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FOREIGN DIRECT INVESTMENT AND THE ENVIRONMENT: BOON OR BANE?

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This paper has been prepared by Mr Bradford Gentry, Yale Centre for Environmental Law and Policy, USA. It will be presented in the opening plenary session of the Conference.

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Plenary Session 1: Context and key issues

FOREIGN DIRECT INVESTMENT AND THE ENVIRONMENT: BOON OR BANE?

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1. Overview

1. "Foreign direct investment ("FDI")[1] and the environment" -- a phrase that has traditionally evoked one of two, opposite reactions:

- FDI is a bane of environmental protection – given its direct use of land and other natural resources, as well as the increased consumption it encourages; or

- FDI is a boon for environmental protection – given the new resources it brings for improving efficiency, transferring knowledge and addressing existing pollution.

2. The resulting conflicts have fed the search for evidence to support each view: multinational enterprises ("MNEs") relocating resource intensive operations to countries with less stringent requirements versus foreign investors cleaning up existing production facilities.

3. FDI is neither a boon nor a bane for the environment – it is both. Because of the huge differences among the locations, sectors and investors involved in FDI, examples can be found to support both positions.

4. The fact that FDI is both a boon and a bane is not a problem – rather, it creates a tremendous opportunity to use FDI as a vehicle for bringing more private investment to the goal of sustainable development. FDI promotes basic economic goals: stability, growth, knowledge transfer. It has the demonstrated potential to promote basic environmental goals: increased awareness of environmental factors, increased efficiency of resource use, new resources to address existing environmental problems. It is the largest investment category most directly affected by environmental considerations. Success with FDI can also be used to pull other types of private investment onto a more sustainable path. While integrating these financial and environmental goals will not complete our journey to sustainable development – important social issues remain to be addressed -- they are critical parts of progress in that direction.

5. FDI's potential will only be realised, however, if both sides of the traditional debate – "baners" and "booners" – are actively involved. For baners, the primary focus should not be on proving that FDI is bad for the environment, but on meeting the need for predictable, transparent and effective regulatory

1 The OECD defines FDI as "capital invested for the purpose of acquiring a lasting interest in an enterprise and of exerting a degree of influence on that enterprise's operations" (OECD, 1998a).

frameworks – in both the investment and environmental arenas. For booners, the primary focus should not be on proving that FDI is good for the environment, but on expanding the collaborations among traditionally warring parties to create new opportunities for environmental investments.

6. Only by working from both perspectives will the risks of either extreme be avoided and the potential benefits optimised. All of the parties traditionally interested in FDI and the environment – host country governments, source country governments, multilateral organisations, multinational companies, environmental NGOs, financial institutions and individual consumers – have key roles to play in this effort.

7. This paper offers some thoughts for discussion on ways to capture the opportunity presented by FDI. It builds on the excellent work done by the OECD over the past several years on FDI and the environment, as well as the background papers prepared for this conference. It has four parts:

- An update on trends in FDI and its links with the environment;
- A framework for using FDI as a vehicle for applying more private investment to the goal of sustainable development;
- Suggested areas of work for key actors; and
- Issues requiring further consideration.

2. Update on trends in FDI and its links with the environment

8. The OECD has prepared comprehensive summaries of recent trends in both FDI (OECD 1998a) and its links to the environment (OECD 1997). The purposes of this section are to provide some additional data and to highlight important characteristics of the FDI/environment relationship.

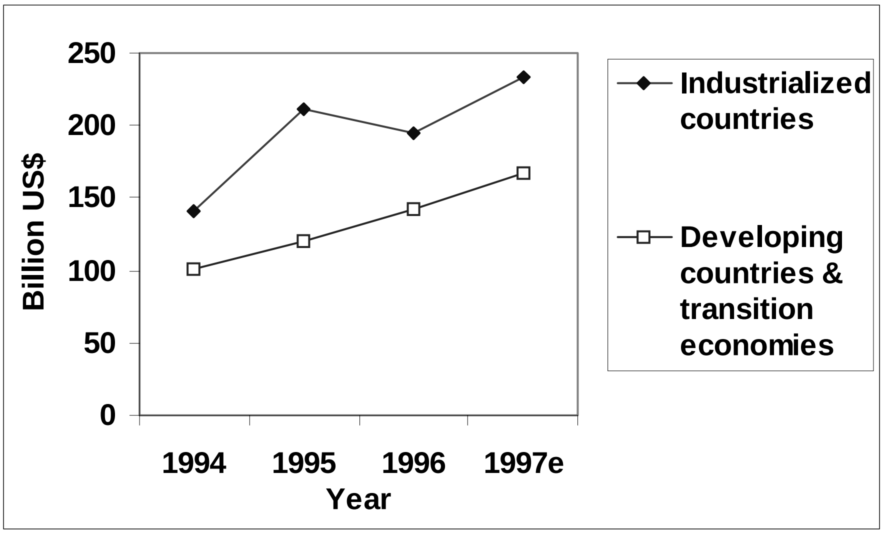
Trends in FDI

9. Amounts: Global FDI continues to expand. According to the United Nations, 1997 was the seventh consecutive year of record FDI inflows, rising 19% to US$400 billion (UNCTAD, 1998).

10. Growth in global FDI appears to have continued in 1998, spurred by a 50% increase in the already record levels of mergers and acquisitions. According to Securities Data Company, the value of cross-border mergers and acquisitions increased from approximately US$ 400 billion in 1997 to approximately US$ 600 billion in 1998 (The Economist, 1999). The total value of mergers and acquisitions world-wide in 1998 topped US$ 2.4 trillion.

