provide a competitive advantage for businesses, especially where consumer / shareholder awareness of negative environmental impacts is strong (UNCTAD 1999).

Table 2. Examples of Key Institutional Roles and Responsibilities

<table>
<thead>
<tr>
<th>Institution</th>
<th>Examples of activities</th>
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<tr>
<td>Government</td>
<td>Governments should be committed to stimulate FDI in low income or heavily indebted countries. Developing and developed country partnerships can promote stable, predictable, non-discriminatory and transparent systems of investment and regulation. Governments can raise consumer/shareholder awareness of good FDI practices and have a vital role in influencing wider implementation of sustainable practice, fair competition and business standards. Host governments can encourage better investment strategies with incentives, e.g. business awards, premiums on export credit insurance, and regulatory mechanisms, as well as the implementation of international flows of FDI flows can be better directed toward the specific goals of sustainable development. Collectively, they need to ensure that finance, trade and investment strategies are mutually reinforcing toward sustainable ends. Critical areas which need to be addressed, include:</td>
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<td>NGOs &amp; civil society groups</td>
<td>NGOs can help address the linkages between FDI and environment, welfare, poverty and inequality, because of their direct experience “on-the-ground” e.g. micro-credit projects and consumer associations. They can contribute to the process of developing, implementation and monitoring of business performance, strategies and benchmarks. They can also inform consumers/shareholders and wider society about companies’ investment policies and standards.</td>
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<tr>
<td>Industry</td>
<td>Parent companies can support more sustainable forms of technology transfer and skill sharing in subsidiaries to encourage self regulation of FDI. Standards for good practice and codes of conduct can enhance corporate transparency and accountability, and encourage equivalent levels of good practice in both parent and host countries e.g. OECDs “Guidelines for Multinational Enterprises” which sets standards for MNEs. However, whilst useful, voluntary codes are subject to interpretation and free riders, therefore incentives are needed to back up good practice. Parent companies can provide frameworks to support subsidiaries developing strategies to implement, monitor and enforce standards of good practice, encouraging trans-national standards. Benchmarking of performance and independent monitors, using performance measures such as Sustainability Impact Assessments (broader than EIA), would also enhance the credibility of businesses codes.</td>
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<tr>
<td>International Institutions*</td>
<td>International development and finance institutions can mitigate some of the risks of investment for small to medium enterprises and developing economies seeking to attract and stabilise FDI flows, through equity loan finance and other insurance provisions to protect against currency transfer, expropriation of profits, and economic disturbances, such as war. Those countries failing to meet criteria for credit / loan programmes need assistance to link them with alternative sources of insurance to attract foreign investors e.g. bilateral aid, multilateral development banks. Other important roles include the assessment &amp; monitoring of FDI within developing countries, dissemination of information about global FDI trends and the impacts to technology and trade, finance, investment and economic growth, as well as raising international awareness of investment conditions of sidelined economies e.g. UNCTAD and ICC guidelines. They can assist the mainstreaming environment finance into financial markets, the development of innovative financial mechanisms, &amp; monitor/foster codes of conduct.</td>
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<tr>
<td>Labour Unions</td>
<td>Unions can help monitor and call employers to account where companies fail to meet core standards, regarding gender, age discrimination, working conditions. They can help develop guides to good practice e.g. International Confederation of Free Trade Unions has set out minimum labour standards and a Framework for Multinational Investment.</td>
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<tr>
<td>Local Authorities</td>
<td>They can undertake Sustainability Impact Assessments and regulate microeconomic and local conditions. This includes monitoring of benchmarks and business practice, voluntary guidelines, EMS and transfer of environmentally sound technology. Also authorities can support small to medium businesses to attract foreign investment e.g. through skills-based training programmes on marketing, performance assessment, management etc.</td>
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Sources: UCTAD, WB, OECD, NCSD, ECOSOC, UN, WWP


All these institutions need greater cooperation, coordination and more openly accountable processes to look at how international flows of FDI flows can be better directed toward the specific goals of sustainable development. Collectively, they need to ensure that finance, trade and investment strategies are mutually reinforcing toward sustainable ends. Critical areas which need to be addressed, include:

- Assessment of the linkages between finance and trade flows, ODA and private investment flows, as well as domestic finance;
• how to redress the imbalance between rich investing nations and poor recipients e.g. through independent arbitration of investment agreements;
• how institutions can prioritise socially and environmentally responsible FDI, whilst stimulating domestic economies;
• how and who will support developing countries to maximise the benefits of FDI (employment, income generation, technology transfer, debt servicing, economic stability) whilst minimising the negative elements (monopolistic TNCs, transfer pricing, social/cultural intrusion, environmental degradation)
• Increasing support (funds, human resources) for monitoring the impacts and progress of macroeconomic policies which are aimed at enhancing the positive impact of FDI in developing countries (NCS 2000).

In relation to monitoring FDI, there is also a need to further develop and apply sustainability indicators to better assess the impacts of FDI for different regions and sectors (Table 3).

