Foreign Direct Investment: Boon or Bane for the Environment?

Bradford S. Gentry

Foreign direct investment (FDI) can be a significant driving force for sustainable environmental management in developing countries. Its environmental effects depend on the investor, the sector, and the country context, especially the policy and regulatory framework. Many multinational firms are concerned about their reputation, prefer regulatory stability and predictability, and have incentives for efficient production—which often means cleaner production. The longer-term nature of FDI and the potential congruence of investors’ and host countries’ interests can offer opportunities for many environmental benefits from this form of investment.

Most governments in developing countries are unable to support their development needs without some kind of external investment. Today, the main options for external financing are private investment—foreign direct investment (FDI), commercial bank loans, and portfolio investment—and official development assistance (ODA). ODA has been stagnant, although it remains important for many countries, especially those that have not been able to attract much private investment. Meanwhile, private investment, including FDI, has climbed sharply. Between 1990 and 1997, international private investment in developing countries grew from less than US$50 billion to about US$300 billion (Figure 1). Even with the decline following the 1997 financial crises, private flows are still more than four times ODA.

Figure 1 — External financing flows to developing countries, 1990–99

A “Race to the Bottom”? Not Really

Many government officials in developing countries—particularly in the finance and investment promotion ministries—believe that environmental requirements will drive private investors to competing countries with less stringent regulations. Environmental advocates fear that governments may engage in a “race to the bottom” by lowering their environmental standards and that multinational investors may seek out “pollution havens.”

In reality, there is little evidence for pollution havens. Because of the longer-term perspective of foreign direct investors, what the great majority of them value above all is predictability. They are likely to consider the lack of clear environmental standards, or their inconsistent application, as an increased risk, not an inducement. Most choose their investment locations for such reasons as market size, growth potential, and access to labor or natural resources. And, even in the absence of effective national environmental programs, many companies operating in the global marketplace still face pressures to improve their environmental performance.

As a result, governments have more room than they think for integrating environmental factors into their investment promotion efforts—to the benefit of all parties. For example, some privatizations have been delayed because environmental issues were not addressed (as happened with Peru’s Centromin mining operation), and others, such as that of the AHMSA steel company in Mexico, became more valuable when environmental concerns were addressed (Gentry 1998, Lovei 1999).

FDI and the Environment

Longer-term perspective. While other forms of foreign investment are also an important part of a country’s financing mix, what makes FDI particularly advantageous for developing countries—from both economic and environmental points of view—is its relatively long horizons and its stability. Given the longer-term perspectives of foreign direct investors and their focus on market growth, their goals for a country’s development are likely to be close to those of the host government. Transfer of knowledge and technology may well accompany FDI, and hosting the operations of multinational firms may help a developing country gain access to wider markets.

Leverage. Of all the forms of international private investment, FDI has the most direct relationship to the environment (Gentry 1998). It often goes into environmentally sensitive sectors such as resource extraction, infrastructure, and manufacturing operations. Foreign investors accordingly often come under pressure to take environmental issues into account when making investment decisions. The opportunities for leverage over the environmental aspects of private investment decisions are therefore greater with FDI than with other forms of investment, which are typically short term or are not intimately tied to specific operations. Using this leverage requires an understanding of the relationship between environmental issues and the business decisions of foreign investors, as discussed next.

Commercial opportunities. Private firms have many reasons for improving their environmental performance, including: reducing costs by minimizing waste; avoiding penalties and pollution charges; increasing revenues by selling “green” products; and safeguarding their reputations as responsible corporate citizens. A recent review of cases in Latin America in which FDI led to improved environmental performance—even when local enforcement was lacking—identified five key sources of commercial advantage for investors (Gentry 1998):

- Improved access to export markets, through, for example, the adoption of internationally recognized environmental management systems or the use of product “ecolabels”
- Increased productivity through more efficient use of raw materials and other inputs
- Preservation of a “social license” to operate in a context of local and international pressure from neighbors, environmental nongovernmental organizations (NGOs), media, shareholders, and customers
- Access to finance, given that international financiers increasingly require attention to environmental risks and, in some cases (as with World Bank Group loans), companies’ adherence to supranational environmental guidelines
- New revenues from participation in “environmental” investments in water systems, cleaner energy, and other projects.

Whether and how a particular firm chooses to act on or ignore these incentives depends on the internal and external conditions and cultures in which it operates. Customers, shareholders, competitors, governments, and environmental organizations all play critical roles in defining the environmental aspects of that external culture.

Using FDI as a Vehicle for Improving Environmental Performance

International private capital flows are an essential element in financing a sustainable future. The question is how to harness the power of private capital to the goal of sustainability. FDI provides a vehicle for helping governments
and others to move in that direction. Some of the opportunities for doing so are described below.

**Effective investment and environmental regulatory frameworks.** Investors seek to increase their profits by applying their investment capital as efficiently as possible to minimize risks and increase returns. Countries' efforts to increase external investment and maximize its environmental benefits must take into account the reasons why foreign direct investors choose particular locations and what leads them to improve their environmental performance. Such efforts must reflect the particular society's broadly defined goals for economic development and environmental protection. Two key aspects of the regulatory framework are critical for many of the most desirable foreign direct investors:

- Reliable business and investment conditions, including clear property rights, price and tax policies, a corporate law system, and dissemination of information
- Predictable and fair environmental regulations and enforcement.

