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Emerging Market Economy Forum

CONFERENCE ON FOREIGN DIRECT INVESTMENT AND THE ENVIRONMENT

SUMMARY OF THE DISCUSSION

The Hague, Netherlands, 28-29 January 1999
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Introduction

1. Recent debates on the environmental implications of foreign direct investment (FDI) have often been highly polarised and polemical. In order to promote a dialogue on the key issues in the FDI-environment relationship, the conference[1] brought together government officials, business persons, trade union representatives, NGOs and academics from OECD and non-OECD countries. In total, 146 people participated in the meeting: 107 from OECD Member countries; 19 from non-member countries (Argentina, Azerbaijan, Brazil, Chile, China, Estonia, Hong Kong (China), Latvia, Malaysia, the Philippines, South Africa and Thailand); 11 from international organisations (EBRD, European Commission, UNCTAD, UNCSD, UNEP, World Bank). Mr. Gerrit Ybema, Minister for Foreign Trade, the Netherlands and Mr. Donald Johnston, OECD Secretary-General opened the conference. The Environment Directorate and the Directorate for Fiscal, Financial and Enterprise Affairs jointly organised the conference and established a dedicated website to disseminate the documentation (website address: http://www.oecd.org/daf/env/index.htm).

2. The objectives of the conference were two-fold:

- to deepen understanding and analysis of the key issues in the FDI and environment relationship within the context of a globalising economy; and

- to examine ways in which this relationship might be improved to mutually reinforce environmental and FDI policy goals.

Discussions in the two plenary sessions and three parallel workshops focused on:

- empirical evidence on the role of FDI in raising or lowering environmental standards or performance;

- the policy and institutional frameworks needed to manage the environmental effects of FDI, including the role of EIA; and

- private and public sector initiatives to promote “best environmental practice” in FDI activities, including the role of corporate and industry codes of conduct, environmental reporting, information disclosure and investment standards.

3. The discussions were frank and a constructive dialogue was established; the informal, non-negotiating nature of the event contributed to this. Participants considered that the meeting was successful in moving the debate beyond polemics and in contributing directly to relevant work underway in OECD: the review of the OECD Guidelines for Multinational Enterprises; discussions about developing a multilateral framework for investment; a three-year project on sustainable development, launched in 1998; and development of an environmental outlook to 2020 and associated policy strategy. Themes raised in the discussion in the two plenary sessions and three parallel workshops are presented below.

1 The conference was organised within the framework of the OECD’s Emerging Market Economy Forum, which brings together OECD Member countries and non-member economies engaged in market reform.

The Impact of FDI on Environmental Standards - “Pollution Havens” and “Pollution Halos”

Data problems

4. There has been vigorous debate about a “race to the bottom” in environmental standards resulting from competition between countries, and also among regions within a country, to attract FDI. The so-called pollution haven hypothesis implies that competitive forces would “push” FDI away from countries with high environmental standards, or “pull” it towards those with low environmental standards. Conversely, the notion of pollution halos suggests that FDI might promote the establishment of higher environmental standards through technology transfer effects or via existing management practices within multinational and other firms. Overall, there does not appear to be evidence corroborating the pollution havens hypothesis. On the other hand, there are some studies, including one tabled in the meeting, that are consistent with the pollution haven hypothesis.

5. Several site-specific examples of pollution havens and halos were cited, suggesting that FDI-related environmental problems may indeed exist in certain industries, sectors, or countries. Since statistical studies tend to draw conclusions at an aggregate level, doubts were expressed about these particular methodologies. A case study approach to future analysis was therefore suggested as a way of gaining more practical insights into the environmental impacts of FDI in specific contexts.

6. Moreover, since existing empirical data and studies are not conclusive with regard to the (relatively narrow) question of pollution havens/halos, they are even less likely to be conclusive with regard to the broader issues involved in the FDI-environment relationship (see next section). A significant data gap therefore exists, and several participants called for work to define and to test possible methodologies that might help meet this need.

7. Several suggestions were offered on how to make more creative use of existing data, such as the development of indices which link investment and environment information in the same parameter (e.g. an “index of comparative environmental advantage for FDI”).

Need for a broader perspective

8. There was consensus that a broader perspective is needed beyond just focusing on the issue of pollution havens and halos. More detailed studies are needed to examine the environmental impacts of FDI in different sectors and countries. For example, the environmental impacts of FDI will probably differ depending on whether that FDI is headed toward manufacturing industries, service industries or resource-using industries. These impacts, and the significance of the costs of addressing them, will also vary according to whether the FDI involves large multinationals, or smaller (and perhaps, domestic-only) firms. There is also the problem of “cascading pollution havens” (i.e. where firms contract out their “dirty” production processes to other companies in order to appear “green” themselves).

