Policy Brief

When More Is Less: The Limited Impact of Foreign Investment in the Americas

By Kevin P. Gallagher and Andrés López | June 11, 2008

A comprehensive review of the impact of foreign investment liberalization in Latin America shows that, with some exceptions, foreign investment has fallen far short of stimulating broad-based economic growth and environmental protection in the region, according to a report by the Working Group on Development and Environment in the Americas. The report recommends that national and regional policies aimed at improving national firms' capabilities should be implemented and that "policy space" for such policies should be accommodated in bilateral, regional, and global trade and investment treaties.

Development and environmental economists from the United States, Mexico, Brazil, Argentina, Chile, and Costa Rica wrote the report, "Foreign Investment and Sustainable Development: Lessons from the Americas,"[1] based on original research from throughout the region. The Working Group analyzed case studies on Argentina, Brazil, Bolivia, Chile, Costa Rica, Ecuador, Mexico, Uruguay, and Venezuela to examine how foreign investment during the reform period has affected economic growth, environmental policy and performance, and the countries' political economies.

Beginning in the early 1990s, nations in the Americas began to liberalize their regimes for foreign investment. Pursued unilaterally or through regional and bilateral trade and/or investment agreements, a typical set of reforms included the elimination of performance requirements such as requirements to source from domestic firms or to export a certain percentage of production, restrictions on the ability to exclude certain sectors from foreign direct investment (FDI) and to "screen" foreign investment for development goals, restrictions on the ability to require joint ventures or research and development facilities, and so forth. Moreover, the reforms alter the nature of settling disputes over foreign investment. Whereas trade agreements have traditionally relied on states to settle disputes among themselves in international fora, newer trade and investor agreements have "investor-state" dispute systems where foreign firms can directly sue a national or local government without host government oversight.

These policies were advocated by the U.S. government, the World Bank, and the International Monetary Fund and endorsed enthusiastically by many governments across the Americas. They have become enshrined in the 1994 North American Free Trade Agreement (NAFTA) between the United States, Canada, and Mexico. NAFTA became the template for subsequent regional and bilateral accords, including the U.S.-Chile Free Trade Agreement, the U.S.-Dominican Republic-Central America Free Trade Agreement (CAFTA), the U.S.-Peru Free Trade Agreement, and countless numbers of Bilateral Investment Treaties (BITS).

Investment liberalization has been part of a larger effort broadly referred to as the Washington Consensus. The broader reforms include a package of economic policies that promote economic development by opening national economies to global market forces. Over the last 20 years, governments throughout Latin America have reduced tariffs and subsidies, eliminated barriers to foreign investment, imposed fiscal discipline by reducing government spending, and have generally reduced the role of the state in all aspects of the economy.

The promise, among others, of following these policies is that FDI by multinational corporations will flow to developing countries and be a source of dynamic growth. Beyond boosting income and employment, the hope was that manufacturing FDI would bring knowledge spillovers that would build the skill and technological capacities of local firms, catalyzing broad-based economic growth; and environmental spillovers that would mitigate the domestic ecological impacts of industrial transformation.

These policies and agreements have raised concerns, not least of all because they have shown poor results. Economic growth in per capita terms in the region was slower than in the last decades of the import substitution period—less than 2% over the period of the reforms dating from 1990. A major finding in this report is that slow growth is in part explained by the fact that FDI failed to lead to more total investment into Latin American economies.

Among the main findings in the report are:

1) FDI was concentrated in a small handful of countries in the region. Brazil, Mexico, Argentina, Chile, and Venezuela received more than 80% of all the FDI in the region;

2) Foreign firms located in Mexico and the Caribbean tended to serve as export platforms to the United States, whereas those located in South America tended to sell to domestic markets in that region;

3) FDI was attracted by traditional determinants, not necessarily whether a nation had a regional or bilateral trade and/or investment treaty or if it could serve as a pollution haven for foreign firms;

4) When FDI did come, foreign firms tended to have higher levels of productivity and higher wages and generally increased trade in the region; yet

5) FDI fell far short of generating "spillovers" and backward linkages that could help countries develop, and in many cases wiped out locally competing firms thereby "crowding out" domestic investment;

6) The environmental performance of foreign firms was mixed, sometimes leading to upgrading of environmental performance, and in others performing the same or worse than domestic counterparts.