*Market incentives and information.* The stimulation of demand for environmentally responsible goods and services can generate new investment opportunities and expand domestic markets. Some of the tools for increasing the demand for such goods and services are related to the regulatory framework—for example, product restrictions, resource pricing, and product information. Others include changing basic consumer preferences through information and education, as well as developing supply chains for meeting existing, unmet demands.

In countries without strong environmental management systems, foreign direct investors can help improve the environmental performance of local firms in several ways. They can bring environmental concerns into the local business equation, involving not just their partners but also their local suppliers and competitors (Box 1). They can provide training for local firms and help them build capacity. And they may be able to put pressure on host country governments to implement existing environmental programs more consistently and predictably and to apply the rules to all enterprises, including local firms.

Foreign direct investors may also have an influence on other international investors by increasing the information available on the links between investment and the environment:

- Many foreign direct investors use the “due diligence” process to gather information on the environmental risks and opportunities facing potential investments in order to determine how best to address them. This search for environmental information can strengthen host country capacity to carry out environmental assessments and audits and to prepare environmental management plans, through the development of local consultancy firms and technical expertise. Investors’ interest in environmental information can also encourage regulators to seek such information in preparation for privatization and infrastructure transactions. The information is then available to other private international investors.
- An increasing number of companies, including many involved in FDI, are taking a new approach toward informing portfolio investors about environmental matters and are moving away from a narrow focus on the commercial risks posed by environmental factors. These firms now believe that attention to environmental issues can increase their competitive advantage, as well as shareholder value. Since the companies themselves are the primary sources of information for financial analysts evaluating possible investments, their efforts are likely to lead an increasing number of mainstream portfolio investors to consider environmental factors (Fernandez and Gentry 1997).

*Public-private collaboration.* Increased reliance on private investment changes but does not reduce the role of the government. Instead of running manufacturing and infrastructure operations, the government becomes an enabler and overseer, establishing the legal and regulatory framework, monitoring environmental performance, enforcing regulations, and taking action to correct market failures.

It is in the area of government regulatory activity that the interests of private investors and the environmental community begin to converge. Both want clear, predictable, transparent regulatory frameworks, consistently applied. Both want to see foreign aid used to build host countries’ capacity

---

**Box 1. Lessons from Guadalajara**

A recent Bank-supported experiment in Guadalajara, Mexico tested whether SMEs could successfully adopt environmental management systems. Eleven large companies, many of them multinationals, agreed to provide assistance to 22 small- and medium-scale suppliers who were interested in improving their environmental performance. The project, which enlisted the private sector, local academic institutions, the Mexican Government, and the World Bank, entailed several two-month cycles of intensive training, implementation, and review sessions. On a 20-point scale, the average score of EMS adoption increased between 1998 and 1999 from 0 to around 16 points for environmental planning and to 11 points for EMS implementation. About 80 percent of the plants reported lower pollution, and nearly 50 percent reported improved compliance and waste handling. Many also reported improved work environments, more efficient use of materials, and better overall economic performance. The Guadalajara project showed that SMEs can successfully adopt EMS with assistance.

to adopt and maintain such frameworks. Increasingly, it is in the interest of each that environmental considerations be integrated into national investment frameworks.

Parties that have traditionally been adversaries—businesses, governments, and NGOs—are finding, more and more, that they cannot meet their core goals by acting alone. Businesses need basic market rules, which are laid down and implemented by governments. Governments need investments in socially beneficial projects, and environmental NGOs need access to additional resources and know-how to improve or protect the natural resource base.

FDI provides unique opportunities for collaboration on priority environmental issues. Interested multinational enterprises can offer useful financial and technical resources. Their involvement may be motivated by business goals consistent with improved environmental performance, as discussed above.

Any such collaboration is complementary to, not a substitute for, a basic regulatory framework. Even where the private sector provides many traditionally public services, it does so within an enabling and oversight framework established and maintained by governments. Collaboration can, however, help define the scope of the necessary requirements and ease their adoption and implementation.

"Booners" and "Baners"

AGENDAS FOR ACTION

To capture the opportunities for using FDI as a vehicle to improve environmental performance, action is required by two camps that are often in conflict—skeptics of and advocates for FDI. Skeptics ("Baners") can work to ensure that environmental factors are effectively incorporated into basic regulatory and market frameworks for private investment. Advocates ("Booners") can both push regulatory structures that encourage private investment, and pursue partnership opportunities. They need not agree on whether FDI is good or bad for the environment. The interplay of their differing, yet complementary, views is the most effective way to capture FDI's potential for contributing to a more sustainable future.

Notes

Bradford S. Gentry is a lecturer at the Yale School of Forestry and Environmental Studies and Director of the Research Program on Private Finance and the Environment. This note summarizes a longer report on the same topic prepared for the Organisation for Economic Co-operation and Development (OECD) and available at http://www.oecd.org/da/evn/index.htm. The author and the World Bank thank the OECD for allowing the earlier work to be used as the basis for this note.

References