9. Some participants considered that competition for FDI among regions within a country would ultimately prove to be a more important issue for the environment than competition between countries. A more basic question is whether foreign ownership is likely to lead to different environmental results than would domestic ownership. If this is unlikely to be the case a focus on foreign investment, rather than investment in general, will not be particularly useful in resolving environmental issues.

10. While the *relocation* of economic activity has usually been the main reason for political interest in FDI, it is the *performance* of investing firms once they are established that matters more for the

environment in the long-run. Thus, some refocusing of attention away from relocation, and towards performance, was recommended. Another micro issue that has been underrepresented in the debates so far is that of the impacts of FDI on individual incomes and consumer behaviour.

11. In terms of the *macro* environmental issues, the focus of the debate should be extended beyond “pollution” to the broader issue of “resource management”. There is also a need to examine the cumulative environmental effects of investments rather than to focus just on individual projects. This approach recognises that although an investment might be judged as “environmentally-friendly” at the plant level, its operations may contribute to a larger scale of economic activity at the macro level, which may in turn lead to additional environmental harms.

12. There were also proposals for broadening the analysis of the FDI and environment issue to include social factors (employment, indigenous rights, labour practices, income distribution, etc.). The addition of these social factors was regarded as essential to place the FDI and environment debate more squarely in a sustainable development context.

13. Several themes emerged as high priorities for further analysis. On the FDI side, these included: (i) better understanding of FDI-environment links in the resource-using sectors; (ii) analysis of whether or not foreign or domestic ownership really matters in determining the environmental impacts of investment, including the use of cleaner and more resource-efficient technologies; and (iii) issues related to regional competition for FDI. On the environment side, these included: (i) the local and international environmental implications of the increased scale of economic activity associated with FDI; (ii) arrangements for domestic governance; and (iii) better understanding of investor environmental performance.

Policy and Institutional Responses in Managing the FDI-Environment Relationship

Level of policy response

14. The appropriate level of policy response to manage the FDI-environment relationship was discussed in the context of domestic and international responses.

15. Since FDI’s impact on the environment is largely local, it is crucial that appropriate domestic policies and associated regulatory frameworks be developed to deal with these impacts. This should involve not only policies directly related to the environment or to investment (e.g. technology transfer, capacity-building, environmental impact assessment procedures), but also other, indirectly-related policies (e.g. land use policies, tax policies, financial incentives, government procurement procedures). The robustness of environmental policies and institutions, including the adequacy of supporting regulatory instruments, are important determinants of the environmental impacts of (foreign) investments at the project and aggregate levels.

16. Opinions were divided concerning the appropriate response(s) at the international level. Setting all environmental standards at the same level would inevitably result in inefficient environmental policies that do not take into account different local environmental circumstances. On this view, international solutions would not necessarily (or by themselves) contribute to an improved environment.

17. On the other hand, some form of international response may be needed to deal with either transboundary environmental issues or the international competitiveness effects of domestic environmental policies. In this context, some participants suggested that there is scope for various forms

of international response. For example, an internationally agreed “minimum baseline” of environmental performance could be useful. It was noted that such a “baseline” already exists in other areas of government policy (e.g. ILO core labour standards).

18. In practice, domestic and international levels of response are not mutually exclusive. There are already some multilateral environmental agreements which have implications for investments, and vice versa. Opportunities exist to build on these existing frameworks for the mutual benefit of both FDI and the environment.

19. The optimal approach may be a dual one: (i) implement appropriate domestic measures where it is possible to do so unilaterally; and (ii) where unilateral measures are not possible, develop international rules to help reduce “free rider” competitiveness problems; such rules should not be used, however, where the risk of free-riding is minimal.

Institutional responses

20. The pace and scale of FDI are challenging the capacity of some host countries to absorb new investment and to manage its environmental implications. In this context, different stakeholders can play important roles in strengthening the integration of investment and environment policy objectives. To provide a framework, several general principles were identified:

- access to information on investment proposals;
- public participation in all stages of the investment and environmental assessment process;
- strengthening legal systems and ensuring access to courts to settle disputes;
- transparency, accountability and predictability in the design and implementation of investment and environmental policies and regulations;
- establishment and enforcement of appropriate environmental standards; and
- no derogations from statutory environmental requirements to attract investment.

21. *Host country governments* should integrate environmental considerations into their macro-economic policies and national sustainable development strategies. Institutionally, this might be supported by formal and informal mechanisms for co-ordination in policy development. At the same time, attention needs to be given to the enforcement of environmental laws and standards (i.e. no exemptions granted), the elimination of environmentally-damaging economic support measures, wider use of economic instruments such as taxes and charges, and clear rules governing investor liability for cleaning up past environmental damage.