Working Group studies documented and analyzed the track record in specific countries and sectors as well:

- In Brazil, Argentina, Mexico—the three countries that have received the lion's share of FDI in the region—and Costa Rica, it found that:

  - Foreign firms have higher wages, productivity, and trade *vis a vis* domestic firms;

  - However, linkages with national firms and the domestic economy in general are weak, specially in Mexico and Costa Rica;

  - Although foreign firms may bring the technologies generated in their headquarters, they do not contribute to an increase in R&D expenditures in the host economies.

- In Brazil, Mexico, Chile, and Argentina

  - Virtually all foreign firms transferred environmental management systems to host countries; however

  - It is not clear that such firms were actually in compliance with host country laws and in Brazil there is little indication that foreign firms were more likely to be in compliance than domestic firms were;

  - There is little evidence that foreign firms are greening their supply chains (given that so many supply chains were wiped out by FDI);

  - In some instances, such as the forestry sector in Chile, foreign firms that exported through fair-trade certification schemes were "upgrading" to higher levels of environmental standards;

  - In others, such as in Mexico's electronics sector, foreign firms were not exporting to meet strong standards in Europe given that their chief export market, the United States, does not have such standards.

- In Venezuela, Bolivia, Ecuador, and Uruguay

  - A Uruguayan BIT constrained the set of policies available to solve a conflict over foreign investment and transboundary environmental problems with Argentina;

  - BITs in Bolivia, Ecuador, and Venezuela were refused by governments that were able to renegotiate the terms of contracts with foreign hydrocarbon firms.

New Directions for FDI and Sustainable Development

The Working Group found, in agreement with the broader literature on the subject, that investment regime liberalization-led FDI has had at best a limited success in Latin American countries.

Hence, it comes as no surprise to find that virtually all newly elected governments in Latin America are rethinking the role of FDI in their economies. While some countries are just beginning to debate the issue, others are going so far as to nationalize foreign firms. Yet, most governments are looking for a balanced approach.

What this report makes clear is that new policies are needed. Based on this new research, three broad lessons can be drawn out as principles for policy-making in this field:

1) **FDI is not an *end* but a *means* to sustainable development. Simply attracting FDI is not enough to generate economic growth in an environmentally sustainable manner.** The report shows that even in the nations that received the largest proportion of FDI in the region—Brazil, Argentina, and Mexico—FDI fell short of generating spillovers and sustained economic growth. FDI needs to be part of a comprehensive development strategy aimed at raising the standards of living of the nation's population with minimal damage to the environment.

2) **FDI policy needs to be paired with significant and targeted domestic policies that upgrade the capabilities of national firms and provide a benchmark of environmental protection.** There are numerous country-specific policies that are either being implemented or debated regarding ways in which Latin American and Caribbean nations can overcome market failures, access to credit problems, and competitiveness issues on the part of their domestic firms. In this regard, lessons from Asia may be drawn, since many nations in that region have put in place targeted industrial policies to link domestic firms to foreign firms to enable domestic firms to develop into competitive exporters themselves.

3) **International agreements, whether at the World Trade Organization (WTO) or at the level of regional or bilateral trade and/or investment treaties (RBTIAs), need to leave developing nations the "policy space" to pursue the domestic policies necessary to foster sustainable development through FDI.** The emerging international regime of international investment rules is restricting the ability of developing nations to pursue some of the policy instruments that have been successful at channeling FDI for development in Asia and elsewhere. When acting collectively under the auspices of the WTO, developing nations have largely succeeded in blocking proposals that would further restrict such policy space. However, slower movement in global trade talks has led to a proliferation of RBTIAs between developed and developing countries. In these negotiations developing countries have much less bargaining power and end up exchanging policy space for market access.

End Notes

1 The full report can be downloaded at: http://ase.tufts.edu/gdae/WorkingGroup_FDI.htm

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