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Hundreds of billions of dollars of private capital annually flow from North to South in the form of foreign direct investment (FDI), portfolio equity investment and debt finance. How this capital is spent will have a much more profound effect on the quality of the global environment than the few billion dollars of official assistance devoted to environmental investments each year. This chapter argues that a variety of factors influence how private capital flows to developing countries affect the environment. In particular, it reviews the incentives and conditions that determine who gets private capital funds and outlines ways environmental goals could be better-integrated into foreign investment processes.

Diversity in International Capital Flows

Any evaluation of private capital flows and the environment must consider not only FDI (which accounts for 54 percent of total capital flows), but portfolio equity investments and debt finance as well:

Portfolio investment: Environmental performance may affect the value of a portfolio investment in overseas companies= shares; the price of a company adhering to high environmental standards may be bid up if investors believe this will positively affect performance, and bid down if investors believe environmental corners should be cut for short-term profits.

Debt financing: Because commercial lending to private companies gives debt holders a stake in the borrower=s financial success, debt holders are concerned about the environmental risks and performance of borrowers as it relates to their ability to pay back loans. Thus, they may encourage the adoption of either lax or stringent environmental standards by their clients.

Qualitative Dimensions of Expanded Foreign Direct Investment

Private international finance has both positive and negative environmental consequences. As FDI encourages growth in the developing world, pollution may be exacerbated. However, as countries become wealthier, they can afford larger investments in pollution

prevention and control. This may eventually lead to reduction in some pollution impacts B but not all. AThus, some environmental harms (notably climate change)Ymay worsen more slowly as more countries develop, but never diminish in absolute terms.@ [160]

As more and more countries develop, the competition increases for limited FDI funds that speed the development process. The process of luring foreign investors sometimes includes a commitment to more lax enforcement of environmental standards.

Yet these competitive pressures differ for different industries. In more commodity-like industries, where products are relatively undifferentiated and small cost differences translate into large market share gains and losses, investment flows are particularly prone to influence based on the level of environmental standards in each country and the standards of the specific projects to be financed.

Pressures to lower environmental standards may come from international investors, or from host governments. North American and European companies have found themselves pressured to eliminate environmental components from proposed power plants in China in order to cut costs. Additionally, some US furniture makers moved their operations from the US to Mexico, where environmental regulations are more lax. Competitive pressures may also operate in the opposite direction: foreign investors in Costa Rican banana production insisted that production be more environmentally sound, because their European customers wanted a better product. Some Asian lumber products have similarly improved environmental performance in response to European consumer sensitivities.

The traditional belief that multinational companies exploit weak pollution control programs in developing countries and despoil the environment is outdated and generally wrong. Foreign investors often set up operations with modern, less polluting, advanced technologies and advanced environmental management systems and training programs that are more advanced than those that exist locally. There are only a few isolated cases in which multinational companies dismantled outdated polluting facilities in their home countries and reassembled them in developing countries. This Atechnology dumping@ usually involves non-Organization for Economic Cooperation and Development (OECD) countries such as Hong Kong, Singapore and Taiwan and concerns sales of outdated equipment to companies in developing countries rather than FDI per se.

Environmental Aspects of FDI

Because the environmental character of industries that receive FDI vary depending on the type of investment and the goal of the investor, it is necessary to distinguish three types of FDI:

- Market-seeking FDI: Pursued by investors seeking opportunities to sell in overseas markets that have a broad sales potential, such as China.

- Resource-seeking FDI: Pursued by investors seeking access to critical resources, such as raw materials and cheap labor.

- Production-Platform-seeking FDI: Pursued by investors desiring to set up overseas facilities in a particular country as a platform for production and sales in a regional market.

- Many multinational corporations (MNCs) adhere to their home country=s high environmental standards for a number of reasons:

- The efficiency of adhering to a single set of management practices, pollution control and training technologies outweighs any cost advantage of relaxing environmental regulations in an overseas facility.

- Because MNCs operate on a large scale, their visibility makes them prone to exposure by local investment officials.