22. Strategic planning also has an important role to play in promoting the development of integrated policies and programmes. These include, *inter alia,* national development strategies, regional economic development plans and strategic environmental assessment(s). At the individual project level, the environmental impact assessment process (EIA) provides a site-specific evaluation of the expected impacts and measures to reduce them. Local capacity-building is also critical. This includes the strengthening of investment analysis expertise in environmental ministries and vice versa, as well as developing the local consulting sector and reinforcing NGO capacity.

23. Promoting environmentally-friendly FDI was also considered a major task for *source country stakeholders*. This could be supported by several measures. First, source country governments should set appropriate environmental standards to guide investor actions in both their domestic and overseas operations. Second, the environmental procedures and practices of government agencies that provide investment assistance, such as export credit agencies, should be strengthened to address more effectively the environmental implications of their activities. Third, technology co-operation within the private sector should focus on cleaner and more resource-efficient technologies. Fourth, supply chains could be "greened" by investors providing training to their foreign suppliers that help them improve their environmental performance.

24. *Civil society* has an important role to play as a "whistle-blower", ensuring that the process of FDI is not only transparent but also takes account of the distribution of costs and benefits to society in general and to affected local communities more specifically. There is also a need for a more constructive engagement among governments, the private sector and civil society in policy and project design, implementation and evaluation.

25. Finally, it was suggested that the role of *international organisations* might focus on several areas. First, international financial institutions (IFIs) could provide resources to help developing, transition and emerging market economies undertake strategic planning to integrate investment, environmental and social policies. Second, these institutions should give greater attention to evaluating the *aggregate* environmental impacts of their investment activities, and not focus exclusively on the environmental impacts of individual projects. In this context, IFIs should implement their EIA and strategic environmental assessment procedures in an open and participatory manner. Third, greater efforts need to be made to mainstream environmental considerations into existing and any new multilateral trade and investment arrangements, as well as bilateral agreements and codes of conduct. Fourth, monitoring, analysis and dissemination of "best practices" on the integration of investment and environmental policies are tasks that international organisations are well placed to facilitate.

The Role of Voluntary Commitments

26. Voluntary commitments can play an important role in host countries as a supplement to existing environmental policies. A major challenge is to use voluntary commitments as part of a strategy to ensure that enterprises, both domestic and foreign, not only comply with national environmental standards but also have incentives to go beyond them.

What standards should apply?

27. A key issue concerns the roles of voluntary commitments and legally binding standards. On the one hand, legally binding standards usually include sanctions for non-compliance. This can help reduce the "free rider" problem associated with voluntary commitments. Some participants also considered that a voluntary approach is sometimes proposed by enterprises to avoid the imposition of binding standards. On the other hand, legally-binding standards within a voluntary commitments context require many years to be agreed upon and, being the result of a negotiation process, are not likely to generate very high standards of environmental performance.

28. Voluntary commitments need to be considered within the broader perspective of the regulatory frameworks established by governments. Such commitments should aim to go beyond the minimum required by regulations. To promote transparency and credibility, there was strong support for making the

reporting of compliance with voluntary commitments binding on the enterprise and to include provision for independent verification.

29. Universal codes of corporate conduct such as the OECD's Guidelines for Multinational Enterprises were considered an important supplement to more detailed environmental codes of conduct of individual enterprises. In particular, such standards can serve as an independent benchmark of the state-of-the-art, thereby helping to harmonise objectives among government, business, labour and other stakeholders, as well as providing a means to address the free rider problem.

30. Defining "best practices" for enterprise environmental conduct is a major challenge. Although business and NGOs have developed a number of criteria, often independently of each other, there appears to be some convergence. For example, that voluntary standards should go beyond the legal minimum, that independent verification of reported performance is necessary, that stakeholders should be engaged in establishing standards and in verifying compliance, that widely recognised standards should serve as benchmarks, and that financial, social and environmental considerations should be integrated.

Promoting the implementation of best practices

31. Once "best practices" have been defined, their implementation needs to be promoted. At the government level, an appropriate enabling policy framework and supporting instruments need to be established. This could include annual awards, greater publicity, access to investment guarantees and reduced premiums for export credit insurance and other incentives. A direct incentive at the firm level is the creation of a corporate culture in which good environmental conduct is associated with enhanced financial performance. Outside pressures, particularly from competitors, shareholders, consumers and civil society, also act as strong levers. The financial services sector also has an important role to play here.