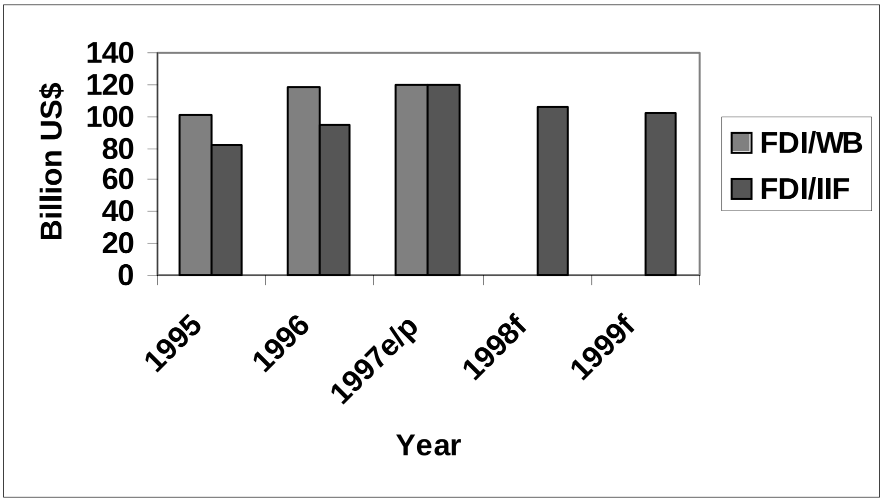
11. Locations: Most FDI continues to go to industrialised countries (Figure 1), while the overall rates of growth in flows to developing countries appear to be slowing (Figure 2).

Figure 1: **Total FDI Inflows 1994 – 1997**



Source: UNCTAD, 1998.

Figure 2: **Net Flows of FDI to Developing Countries 1995 – 1999**



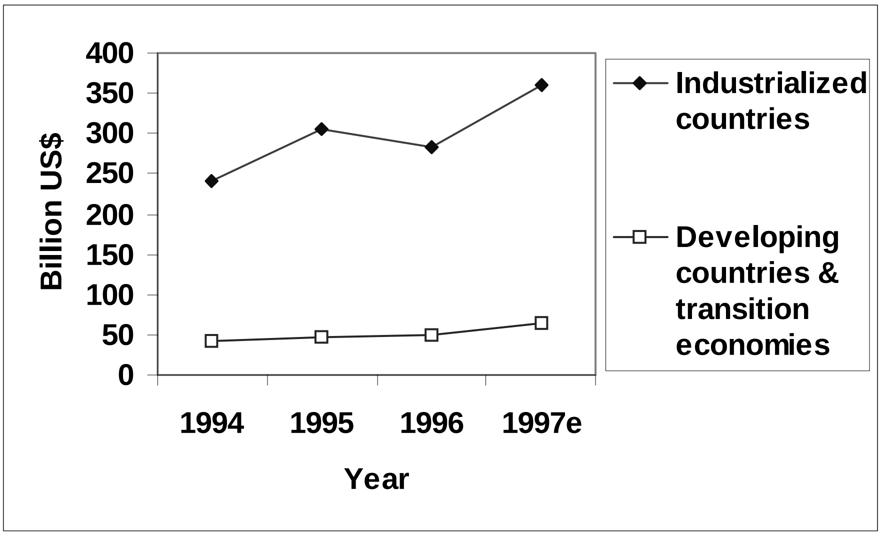
Sources: World Bank ("WB"), 1998; Institute of International Finance ("IIF"), 1998.
Notes: World Bank data for 1997 is preliminary. IIF data for 1997 is an estimate, while that for 1998 and 1999 is a forecast.

12. The actual rates of change in FDI flows vary from country to country, however. For example, 1998 was a record year for FDI in Thailand (Nation, 1999), while Indonesia is likely to face continuing reductions in FDI (Jakarta Post, 1998). China had to revise upward its estimates for 1998 – to record levels (Lu, 1998).

13. FDI flows also remain geographically concentrated. The top 10 developing country recipients of FDI received 72% of the flows in 1997, down only slightly from 76% in 1994 (World Bank, 1998a). For 1999, one survey of corporate executives (A.T. Kearney, 1998) found that the most likely destinations for FDI are the United States, Brazil, China, the United Kingdom, Germany, and Poland, closely followed by Mexico, France and Spain.

14. <u>Sources</u>: Most FDI continues to come from industrialised countries.

Figure 3: **Total FDI Outflows 1994 – 1997**

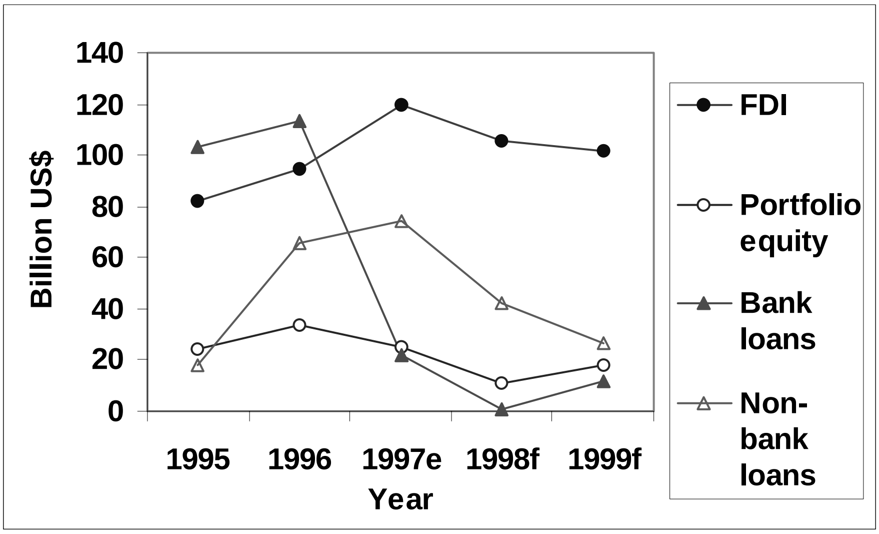


Source: UNCTAD, 1998.

15. At the same time, the number of foreign direct investors based in developing countries continues to grow. A significant number of these MNEs are small and medium-sized companies. Their presence challenges traditional theories that only large companies can engage in FDI and only when they have a competitive advantage to exploit. In fact, some commentators now suggest that FDI can help a company overcome competitive disadvantages through access to external resources (Chen and Chen, 1998).

