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**THE ENVIRONMENTAL IMPLICATIONS OF FOREIGN DIRECT INVESTMENT:  
POLICY AND INSTITUTIONAL ISSUES**

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**Executive Summary**

Since the beginning of the decade, private capital has surged in importance as a source of finance for emerging market economies. Of the approximately US\$244 billion of private capital that came to developing countries in 1996, almost half consisted of foreign direct investment (FDI). FDI can be distinguished from more volatile private capital flows, such as portfolio investment or bank lending, in that it is usually for the long term. The investing transnational corporation (TNC) aims at enhancing its competitive value by entering into new markets, obtaining access to new resources, or achieving efficiency gains.

Most private financing flowing to the developing world has focused on a small group of high-performing countries. In an effort to attract a larger share of this private capital, many countries are in a race to liberalise their regulatory regimes. In 1997, 76 countries made changes in their FDI regulatory regimes, 90 per cent of which were aimed at creating a more favourable climate for FDI, *e.g.* streamlined approval procedures and/or special trade and investment zones.

The impact of FDI on a host country's environment depends *inter alia* on the industry and sector involved, the reason for the investment, and the environmental controls in place. In certain circumstances, FDI can bring about significant environmental improvement. For example, much of the FDI that has recently flowed into Central and Eastern European (CEE) manufacturing facilities has brought about an upgrading of technologies and has remedied past environmental damage (PED). Investors have brought capital and know-how, introduced more efficient methods of production, and demonstrated the link between good environmental practices and profitability.

Other types of FDI, *e.g.* investments into resource extraction industries such as mining and logging, have frequently led to serious and at times irreversible environmental degradation. This has particularly been the case in countries where property rights are poorly defined, and few safeguards are in place to ensure proper attention to the matter of environmental protection.

For host countries, the challenge is to maintain economic policies and environmental protection measures to ensure that incoming FDI contributes to a process of sustainable economic development. In a few countries, investment guidelines have been developed with a view to the potential impacts, including environmental, of various types of investment.

In several CEE countries, some initial steps have been taken to institutionalise co-operation between economic and environmental policy makers, after insufficient attention to environmental concerns in early privatisation transactions had led to costly mistakes. In Poland and Hungary, for example, environment units have been set up within privatisation agencies. These units provide expert assistance in deciding how to deal with an enterprise's environmental problems at the time of property transfer. By addressing investors' concerns about liability for past environmental damage (PED), they have contributed to the region's success in attracting FDI.

Efforts to integrate environmental concerns into economic policies need to be accompanied by the development of robust environmental regulatory frameworks, together with professional and properly resourced regulatory agencies able to implement and enforce those regulations.

One essential regulatory tool for controlling impacts from new projects is the environmental impact assessment (EIA). The EIA is not intended to arrest development, but to determine a proposed project's potential social and environmental impacts, so that government officials are fully informed when deciding whether to grant or deny permission for the project.

The EIA process can encourage consideration of less environmentally harmful alternatives, or identify ways in which a project could be altered to have a lesser environmental impact. However, it may lead to unsatisfactory results or be subject to abuse in countries where the political system is closed or where informed participation of local people is not possible. Its effectiveness depends on the competence of the bureaucrats and environmental professionals involved, and on whether rule of law is in place, along with an educated and knowledgeable public.

Another important tool when FDI is intended for an existing operation, is the environmental audit. By identifying and evaluating existing environmental problems, the audit enables the buyer and seller to determine a fair price for the property, and to allocate responsibility for these problems. If the seller is the state, as in the case of privatisation, it can be possible to structure specific environmental solutions into the deal itself.

But the fast pace of globalisation, the competition for FDI, and the sheer size of many TNCs can make it difficult for a host country acting alone to put in place adequate environmental controls over incoming FDI. Pressure is therefore mounting on other stakeholders, including investors' home countries and international actors, to take a larger share of the responsibility in this area.

The scope of home countries' responsibility if a TNC's activities abroad cause environmental damage is a much-debated issue. Some home country governments have argued that any unilateral measures would be patronising and impinge upon the sovereign right of host countries to take their own decisions concerning FDI. Nevertheless, a consensus has emerged over the years that governments of home countries do have certain responsibilities if commercial activities originating on their territory could cause environmental problems in another country's territory. An example of this is the Basel Convention obligation that countries of origin must repatriate shipments of waste that cannot be safely handled or disposed of in the country of destination.

In recent years, attention has focused on the role of national export credit agencies in providing capital for home country investors seeking new opportunities abroad. Though most export credit agencies have resisted taking action in this area, pressure is mounting for the development of common environmental guidelines. The aim is to ensure that FDI supported by government credit or guarantee schemes will be environmentally responsible.

On the international front, international financial institutions (IFIs) have been under pressure for a number of years concerning the environmental impacts of their project development and lending activities. Today, virtually all IFIs have environmental guidelines in place for helping to determine what projects to finance. The attention paid by the IFIs to environmental considerations is particularly important where a home country's capacity for environmental regulation is still rudimentary.

For example, the World Bank requires all proposed projects to be screened to determine their potential environmental impact. EIAs are required for projects identified as posing significant environmental risk. The result of the EIA may lead to mitigation efforts being built into the project deal, and generate support for developing the home country's institutional capacity for environmental protection.

Another significant international effort are UNEP's efforts to develop internationally recognised guidelines on best environmental practices for various sectors. The Forest Stewardship Council's certification scheme for sustainably produced wood products is also noteworthy.

The long-term need, of course, is to integrate environmental concerns into development policies for, *e.g.*, transport, energy, agriculture and industry. Also needed are more guidelines on how concessions for resource exploitation can be based on principles of sustainable development.

With the aim of ensuring that governments and international institutions act responsibly with regard to FDI and its impacts, NGOs use the same cross-border flows of information that are transforming the global economy. An example of this is the global coalition that has formed around the proposed Chad-Cameroon oil pipeline and started to raise questions about the validity of an EIA process where the affected public is unable to participate effectively.

This prospect of a global public concerned about the environmental consequences of foreign and domestic investment, and the adequacy of opportunities for participation in decision making by those affected, is an interesting development. If host country governments and investors react to restrict information and access to decisions, the consequence may be more blockage of investment projects. A more enlightened response will be to ensure free flow of information and transparency of decision making, and to hold investors in both manufacturing and resource extraction industries to high international environmental standards, wherever they operate.