Foreign Investment and Sustainable Development

Lessons from the Americas

Working Group on Development and the Environment in the Americas

Executive Summary

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A comprehensive review of the impacts of foreign investment liberalization and related economic reforms 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 the "policy space" for such policies should be accommodated in bi-lateral, regional, and global trade and investment treaties.

The report, "Foreign Investment and Sustainable Development: Lessons from the Americas," is the product of a series of studies conducted by development and environmental economists from the U.S., Mexico, Brazil, Argentina, Chile, and Costa Rica. Drawing on case studies from across the region—Argentina, Brazil, Bolivia, Chile, Costa Rica, Ecuador, Mexico, Uruguay, and Venezuela—the Working Group examined how foreign investment during the reform period has affected economic growth, environmental policy and performance, and the countries' political economy. The full technical studies are available on the working group web page and will be published in a comprehensive book by Anthem Press in 2009.

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 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, such 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., 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 U.S., Canada, and Mexico became the template for a range of subsequent regional and bilateral accords, including agreements on the U.S.–Chile Free Trade Agreement, U.S.–The 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 of course, 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 twenty years, governments throughout Latin America have reduced tariffs and subsidies, eliminated barriers to foreign investment, restored 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 and be a source of dynamic growth in host countries. 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, in part because they have shown poor results. Economic growth in per capita terms in the region was slower—less than 2% since 1990, the period of the reforms, than in the last decades of the import substitution period. **A major finding is that slow growth is in part explained by the fact that FDI failed to crowd in more total investment into Latin American economies.**

Main Findings of the Report

1. **FDI was concentrated in a small handful of countries in the region. Indeed, Brazil, Mexico, Argentina, Chile and Venezuela received more than 80 percent of all the FDI in the region;**
2. **Foreign firms by-and-large located in Mexico and the Caribbean tended to serve as export platforms to the United States, whereas those that located in South America did so to sell to domestic markets in that region.**
3. **FDI was attracted by traditional determinants, not necessarily whether a nation has a regional or bi-lateral trade and/or investment treaty or if it can serve as a pollution haven for foreign firms;**
4. **When FDI did come, foreign firms tend to have higher levels of productivity and higher wages and were likely to increase trade in the region; yet FDI fell far short of generating "spillovers" and backward linkages that help countries develop, and in many cases wiped out locally competing firms thereby "crowding out" domestic investment.**
5. **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**—three countries that have received the lion's share of FDI in the region—and **Costa Rica** it is 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, especially 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 it little evidence that foreign firms are greening their supply chains (given that so many supply chains were wiped out from FDI in the first place); and
  - 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 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 in **Uruguay**
  - A Uruguayan BIT constrained the set of policies available to solve a conflict over foreign investment and transboundary environmental problems with Argentina; whereas
  - BITs in Bolivia, Ecuador, and Venezuela were reneged by government who were able to renegotiate the terms of contracts with foreign hydrocarbon firms.

New Directions for FDI and Sustainable Development

The Working Group, in agreement with the broader literature on the subject, found 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 simply at the stage of starting to debate the issue, others are going so far as to nationalize foreign firms. Yet, most governments are looking for a more balanced approach. What this report makes clear is that new policies are needed. Based on the research mentioned above, three broad lessons can be drawn out as principles for policy-making in this field:

FDI is not an ends 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 lion's share 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.

FDI policy needs to be conducted in parallel 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 LAC nations can overcome information and coordination externalities, access to credit problems, and competitiveness issues on the part of their domestic firms. In this regard, parallels or 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 the extent that the domestic firms develop into competitive exporters themselves.

International agreements, whether at the WTO or at the level of regional or bi-lateral 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 where developing countries have much less bargaining power and end up exchanging policy space for market access.

The studies in this report highlight the economic, social and environmental costs of the present approach. Hopefully, they also point to some of the ways in which national policies and international trade agreements can be transformed to better meet societies' goals.