16. <u>Relative stability</u>: Even during the financial crises of 1997/1998, FDI remained the most stable form of international private investment in developing countries.

Figure 4: **Net Private Flows to Developing Countries 1995 – 1999**



Source: IIF, 1998.
Notes: Data for 1997 is an estimate, while that for 1998 and 1999 is a forecast.

17. According to UNCTAD (1998), the major reasons for this relative stability are FDI's:

- Longer-term profit horizons
- Longer-term assessment of market potential
- Lower susceptibility to "herd" behaviour because of the different investment motivations at work
- Difficulty of being pulled out of the country once invested

18. Choice of destination: MNEs choose the location for their FDI based on a number of different factors. According to a recent survey of top executives (A.T. Kearney, 1998), the most important considerations are:

- Market size
- Political stability
- GDP growth
- Regulatory environment
- Profit repatriation regime

19. The importance of political stability and the regulatory environment increased during 1998, presumably in response to the financial crises in Asia and Russia.

20. UNCTAD (1998) considers a mix of country and firm specific factors when analysing how MNEs choose the location for their FDI. At the firm level, they include the motive for the investment (market, resource or efficiency seeking), whether the investment is new or sequential, the size of the company and its business sector. At the host country level, the policy framework for FDI is the critical

factor, including stability, rules for business operations, protections for foreign investors, as well as tax and trade policies.

21. Two important points arise from these analyses:

- First, host country policy frameworks matter; and
- Second, environmental factors are rarely mentioned as locational determinants.

22. Taken together, these conclusions help lay the basis for integrating investment and environmental considerations in a country's development plan – as described below.

FDI's Links with the Environment

23. While FDI continues to grow, so too does our understanding of its different links to environmental factors. Without repeating the more complete treatments provided elsewhere (OECD 1997, Zarsky, 1998, Gentry, 1998a), this section highlights two aspects of the FDI/environment relationship.

24. <u>Varying environmental impacts</u>: Since FDI is not monolithic, neither is its impact on environmental performance.

25. Fortunately, our collective understanding of how the FDI/environment link can vary across locations, sectors and investors continues to expand. Some of the major distinctions include the following:

- *Locations*: (a) does the host country have a strong environmental regulatory framework in place (foreign direct investors in the US have contributed significant amounts to cleaning up contaminated sites owned by the companies they acquired); (b) is the investment in a new or an existing operation (improving the economic efficiency of existing operations can also reduce environmental loadings); or (c) is the investment in an urban or a rural setting (affecting the likelihood that sensitive sites are implicated);
- *Sectors*: (a) is it an environmental investment (such as in improving water systems); (b) is it in services, such as banking or telecommunications (with their less direct environmental implications); or (c) if it is in manufacturing or resource extraction, is it to establish a base for exports (potentially exposing the company to greater environmental pressures from customers); and
- *Investor*: what level of environmental pressure does the investor already face locally, globally and in its home country (affecting its willingness to consider and address environmental issues as part of its investment).

26. Such differences are important to both the design of integrated investment and environmental frameworks, as well as to the identification of areas of potential collaboration, as described below.

27. <u>Shared roots of environmental and financial crises</u>: Efforts to integrate investment and environmental policies are helped by the growing realisation that the environmental and financial crises in developing countries have shared roots and responses (Georgieva, 1998).

28. Predictable, transparent and effective regulatory structures are the common elements. In the environmental arena, if environmental requirements (broadly defined) do not lead firms to internalise the otherwise externalised environmental costs of their activities, there are few incentives not to pollute air, water and land. In the financial arena, if basic investor protections are not in place, along with other provisions addressing the special needs of foreign investors, private investment will not come.

29. The Asian financial crisis has led the private financial community to advocate regulatory reforms in host countries that resonate well with environmental advocates. For example, in his September 1998 letter to the World Bank and the International Monetary Fund, the Managing Director of IIF called for:

- “A soundly managed, well-regulated financial system;”
- “A legal framework that promotes fairness and reduces uncertainty;” and
- “Increased transparency.” (Dallara, 1998)

30. If similar steps were taken by host country governments to implement effective environmental regulatory frameworks – particularly those integrated with investment programs – tremendous progress could be made on many pressing environmental issues.

3. FDI as a vehicle for applying more private investment to the goal of sustainable development

31. The most useful response to this growing body of information, is to see FDI as the “thin end of the wedge” for capturing these integration opportunities in the move toward sustainable development. From a development perspective, FDI is viewed as the most desirable form of international private investment. From an environmental perspective, it has the most direct links to environmental factors. FDI also carries with it the potential to affect other investment flows, helping to pull them into a more integrated approach as well.

32. This section offers some points for discussion on ways FDI might be used to further this integration. Two words of caution are necessary, however. First, this paper only addresses the economic and environmental aspects of sustainable development as applied to FDI. Given the social and equity aspects of MNEs – good and bad – considerable amounts of work still need to be done to include this third element of the sustainable development concept. Second, FDI alone is not sufficient to bring us to a sustainable future. Other forms of private capital – from domestic savings to portfolio equities – must also be engaged, alongside public funds. For the reasons below, FDI provides a ready starting point for our efforts at integration.

