



## *International Investment Rules and the Environment: Stuck in the Mud?*

By Lyuba Zarsky, Nautilus Institute for Security and Sustainable Development

The governance of international capital flows will be one of the key environmental policy issues of the next decade. Along with labor, human rights, and other social advocates, environmentalists are increasingly demanding that international rules and corporate norms governing investment explicitly embrace environmental and social performance goals.

The 1990s witnessed a sea change in the pattern of international capital flows. In 1990, official sources accounted for more than half of international capital flows to developing countries. By 1995, over three-quarters came from private sources. The biggest story was the explosion in portfolio (equity and debt) investment, which soared from \$5 to \$61 billion from 1990-95.

The growth of foreign direct investment (FDI) is equally dramatic. From 1990-95, the volume of FDI

flows to developing countries nearly quadrupled. Reflecting a strong "rich country bias," the lion's share of FDI still flows between G-7 countries. Nonetheless, developing and transition countries, especially China, have become important FDI recipients.

The surge in FDI has been propelled by global and national moves toward trade and investment liberalization. According to a recent UNC-

TAD (UN Conference on Trade and Development) report, 95% of the 599 changes in laws and regulations governing FDI in developing countries between 1991 and 1996 were directed toward liberalization.

Given the lack of effective state regulation in many developing countries, the explosion of FDI has triggered a hot debate about how to govern global investment. The debate revolves around assessments of environmental and social impacts of FDI in both home and host countries. The key question is whether—and at what pace—globalization will induce standards to harmonize upward or downward.

Environmentalists argue that, given the current lack of national and global regulation, the gravitational pull is decidedly downward. Gaps in standards either draw the dirtiest OECD (Organization for Economic Cooperation and Development, composed of the world's 29 wealthiest countries) industries to develop-

ing countries or encourage foreign firms to pollute once they get there. In either case, the effect is the creation of "pollution havens". In addition, local and/or national policymakers and communities compete intensely to attract or retain FDI, especially by powerful transnational corporations (TNCs), which are increasingly establishing global production and supply networks. Less onerous or "more flexible" environmental regulation is a locational bargaining chip. The result? A "race to the bottom" in environmental standards, as OECD countries struggle to keep TNC investment at home.

Proponents of free markets counter that FDI is good for the environment, because it diffuses cleaner technology and best management practices, thus creating "pollution halos." Moreover, "green consumers" in rich countries increasingly demand better environmental performance from poorer countries. Free-marketeers thus contend that national policies and global investment rules promoting maximum openness to FDI will drive an upward process of harmonization, with developing-country standards and performance racing toward higher OECD levels.

The problem with the "halo" perspective is that, even under the most optimistic scenario, environmental progress is likely to be slow and incremental—too slow to significantly alter clear trends toward severe ecological degradation. Though they help to promote technological innovation and diffusion, the relentless pressures of neoliberal international competition mitigate against bold policy initiatives to significantly move toward sustainable economic development paths. On the other hand, it is likely that strong popular demands to maintain environmental quality will remain politically and commercially salient in OECD countries. Environmental standards may be pulled downward incrementally, but are not likely to slide down dramatically or across the board.

Thus, rather than racing anywhere, the most likely pull of globalization on environmental standards—under an investment regime guided by neoliberalism—is toward sluggish and slow change. Environmental standards are "stuck in the mud," with policymakers and corporate managers alike looking over their shoulders at what their competitors are doing. To get out of this "prisoner's dilemma" and move beyond incremental improvement, international collective action will be required to lift environmental standards for industry at a global level. This will entail establishing global rules for investment—including for industrial sectors—that explicitly embrace environmental performance goals.

### Key Points

- International competition for investment keeps environmental standards "stuck in the mud."
- With the right set of global rules, foreign direct investment could be a channel for ecologically sustainable economic development.
- In the coming decade, U.S. policy will be decisive in shaping international investment rules.

Current U.S. policy rests squarely on neoliberalism—dismantling national barriers to international trade and investment and creating global commercial disciplines while leaving the social and environmental regulation of markets to nations.

U.S. foreign policymakers, however, are not wholly insensitive to environmental concerns. The Office of the U.S. Trade Representative has a section devoted to natural resources and the environment. At the World Trade Organization, the U.S. has been viewed as a leading environmental proponent—at least when it suits U.S. commercial interests. In keeping with its overarching commitments to neoliberalism, U.S. investment/ trade-environment policy has two tenets: 1) liberalization is, on average, good for the environment; and 2) the best way to increase TNC global environmental performance is through voluntary corporate self-regulation.

What is the evidence that these tenets are valid? In a recent literature review, the OECD found that FDI generates both positive and negative environmental impacts at the micro (that is, plant or local) level. However, the OECD identified a significant research gap on the ecosystem-wide scale or macro effects of FDI, especially of FDI-induced increases in income. Free-marketeters have made much of two studies by economists Gene Grossman and Alan Krueger showing that environmental quality rises with income, once per capita income reaches about \$5,000-8,000. Richer consumers, for example, are able to buy better cars, reducing air pollution.

These studies, however, utilize narrow indicators of local environmental performance, e.g., measures of urban air and river pollution in Mexico. They ignore a range of other environmental impacts that have been shown to increase with affluence, including bioaccumulating toxic and hazardous wastes, the loss of biodiversity/habitat, and atmospheric pollution. Raising incomes in developing countries should be a central goal of global investment rules, but it will not, of itself, put economic development on an ecologically sustainable footing.