- The threat of liability for failure to meet standards encourages the adoption of better environmental standards than are locally required.

However, even when MNCs follow strict environmental regulations in developing countries, the results are varied. The host country may not provide the same degree of pollution control infrastructure found in the corporation=s developed-country home base. For example, many developing countries lack sewage systems that can handle the partially treated wastewater of MNCs. Additionally, local suppliers and service providers of MNCs often do not adhere to sound environmental standards.

The increased scale of economic activity resulting from FDI may have serious environmental consequences. Forestry and agricultural activities at commercial scale for export markets may involve monocultures with ecologically damaging impacts. Further, companies from countries that lack strict environmental standards may ignore the requirements of environmental stewardship.

Economists have found little empirical evidence exists for the Arace to the bottom@ theory which states that countries with low environmental standards attract dirty industries. This may be because environmental compliance costs are usually too small a factor in a company=s overall production costs to affect its choice of location. There is some evidence, however, that companies with much higher than average pollution control costs do move to areas where environmental standards are more lax.

The race to the bottom model is more evident within countries with high environmental standards such as OECD nations (among which most international capital flows occur); companies in these countries move to jurisdictions with relatively lower environmental standards. This results in a Apolitical drag@ effect in which standards are not raised to optimal levels, or existing rules are not enforced in the majority of jurisdictions.

On the other hand, there is scant evidence that developing countries set higher environmental standards for projects funded by foreign investors. So what drives FDI environmental performance? FDI improves environmental performance when it translates into better business. Four major categories of commercial benefits, which motivated corporate environmental improvements, were identified in a study of Latin America:

- Improved access to export markets: Perceived consumer demands for environmentally responsible products and a desire to keep up with environmentally friendly competitors.

- Increased productivity: Because pollution equals waste, foreign investors seek to achieve a profitable balance between increased production efficiencies and higher pollution control costs.

- Maintenance of a Asocial license@ to operate and expand: MNCs face international pressures to be Agood environmental actors@ and home-country pressures not to Aexport@ pollution.

- Access to finance: Many external financing sources, including government financing bodies such as the US Export-Import Bank, make loans conditional on adherence to certain environmental standards. Even private financing often requires a minimum level of environmental Adue diligence.@

MNCs typically seek consistent environmental enforcement, not lax enforcement. They may be deterred from investing in a country that has a precedent of placing excessive burdens on companies for the cleanup of past contamination.

Integrating FDI Practices and Environmental Goals

ATo the extent that environmental investments yield adequate returns, FDI source and host countries alike would benefit from finding ways to channel private capital flows into environmental infrastructure projectsYas part of broader development efforts.@ [167]. These rules should be developed and enforced multilaterally.

Research shows that countries that have straightforward, transparent and efficient environmental regulations do not as a result lose, and may even attract, FDI (endnote, Gerty et al, 1996). For example, after Mexico recently increased its environmental enforcement, FDI in the Mexico City area expanded, and the air quality actually improved. OECD countries can support and encourage developing country efforts to create functioning environmental programs in the following ways:

- Move towards consistent implementation of minimum environmental standards for major development projects that have implications for the Aglobal commons.@ This could be institutionalized through the proposed OECD Multilateral Agreements on Investments (MAI).

- Make foreign assistance conditional on specified environmental results.

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- Offer funding to promote environmental compliance in developing countries.

- Provide specific incentives for cooperation (such as the joint implementation program in the Framework Convention on Climate Change).

- Increase the data available to companies and governments regarding environmental components of siting decisions and the role of environmental standards in such decisions. This data should divide FDI up into its components (such as market-seeking investments, etc.).

- Institutionalize eco-labels and standards, such as the ISO 14000 series, to empower consumers to bring pressure on producers.

Foreign investors are generally not Aanti-environment.@ They are, however, profit maximizers. If it is to their business advantage to improve environmental performance, they will do so.@ [169] Government policy frameworks and consumer pressures can have a major influence on business calculations concerning the environment.

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