More private investment is needed for sustainable development

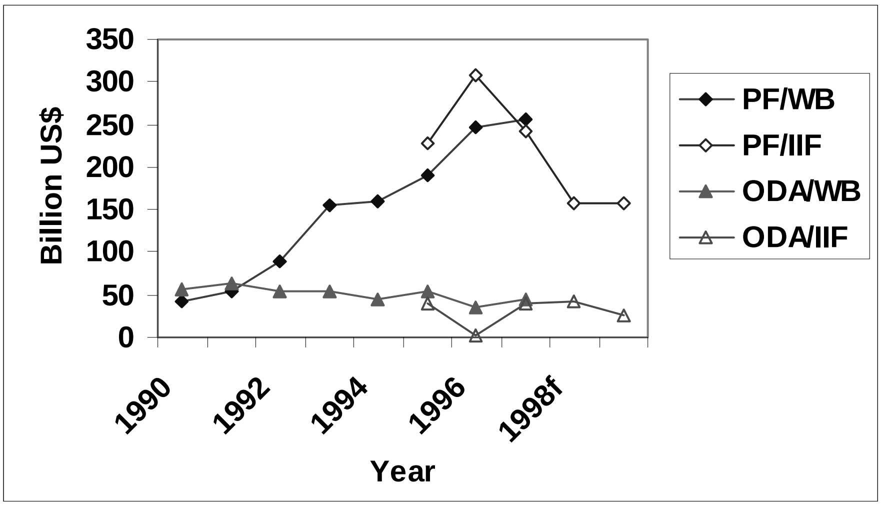
33. Agenda 21, adopted at the 1992 Earth Summit, estimates that US$ 600 billion is needed each year between 1993 and 2000 to put developing countries on a path to sustainable development (UNCED, 1992). Since then, estimates of the new investment needed by developing countries have continued to rise.

34. Most of the funding for meeting these needs in any particular country will have to come from its own public and private resources. Unfortunately, in many developing countries, domestic resources are insufficient to meet even basic needs. As a result, the poorest countries have had to rely on transfers of foreign capital to meet a portion of these goals. Agenda 21 anticipated that, of the US$ 600 billion required each year, approximately US$125 billion would come from foreign sources (UNCED, 1992).

35. The expectation was that most of these "new and additional" resources would come in the form of "Official Development Assistance" ("ODA"). Those hopes have not been met, however. Since 1993, ODA levels have declined by almost 25% (UN, 1998b).

36. During the same period, total global flows of private capital doubled and, as shown in Figure 5, private investment in developing countries exploded. Even with the current global financial crisis, the IIF estimates that net private flows to developing countries will remain over four times larger than official flows in 1998 and 1999.

Figure 5: **Private Flows ("PF") To Developing Countries vs. ODA 1990 through 1999**



Sources: World Bank ("WB"), 1998; IIF, 1998.
Notes: World Bank data for 1997 is preliminary. IIF data for 1997 is an estimate, while that for 1998 and 1999 is a forecast.

37. The shift from foreign aid to private investment is a good thing. Governments cannot achieve sustainable development acting alone. They certainly cannot create or provide all or even a majority of a nation's wealth. Rather, as discussed below, their role should be to set and oversee the frameworks for private economic activity -- including environmental considerations.

38. The shift does not, however, decrease the importance of foreign aid, effectively applied. Many developing countries have been left out of this surge in private capital flows. Between 1990 and 1997, nearly 80% of the private investment in the developing world went to three regions (Asia, Latin America and Central Europe) and twelve countries (Argentina, Brazil, China, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Russia, Thailand and Turkey)(World Bank, 1998a). While these countries represent a

large percentage of the world’s total population, and several have great stores of biodiversity, they are only a few in number. Other developing nations struggle to increase their share of private flows. Those that are not successful -- particularly in sub-Saharan Africa or parts of South Asia -- are in serious danger of being left further and further behind. To the extent foreign aid can help more of the developing world tap into global flows of private capital -- and weather the storms therein -- it is an appropriate and important use of taxpayers’ money.

39. As a result, both in theory and in practice, international private capital flows are an essential part of financing a sustainable future. In theory, because most countries have chosen a market economy. In practice, because domestic capital and ODA are insufficient to meet the needs of many developing nations. The question then becomes how to harness the power of private capital to the end of sustainable development.

FDI is the most desirable form of private development finance

40. FDI is often viewed as the most desirable form of international private development capital:

- “Foreign direct investment can be an especially fruitful form of financial inflow, which is why it is often encouraged as one of the first components of capital inflows to be liberalised.” (UN, 1998a)

- “If developing countries are to get more global knowledge, they need to attract more FDI.” (World Bank, 1998b).

41. The characteristics of FDI that support this view include its long-term nature, relative stability, contributions to economic growth, and potential for knowledge transfer (OECD, 1998b)

42. Clearly, FDI cannot and should not be the only form of international private capital to which a country has access (The Economist, 1998). Local and international commercial banking, along with securities markets, are all important parts of the financing mix.

43. Given the long-term interests of foreign direct investors and their focus on market growth, their goals for a country’s pattern of development are likely to be close to those of the host government. This provides the first important building block for the effort to use FDI as a vehicle for integrating investment and environmental factors.

Increased reliance on private investment changes, but does not reduce, the role for governments

44. Some government officials, however, appear to hope that bringing private investors into traditionally government-run operations -- from manufacturing to infrastructure -- ends their involvement. Finding that they are mistaken often comes as a shock.

45. Instead of ending, the role for governments shifts from being the provider of the service, to its enabler and overseer. Governments enable private involvement by setting the frameworks for private investment and environmental performance. They oversee private involvement by monitoring the functioning of both the frameworks and the private entity, and taking action when either fail to perform.

These critically important roles have at their core creating market frameworks (such as for private property rights) and addressing market failures (such as the pollution of public resources).

46. This is where the policy recommendations of the environmental and investment communities start to come together. Both want clear, predictable, transparent regulatory frameworks, consistently applied. Both want to see foreign aid used to build the capacity of host countries to adopt and maintain such frameworks. Increasingly, it is in each of their interests to have environmental considerations integrated into national investment frameworks.

More environmental policy leverage exists over FDI than any form of other private investment

47. Analysing the environmental aspects of their operations is particularly important for foreign direct investors. FDI is the largest type of international private investment most directly implicating environmental matters (Gentry, 1998a). It often goes directly into resource extraction, infrastructure or manufacturing operations – with all of the potential environmental impacts they raise.

48. These potential impacts, in turn, generate commercial pressures on foreign direct investors to integrate environmental issues into their investment decision-making in ways not shared by most other investors. Portfolio investors in equities or debt are generally one step removed from the actual operations and can transfer their interests more rapidly (Fernandez, Gentry and Esty, 1998). Commercial banks can face similar environmental pressures in their longer-term, real estate backed lending, but are often looking at short-term working capital loans facing fewer environmental risks (Ganzi, Seymour and Buffet, 1998).