Table 3. Examples of Indicators for FDI and Sustainability

<table>
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<tr>
<th>Type</th>
<th>Example of indicator</th>
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<tbody>
<tr>
<td>Economic Investment and Productivity</td>
<td>Net Foreign Direct Investment (FDI); Net Foreign Direct Investment (FDI) as % of GDP and of GFCP; Net change in foreign investment between the reporting country and the rest of the world; Net resource transfer. Ratio of aggregate Net Resource Transfers (long-term) to GNP (%). R &amp; D expenditure from FDI in local economy. % of FDI into Greenfield investments.</td>
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<tr>
<td>Other financial factors</td>
<td>Ratio of Total Official Development Assistance (ODA) given or received to Gross National Product (GNP) from Bilateral and multilateral sources. Ratio of total external debt to GNP (%). Ratio of total debt service to exports of goods and services, including worker's remittances %. Per capita domestic saving and investment.</td>
</tr>
<tr>
<td>Social Labour standards and employment</td>
<td>Adoption of ILO labour standards and indicators. % employment in host economy created (directly/indirectly) by FDI.</td>
</tr>
<tr>
<td>Social Education</td>
<td>Enrolment ratios by level of education, public/private expenditure on education/training, expected number of years of formal schooling</td>
</tr>
<tr>
<td>Environmental Best Practice</td>
<td>Adoption of environmental management systems, environmental reporting, energy efficiency. Green accounting e.g. “green” net national product (green NNP), genuine savings etc.</td>
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<tr>
<td>Environmental Protection</td>
<td>% of FDI into environmentally sensitive sectors. Ratio of environmental protection expenditures to Gross Domestic Product (GDP) %. Degree of implementation of Multi-lateral Environmental agreements.</td>
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</table>

Sources: World Bank a., World Bank b., UNCED, WWF

The question that remains to be answered is whether FDI can be better targeted toward the advancement of developing and heavily indebted countries, whilst ensuring the global security of coming generations. The General Assembly Special Session “Financing for Development” (FfD) in 2001 will consider how to mobilise domestic resources, international private financial flows, international financial cooperation, trade, debt, new financial mechanisms and governance, in the context of increasing globalisation. During CSD 8 many of the elements of the FfD process were set as priority areas for future activities. The CSD called for international cooperation over capital flight and profit repatriation, integration of environmental priorities into public policy and programmes, as well as the use of economic instruments and incentives to support long term private investment. The FfD meeting is therefore a crucial opportunity to take a closer look at institutional processes and the linkages between FDI, trade and financial mechanisms, so that all of these can be better targeted toward meeting sustainable development targets. The tenth CSD in 2002 is likely to provide a good opportunity to review the outcomes of these discussions and their implications. In this way the Earth Summit, later the same year, will serve as a platform for specific and coordinated international, regional and local programmes and initiatives geared toward making FDI a positive driver for a more sustainable future.
Footnotes

1. FDI: long term investment of a “parent” enterprise from “home” economy into a subsidiary, affiliate, or branch enterprise in a foreign “host” economy. FDI flows include assets, property (e.g. parent company technology, branding, skills) &/or capital investment (greater than 10% of total shares in a company), reinvested earnings (retained profits in an affiliate, or intra company loan/debt transaction (long term borrowing/lending) between firm and affiliate enterprises. FDI stocks are the value of capital and reserves (including retained profit) attributable to a parent enterprise. Other types of foreign investment: portfolio investment (shareholder investment in less than 10% of a company’s capital) and bonds/loans are obtained from foreign banks. N.B. data is missing for certain countries and sectors (UNCTAD 1999)

2. Relevant ILO articles include: forced labour (articles 29 and 10), right to freedom of association and collective action (87 and 98), discrimination (111, 100), minimum age (138), minimum wage (131), working environment (148).

3. See articles: 4.5 in Agenda 21, 67 in WTO and 4 in GATT.

4. In May 2000 the first substantive session in a series of PrepComms and regional meetings was held for the high level FiD meeting in 2001. It involves IMF, UNCTAD, WB, WTO, other regional bodies, development banks, NGOs and industry.

References and Links

ECOSOC (1999) Report on the seventh session, decision 7/3 Tourism and Sustainable development
Habitat II (1996) Istanbul, Section IV, Global Plan of Action
ICC/UNCTAD Investment Guides for Africa www.ipnet/unctad/investment
UNCED (1992) Agenda 21: The UN Programme of Action from Rio. Earth Summit’ 92 ch. 31
UNGA (1999) The financial Crisis and its impact on growth and development, especially in developing countries. Report of the Secretary General. Agenda item 97 (b)
WCW (1995) World Conference on Women, Beijing, Ch.1 A
WCW (1995) World Conference on Women, Ch.1 A, Beijing, 1995
Key Organisations

International Monetary Fund (IMF) 700 19th Street NW, Washington DC, 20431 USA Tel/Fax: +1 202 6237000/4661 [http://www.imf.org](http://www.imf.org)

Organisation for Economic Co-operation and Development (OECD), 2, rue André-Pascal, 75775 Paris Cedex 16, FRANCE Tel: +33 (0)1.45.24.82.00 [http://www.oecd.org](http://www.oecd.org)

UN Commission for Sustainable Development (UN CSD) UN Division for Sustainable Development (UNSD) New York NY 10017 USA Tel/Fax: 2129633170 [http://www.un.org/esa/sustdev](http://www.un.org/esa/sustdev)


Finance for Development, Development Policy Analysis Division, Department of Economic & Social Affairs, UN, Room DC 22162, New York, USA, Tel: +1212 9634690 [http://www.un.org/esa/analysis/ffd](http://www.un.org/esa/analysis/ffd)

United Nations Industrial Development Organization (UNIDO) Vienna International Centre P.O. Box 300, A-1400 Vienna, Austria Tel/Fax: +43 1 26026 / 92669 Internet address: [http://www.unido.org](http://www.unido.org)


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