32. Encouraging the adoption of best practices in small and medium-sized enterprises is another important challenge. Often, these enterprises do not have the resources in terms of time, finance and personnel to dedicate to environmental concerns. Timely dissemination of information and in-plant assistance to these enterprises on best environmental practices would often be cost-effective. Reducing the costs of achieving an appropriate level of environmental reporting would also be a positive step. This might include the development and wide dissemination of a standard reporting model, available in a low-cost software package.

33. The "free rider" problem might be addressed through non-binding codes of conduct, such as the OECD Guidelines for Multi-national Enterprises. In particular, encouraging subcontractors and suppliers (who are often smaller enterprises) to comply with the Guidelines could promote wider compliance. This might be feasible in the case of contractors, but more difficult in the case of suppliers. Those codes should not only focus on unsatisfactory practices; efforts should also be made to highlight good examples and role models in the private sector.

Ensuring credibility

34. Corporate environmental reporting often suffers from a lack of credibility in the public's view, even in cases where this is not fully justified. Reporting that emphasises "trust me" is no longer accepted by the public; "show me" is now required.

35. One way to improve credibility would be through greater use of benchmark targets and standardised reporting against these benchmarks. Concern was expressed, however, about the feasibility and practical value of such an approach.

36. External verification of reported environmental performance is one means of promoting credibility among stakeholders. Such verification is done against recognised and independently-set standards. Guidelines for reporting have been developed by, *inter alia,* UNEP and the Coalition for Environmentally Responsible Economies (CERES) and an attempt is currently being made at a global reporting initiative. It was recognised, however, that verification is neither a panacea for ensuring credibility nor a substitute for engaging stakeholders in dialogue.

Conclusions

37. There is a need to use a much broader and more integrated analytical framework -- one which considers both micro and macro perspectives of the FDI-environment relationship. All stakeholders represented in the conference have a contribution to make to this broader perspective.

38. It is useful to distinguish between *FDI host countries and FDI source countries.* Concerning the former, there is a need to strengthen the analytical, policy and institutional capacities with respect to both FDI and the environment. Source countries could assist by sharing best practice experiences in developing and implementing policy, including the role of policy tools such as economic instruments, voluntary agreements, strategic environmental assessment and EIA. They could generally serve as a role model, demonstrating that high environmental and investment standards can be made mutually-supporting.

39. The *private sector* has a responsibility to not only comply with legislative and other statutory requirements, but also to meet a wider responsibility to both society in general and local communities in particular for the environmental performance of their operations. The issue of whether and how "best practices" might be used as standards requires further reflection. Best practices should, however, be incorporated into corporate codes of conduct and universal codes, such as the OECD Guidelines for Multinational Enterprises. In this context, the private sector has a key role to play in defining with its constituents what best practices are in different industries and sectors, as well as their means of implementation and enforcement.

40. *International organisations* should develop programmes within their core expertise and ensure that information on these programmes is exchanged to assure synergies and to avoid duplication of effort. They could also act as "honest brokers" by bringing together stakeholders to analyse and discuss specific issues outside a negotiating framework.

41. *NGOs* should continue to play their role as "whistleblowers" on the policies and actions of governments, international organisations and the business sector. They also have an important role to play as a responsible partner in dialogue consultations: with governments (concerning policies) and with business (as far as individual projects are concerned).

42. There was consensus that the *conference had generated a momentum* that should be built upon. In particular, there was wide support for a follow-up event to be organised at an appropriate time in the future in order to review progress made by the different stakeholders and to engage them more deeply.

43. Several *priority areas for future work* were identified:

- Analysis of the pollution havens and halos issue should extend beyond its present focus on industry *relocation*. More emphasis should be given to monitoring the environmental *performance* of investors, including the cumulative, scale effects of investment. Case studies of the environmental implications of FDI in different sectors, regions and countries of different economic structures would be particularly useful.

- Sectoral differences need to be better taken into account. The resource-using sector merits priority attention, given its potential to generate important environmental and social impacts on affected communities. Consideration should also be given to further promoting public-private sector partnerships (e.g. in the urban water sector), to provide positive environmental benefits.

- Improved policy and institutional frameworks for integrating investment and environmental policy goals require further analysis. This includes opportunities for, and barriers to, strengthening co-operation within government, and between government and other interested parties.

- Voluntary environmental commitments by enterprises can play a useful role in many countries. Such commitments are more likely to be effective if they contain benchmarking criteria and provide for independent verification of environmental performance. The OECD Guidelines for Multinational Enterprises, presently under review, could contribute to these efforts by incorporating “best practices” in the areas covered.

- Further analysis of the role of environmental standards in investment activities would be timely. This could build upon work carried out by some international financing institutions and extend the analysis to include both OECD and non-OECD countries.