49. The results are both greater opportunities for leverage over the environmental aspects of private investment decisions with FDI, as well as greater potential for affecting – either damaging or improving -- environmental conditions. Using this leverage requires an understanding of how environmental issues can affect the operations of foreign direct investors. As shown in Figure 6, private firms face a spectrum of commercial reasons for choosing to improve their environmental performance, ranging from reducing costs to increasing revenues.

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

Figure 6: **Potential Commercial Benefits of Improved Environmental Performance**

		Avoid Penalties Jail		**Increase Efficiency of Resource Use**		**Enhance Reputation With Governments, Shareholders, Employees**		**Access Finance**		**Sell Pollution Control Goods & Services**	
Reduce Cost of Doing Business	▼	▲	▼	▲	▼	▲	▼	▲	▼	▲	***Increase Firm Revenue***
	Pay Less For Pollution Damage		**Prevent Pollution**		**Enhance Reputation With Neighbours**		**Enhance Reputation With Customers**		**Sell Green Consumer Products**		

Source: Yale/UNDP Public-Private Partnerships Program, 1998.

51. Given the visibility and scope of their operations, MNEs – particularly those from industrialised countries – are under considerable pressure to address the major environmental risks and opportunities facing their operations. A recent review of Latin American cases where FDI led to improved environmental performance – even in the absence of local enforcement – identified five key sources of commercial advantage for the investors (Gentry 1998):

- *Improved access to export markets*, such as through the adoption of environmental management systems or the use of product "eco-labels;"

- *Increased productivity*, through more efficient use of raw materials and other inputs;

- *Maintenance of a "social license" to operate*, in the face of local and international pressure from neighbours, environmental NGOs, shareholders and customers;

- *Access to finance*, where international financiers increasingly require environmental risks to be addressed and, in some cases (such as the World Bank Group), "supra-national" environmental guidelines to be met; and

- *"Environmental" investments*, in water systems, cleaner energy and other projects.

52. These commercial incentives for improved environmental performance can then be used to help guide efforts to integrate investment and environmental considerations.

Host country governments have room to integrate investment and environmental factors into their development frameworks

53. Unfortunately, many government officials – particularly those in the investment promotion and finance ministries – appear to believe that attention to environmental matters will drive private investors to competing countries. Concern is frequently expressed that effective national environmental programs

always mean increased capital and operating costs. In an increasingly competitive world, the possibility of adding more cost to an investor's production base is viewed with alarm. In turn, this leads to charges by environmental advocates that governments are in a "race to the bottom" in lowering their environmental standards and that multinational investors are seeking out "pollution havens."

54. If the goal is to promote medium to long-term investment in productive operations, particularly through FDI, both the governments' and the environmentalists' concerns are overstated. What the vast majority of private direct investors value above all is predictability. The lack of clear environmental standards, or their inconsistent application, is viewed by many FDI investors as an increased risk, not an inducement.

55. The integration of predictable environmental standards into investment promotion frameworks reduces these risks and will not drive private direct investors away. As described above, most choose their investment locations for other reasons – market size, growth potential, access to labour or natural resources. Even in the absence of effective national environmental programs, companies operating in the global marketplace face a range of pressures to improve their environmental performance. While environmental costs can be significant in some sectors, they are not major competitiveness factors for most industries. Interestingly, the World Bank's 49 "Competitiveness Indicators" do not even include environmental regulation as a relevant factor (World Bank, 1998c) and the top ten entries in the "World Competitiveness" rankings all have extensive environmental programs in place (IMD, 1998).[2] One study even found that transnational corporations adhering to high environmental standards in all the economies in which they operate, including emerging markets, have higher market values than their competitors (Dowell, Hart, Yeung, 1998).

56. As a result, governments have more room than they think for integrating environmental factors into their investment promotion efforts. For example, privatisation's have been both delayed for not addressing environmental matters (the Centromin mining operation in Peru) and made more valuable when environmental issues are addressed (the AHMSA steel plant in Mexico)(Gentry, 1998a).

Both the amount of FDI and its environmental content can be increased by shaping markets and promoting collaborations

57. Foreign direct investors seek to increase their profits. They do so by applying their investment capital as efficiently as possible to minimise risks and increase returns. How they do so is driven by the markets in which they operate and the relationships they build.

58. Integration efforts should seek to optimise investment and environmental goals by affecting these markets and relationships. They must incorporate the reasons why foreign direct investors choose particular locations, as well as the reasons why firms improve their environmental performance. They must reflect society's (broadly defined) goals for economic development and environmental protection.

59. There is no one, "right" way to conduct this process of integration. By its very nature, it will be a complex undertaking, reflecting many different values and approaches across countries, cultures and organisations. Some of the touchstones for such processes include the following.

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2 The top ten countries are: United States, Singapore, Hong Kong, Netherlands, Finland, Norway, Switzerland, Denmark, Luxembourg, Canada.

60. *Shaping markets:* Two factors are most important to shaping markets for increasing the amount of FDI made in a manner consistent with sustainable development – creating effective regulatory frameworks and spurring customer demand.

61. *Creating regulatory frameworks*: As noted above, setting the ground rules for the functioning of a market economy remains a key role for governments – in both the financial and environmental arenas. These rules define the basic framework within which foreign direct investors must operate when producing and selling their goods and services.

62. From both an investment and an environmental perspective, key components of an integrated regulatory framework are property rights, prices, information, and implementation capacity. Property rights are the cornerstone of both private investment and private conservation of natural resources (Rose, 1997). The prices of local goods and services – including the use of energy and natural resources – directly affect the behaviour of private firms. Increased access to information on environmental risks – along with other factors affecting the likely success of an investment – is of growing importance to foreign direct investors. None of these rules are of any use, however, if they are not effectively implemented.

63. A growing menu of policy options exist for attracting FDI (UNCTAD, 1998) and for protecting the environment (USOTA, 1995). Many different actors play key roles in their adoption and implementation. Suggestions for steps they can take to integrate investment and environmental goals are described below.

64. *Spurring demand*: In addition to basic regulatory frameworks, markets -- hence private investment -- are shaped by customer demand. If the demand is not there for environmentally responsible goods or services, few potential investors will be interested -- be it for pollution control equipment or sustainable forest products.

65. Building demand for improved environmental performance or sustainable products involves a wide range of actions. Some are related to the basic regulatory frameworks described above -- particularly product restrictions, resource pricing and product information. Others go to changing basic consumer preferences or developing supply chains for meeting existing, unmet demands. Again, a wide range of actors play key roles in spurring demand and some specific suggestions are provided below.

66. The goals of these efforts to shape markets are:

- To optimise investment and environmental objectives
- By combining effective regulatory frameworks
- With broader commercial incentives
- To make profitable private investments
- Consistent with a sustainable future

67. FDI's focus on market size, growth and stability, as well as the resources it brings and its direct links with the environment, make it an especially useful vehicle for efforts to meet these goals.

68. *Promoting collaborations*: FDI also provides unique opportunities for collaborations to address priority environmental issues. Increasingly, traditionally adversarial parties -- businesses, governments, NGOs -- are finding that they cannot meet their core goals acting alone (Gentry and Fernandez, 1998). Businesses need governments to set and implement basic market rules. Governments need businesses to invest in socially beneficial projects. Environmental NGOs need access to additional resources and know-how to improve or protect the natural resource base. Collaboration on areas of shared need is one way to respond.

69. A growing number of businesses, governments and NGOs are finding that they share interests in at least some aspects of environmental protection (Nelson, 1996). As described above, businesses have more opportunities for capturing commercial advantage through improved environmental performance. Governments have room both to sponsor opportunities for profitable "environmental investments" (such as in water systems) and to integrate environmental factors into their broader investment frameworks. Environmental NGOs have increased their collaborations with firms, on activities ranging from new product development to social development plans for new resource extraction activities (McPhail and Davy, 1998).

70. FDI can provide a focus for these collaborative efforts. Interested MNEs (and not all will be) can bring useful financial and technical resources to bear. Their involvement may be motivated by business goals ranging from increasing revenues (by selling pollution control goods or services) to enhancing their reputation with key stakeholders (such as employees, shareholders, governments and neighbours). If governments and NGOs understand the basis for MNE involvement, as well as its limits -- MNEs will rarely engage in activities that are not to their commercial advantage (however broadly defined) -- considerable progress can be made on specific projects.

71. Collaboration is a complement to, not a substitute for, basic regulatory frameworks. As noted in Figure 7, 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, as well as ease the process of their adoption and implementation. All of the actors traditionally interested in the FDI/environment linkage can play key roles. Specific suggestions are provided below.

Figure 7: **Allocation of public/private responsibilities across different forms of public-private collaboration in the provision of urban environmental services**

	Setting Perf'ance Stnds	Asset Owner-ship	Capital Invest-ment	Design & Build	Opera-tion	User Fee Collec-tion	O'sight of Perf. & Fees
Fully Public Provision							
Agreeing Community Standards							
Passive Private Investment							
Design and Construct Contracts							
Service Contracts							
Joint Ventures							
Build, Operate, Transfer Contracts							
Concession Contracts							
Passive Public Investment							
Agreeing Private Standards							
Fully Private Provision							

Source: Yale/UNDP Public-Private Partnerships Program, 1998.
Key: Dark gray square = public responsibility
Light gray square = shared public/private responsibility
White square = private responsibility

Success with FDI can pull along other types of private investors as well

72. The impacts of successful efforts to shape markets and promote collaborations go beyond FDI. Domestic investors will be affected, as will other types of international private investors. Many of these effects will occur for exactly the same reasons that foreign direct investors are affected -- changing the commercial context in which businesses operate. In addition, FDI investors themselves can help carry the work to other parties, as described below.

73. *Local firms*: In countries without strong environmental systems in place, foreign direct investors can help improve the environmental performance of local firms in several different ways. First, they can bring environmental matters into the local business equation, not just with their partners (by installing environmental management systems), but potentially with their local suppliers (by requiring that certain environmental standards be met) and competitors as well (by using environmental factors as a source of competitive advantage). Second, they can provide training and capacity building for local firms (as described in Box 1).

Box 1: Public-Private Collaboration on Environmental Training for SMEs -- ISO 14000 and Eco-efficiency

Philips Electronics and other member companies of the World Business Council for Sustainable Development ("WBCSD") are working with UNDP to provide training and mentoring programs for small and medium sized businesses in developing countries.

The training efforts build from the fact that an increasing number of multinational companies are sending environmental trainers around the world to work with personnel in their own facilities. Companies like Philips are happy to have their trainers stay an extra day or two and run the same training for interested local companies, technical institutes and government agencies. Already they have done so in India, China and Brazil.

Source: Yale/UNDP Public Private Partnerships Program, 1998.

74. Third, foreign direct investors may also push host country governments to implement their existing environmental programs in a more consistent and predictable manner – including against local firms. Often, these initiatives grow out of the foreign investor's concern over discriminatory treatment on environmental matters (Gentry, 1998b). Since MNEs have the capacity and resources to meet or exceed local requirements in most cases, their interest is usually not in the level at which a particular standard is set, but whether it is applied in a predictable, transparent and consistent manner – much the same as for investment related standards.

75. Obviously, foreign direct investors' interest in a consistently applied regulatory system raises the spectre of unfair competition against local firms (if they are unable to meet the requirements) or of the host country government ignoring the violations identified by the foreign investor (Gentry, 1998a). These issues need to be taken seriously and handled sensitively. It may be that any effort to have more consistent application of existing environmental standards should be accompanied by a capacity building program for local firms (in which foreign investors might play a part), as well as a timetable for implementation.

76. *Other international investors*: In addition to consistently applied local standards, foreign direct investors may have an impact on other international investors by increasing the amount of information available on the investment/environment link. This may happen in at least two ways.

77. First, many foreign direct investors use their "due diligence" process to gather information on the environmental risks and opportunities facing potential investments in order to determine how best to address them. To the extent that this search for environmental information builds the capacity (through the development of local consultancy firms) or requirements (such as in privatisation or infrastructure transactions) for providing such information, it will be available to other private international investors as well.

78. Second, an increasing number of companies, including many involved in FDI, are attempting to communicate with portfolio investors in new ways on environmental matters (Descano and Gentry, 1998). Instead of focusing solely on the commercial risks posed by environmental factors, they now believe that attention to environmental issues can increase their competitive advantage, as well as shareholder value (Blumberg, Blum and Korsvold, 1997; Arnold and Day, 1998). Since the companies themselves are the primary sources of information to financial analysts evaluating possible investments (Gentry and Fernandez, 1997), their efforts are likely to lead an increasing number of mainstream portfolio investors to consider environmental factors.

4. Suggested areas of work for key actors

79. FDI can be a vehicle for integrating investment and environmental objectives – but only if both "baners" and "booners" are active participants in the effort. Baners need to ensure that environmental factors are effectively incorporated into basic market frameworks. Booners need to ensure that the frameworks encourage private investment. Both need to participate in collaborations likely to advance their respective interests.

80. Baners and booners will never need to agree, however, on whether FDI -- on balance -- is good or bad for the environment. There is more than enough work to be done as part of the integration effort that both can find tasks consistent with their beliefs and the information they generate.

81. Some of these tasks are described in this section. All of them are aimed at the key areas identified above:

- Shaping markets, by creating regulatory frameworks (property rights, prices, information and implementation capacity) and spurring demand; and

- Promoting collaborations.

82. Instead of repeating the long lists of recommendations on FDI and the environment that have been provided elsewhere (French, 1998; Gentry, 1998a), the following highlights a few areas of major opportunity or need. Many others exist. Hopefully, the conference for which this paper has been prepared will generate many more specific recommendations – as well as concrete actions.

Host country governments

83. The most important action by host country governments is to take environmental matters seriously as part of their national development plans. This means identifying priority environmental pressures (such as the provision of drinking water, World Bank, 1997), and making resources available to address them -- either directly or through involvement of the private sector.

84. A good starting point is integrating environmental factors into the framework for private investment in infrastructure and other existing government operations (such as manufacturing). Potential foreign investors will require information on the environmental risks facing these operations. They will seek predictable and effective regulatory frameworks. Governments will reduce the risk (thereby often increasing the value) of the investment by addressing these concerns directly. Once the investment is made, new resources and technical know-how will be available for helping to address the existing problems in a cost-effective manner. Governments will be able to oversee the investor's compliance with the applicable standards and take appropriate action in case of failure.

85. For investments in new production operations, particularly resource extraction in formerly undeveloped areas, MNEs face increasing international pressure to obtain a "social license to operate" (as discussed above). They are also usually choosing the location because of the presence of the resource in question, not because of the absence of local environmental pressures. This combination again creates strong incentives for investors and governments to address environmental issues as part of the transaction process. Requirements for environmental reviews are an important part of this process -- for both parties. The challenge is to conduct the review in a way that is neither a sham, nor a roadblock, but an inclusive, valuable method for effectively identifying and resolving priority issues, in a timely manner.

86. Beyond these investment specific opportunities, host country governments should also assess the functioning of their regulatory systems. Do they provide market frameworks and incentives that encourage increased private investment in a sustainable future? If not, changes should be made. In some countries, this might involve implementing the existing requirements that have lain idle in the law books. If those existing requirements do not meet local needs or capacities, host country governments should consider starting a dialogue with foreign direct investors, local industry, environmental advocates, and civil society on adopting locally effective requirements that address priority environmental issues (Gentry, 1998c).

Source country governments

87. Since most source countries are industrialised countries, they are also the largest host countries for FDI. As such, any recommendations for host country governments apply equally to them and pose large challenges to traditional environmental policies (as discussed below).

88. In addition, there are three major areas in which their actions can help the integration of investment and environmental considerations in other host countries: ODA; domestic standards; and domestic markets.

89. First, the primary focus of ODA should shift from supporting government operations in all developing countries to a two-part strategy -- (a) using ODA to catalyse additional private investment consistent with a sustainable future; and (b) focusing ODA on the poorest countries. Much of this work has already started. More ODA funds are being used for guarantees, loans and equity investments alongside private capital. The growing awareness of the critical need to build the capacity of government

officials as enablers and overseers of private investment in infrastructure is leading to the creation of new, multi-donor technical assistance programs. Some countries already include environmental factors in their review of aid requests, more should.

90. Second, source countries that have high domestic environmental and financial standards should maintain them. Much of the pressure on MNEs to address environmental issues in their global investments arises from forces in their home country. High environmental and financial standards have not hurt, and many people think they have helped, the competitiveness of countries such as the US and Germany. Maintaining, or even increasing these pressures, will intensify the commercial pressures on MNEs to act as catalysts for integrating investment and environmental considerations in host countries.

91. Third, source countries should find ways to use their domestic markets to help spur demand for sustainable investments. For example, banana producers in Costa Rica were starting to apply much higher environmental management standards than those in neighbouring countries as part of their effort to increase sales in Europe -- until the EU reduced its quotas for Central American bananas (Rivera and Brenes, 1998). The Clean Development Mechanism ("CDM") under the Kyoto protocol, however controversial, offers industrialised countries the opportunity to create investment opportunities in developing countries by offering regulatory credits to domestic firms. Reducing subsidies for environmentally damaging domestic agricultural operations could also create new opportunities for investments in more sustainable production.

Multilateral organisations

92. Multilateral organisations (such as the OECD, development banks and UN bodies) should use their convening powers to support integrative and collaborative activities (in addition to applying any ODA funds as described above).

93. Experiences integrating investment and environmental frameworks need to be collected and shared. While many events bring together either the investment or the environmental communities, few combine the two. Doing so is necessary both to understand the different perspectives and approaches being brought to the table, as well as to catalyse concrete action in specific cases. The structure and discussions planned for this conference on integrated frameworks for privatisation and more general foreign investment, as well as on the operating standards being applied by or made available to MNEs, are useful efforts that should be followed by others.

94. This experience also needs to be applied. Multilateral organisations can help this occur by providing on-going support for collaborative efforts to address specific issues at the local, national or regional levels. Collaborations require a focus. Solving a shared problem in a particular context can provide that focus -- whether it be a poorly functioning regulatory system or an inadequate water supply. If foreign direct investors are affected or present, they can bring additional resources to bear on its solution. Multilaterals should work with host country governments, local and foreign industry organisations, environmental and community organisations, and others to help apply these resources to priority issues.

Foreign direct investors

95. First and foremost, foreign direct investors should keep investing -- and find new markets in which to do so. Beyond that, they should also take a number of steps that increasingly make good business sense, for all of the reasons discussed above:

- *Apply global environmental management systems*: Many different approaches are available -- one size does not, and never will, fit all. Firms should choose systems that work for their internal and external cultures. The touchstone should be whether the system helps the company manage the risks and capture the opportunities in a manner defensible to its major environmental stakeholders, broadly defined (employees, shareholders, customers, regulators, neighbours, media, and others).

- *Promote effective regulatory frameworks*: Predictable and transparent regulations, consistently applied -- this is what foreign direct investors look for in the financial arena and, increasingly, in the environmental arena. Contacts with governments and others should be used to support this goal.

- *Collaborate on priority local issues*: Considerable amounts of local good will can flow from making acceptable levels of firm resources available for partnerships to address specific environmental problems.

Environmental NGOs

96. Environmental advocates need to encourage increasing amounts of private investment in sustainable development. They can do so by understanding the leverage points for private investors and applying them in the three areas noted above: creating regulatory frameworks (design and implementation); spurring demand; and promoting collaborations.

97. Many excellent initiatives are already underway in each of these areas. Three specific areas on which further NGO support would be most useful are:

- *Build host country political support for effective, integrated regulatory frameworks*: Significant change to regulatory systems or their implementation requires local political support. Broad political support for addressing any underpricing of environmental resources will only exist if can be shown as interfering with local development priorities (ranging from human health to export promotion). NGOs can help inform and rally such support.

- *Participate in investments with strong environmental links*: NGOs can help intensify the incentives for foreign investors and governments to address environmental issues as part of new investments (as discussed above), as well as help them do so. Clearly, they should participate in environmental review processes. In addition, they should seek out opportunities to work with investors to design acceptable investment requirements – as well as methods for monitoring and ensuring that the requirements are met.

- *Demonstrate the profitability of sustainable private investments*: Both governments and private investors are looking for profitable, “sustainable” investment opportunities. Few have the expertise or the commitment to develop such deals across a wide range of sectors or locations. NGOs should use their networks to work with those that do exist to develop, test, replicate, and incorporate such opportunities into the broader policy and investment communities.

Financial institutions

98. Financial institutions should ask questions about the links between environmental and financial performance. As the scope of the potential commercial impacts of environmental factors grows, so too does the scope of their financial impacts. The financial analysts who identify those with material financial consequences ahead of their competitors will have an advantage. While it is up to the companies to demonstrate that environmental issues are financially significant, financial analysts should increasingly seek information on environmental factors as part of their investment calculations.

Individual consumers

99. Consumers should buy "sustainable" products – at least when they offer the same services at a competitive price. They should also support efforts – from product information to resource pricing – to make more such products available. It will be up to companies and NGOs to offer information and products to help spur the demand, and governments to create market frameworks supportive of their efforts.

5. Issues requiring further consideration

100. The opportunities are great for using FDI as a vehicle to apply more private investment to the goal of sustainable development. However, even if all the recommendations outlined above and in the cited papers are adopted, other areas still need to be addressed in order to carry us closer to that goal. Some of the major remaining hurdles include the following:

Increasing the environmental sustainability of capital flows among industrialised countries

101. The vast majority of private capital flows is among industrialised countries. How these flows are applied is at least as important to the sustainability of world development as are flows to the developing world. Particularly in the US, the sustainability debate -- with its implications for the efficiency and equity of resource use -- has yet to be reflected in the environmental protection regimes built up over the past 25 years. As a result, even though foreign direct investors in the US are likely to meet US standards for environmental protection, it is much less clear that meeting those standards makes the investments environmentally sustainable. More fundamental changes in the primary focus of environmental policy -- from pollution control and clean-up, to materials flows and resource use efficiency – are required (Powers and Chertow, 1997).

Linking the environmental and social components of sustainable development

102. This paper considers only two of the three aspects of sustainable development -- economic and environmental performance. Improving social welfare has not been addressed. There is a common perception that social welfare and environmental protection are at odds -- witness the debates about "jobs versus the environment" or "people versus parks." While the links between economic development and both social and environmental factors have been extensively pursued, the work linking social and environmental considerations is less well developed. Such inquiry tends to be politically sensitive and complex. It has become almost a cliché to say that poverty is the most serious environmental threat, while leading to little actual integration of social or environmental programs. Expansion of the efforts to bring the social and environmental dimensions of sustainable development together remains critical.

Starting the journey toward sustainable development

103. Finally, this paper takes a "bottom-up" approach, identifying factors that are already affecting investor behaviour and using them as the base for integrating investment and environmental policy. The question that remains is whether a multitude of such incremental improvements in environmental performance will be sufficient to place the world on a sustainable path. Many environmental advocates believe that much more fundamental changes in production and consumption patterns are necessary. Even if more fundamental change is required, however, that change will come about best through private initiatives responding to market frameworks and incentives -- shaped by customers and investors, with input from governments, NGOs and other interested actors.

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