Moreover, foreign firms apparently do not consistently perform better in developing countries. In some sectors, notably energy, foreign firms are likely to have superior technology or close links to "green consumer" markets. Both foreign and domestic firms seem to be incrementally improving their environmental performance in many parts of the world, primarily due to national regulation and/or local community pressure. For the most part, foreign links, including export markets and plant ownership, seem to make little difference to firm performance. Though FDI may offer benefits in particular sectors in particular countries—for example, cleaner energy technologies in China—there is no discernible, broad "pollution halo."

There is some evidence that green consumers in Europe and North America are using ecolabels to positive effect, especially concerning sensitive resource-based products like timber and bananas. The improvements, however, have been incremental. The "Eco OK" label, for

Costa Rican bananas allows European consumers to reward producers who reduce agrichemical inputs and improve worker health and safety. However, it does not stem—and may even promote—the widespread ecological damage caused by monocultural banana production. Thus, even the halos that do exist are apparently pretty small.

On the other hand, there is little evidence to support the "pollution haven" hypothesis, at least in terms of the industry-location variable. Differences in environmental standards seem to have little influence on where firms locate, probably because costs of compliance with environmental regulations are low. However, there is substantial evidence of poor environmental performance by foreign companies in developing countries. Indeed, in some cases, FDI has generated egregious local and even national ecological degradation with severe impacts on human health—oil exploration and drilling in Nigeria and the Amazon, minerals extraction in Indonesia and the Philippines, chemical plant explosions such as in Bhopal. Thus, although foreign firms may not be drawn to relocate by lower standards, they may perform like environmental renegades once they get there.

There is also substantial case-study evidence that local policymakers—from Costa Rica to China to California—are sensitive to the potential effects of higher environmental standards on TNC investors. They may not weaken standards, but they may not enforce them either, and they certainly hesitate to raise them.

This mix of demonstrated impacts mitigates against any overarching conclusion about the effects of FDI "on average." There is no average; performance is context-dependent and other things are far more important than ownership. If a goal of U.S. foreign policy is to promote ecologically sustainable development on a global basis, then what is needed is effective collective regulation of industry that addresses both the "micro" and "macro" ecological impacts of international investment.

What about the efficacy of corporate self-regulation? As yet, there are few in-depth studies, and research is hampered by the reluctance of companies to disclose environmental performance data in either domestic or overseas operations. Early evidence from the U.S., however, suggests that experiments to give more regulatory flexibility to corporations, especially in the high-tech sector, have fallen short of expectations. Without better company disclosure and third-party monitoring, self-regulation will be doomed to the realm of public relations-type claims—including by U.S. policymakers—that lack credibility.

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## Key Problems

- The U.S. has pursued investment liberalization without considering environmental or social impacts either at home or overseas.
  - U.S. policy is based on two unproven tenets: that, on average, FDI is good for the environment and that voluntary self-regulation is the best way to raise corporate environmental performance.
  - The evidence shows that the environmental impacts of FDI are context-dependent and that effective regulation is key to corporate environmental performance.
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The U.S. will play a decisive role in shaping the regulatory architecture for international investment. To shoulder its global role responsibly, Washington must first clearly define its policy goals. In the MAI (Multilateral Agreement on Investment) process, which the U.S. initiated and led, environmental and social concerns were initially not even on the radar

screen. Even after a storm of public criticism, environmental issues made only a minor appearance. Yet the evidence shows that regulation—or the lack of it—matters. Foreign investment, both direct and portfolio, could act to promote ecological sustainability, which is—or should be—a strategic U.S. foreign policy goal.

U.S. policy on international investment should thus not veer toward short-term commercial gain via liberalization but should be based firmly on a wider set of integrated economic and environmental, as well as security and social, objectives. Policy goals should be clearly articulated—via a

process of wide public debate and consultation—and implemented by all the relevant bureaucracies. How investment is governed globally has impacts not only for business and for the environment but for international peace, human rights, and social justice.

To promote sustainable development, U.S. policy should thus aim not only to define and enforce environmental standards but to increase the flow of economically beneficial foreign investment to developing countries, especially the poorest. It should also aim to reduce beggar-thy-neighbor, conflict-enhancing competition for FDI, and it should promote human rights.

The challenge, then, is how to channel investment toward sustainable development. First, it is clear that regulation matters. Though local and national regulation are important, there is a great need for an overarching global framework to define and raise investor environmental responsibilities. Located within a set of global or regional rules governing investment, environmental norms would likely best be defined at the level of industrial sector.

Global environmental rules for industry should embrace both process and performance standards. Process standards include mandatory environmental impact assessment and mitigation. International baseline performance standards, such as those developed by the World Bank, set caps on specific pollutants. Effective international standards should be minimum standards that countries and companies can exceed if they wish, and they must be set high enough to have a real impact. The formulation of such standards should include widespread consultation among both developed and developing countries as well as among environmental and other NGOs. Although the aim is to achieve a high level of consensus, there will also likely need to be a bargaining process between richer and poorer countries.

Second, the U.S. should help to build national-level environmental governance capacities in developing countries via technical assistance, institutional strengthening, and other foreign aid. Governments need help to establish their broad development objectives and to subject FDI projects to preliminary strategic environmental and social assessment. They also need technical and financial help to develop their own capacities to regulate industry, whether domestic or foreign. For many countries, the key issue is effective enforcement of existing regulation.

Third, the U.S. needs to promote innovations in domestic corporate governance that enhance the social and environmental accountability of U.S. TNCs. Many TNCs have adopted voluntary, self-regulatory codes of conduct such as ISO 14,000, the latest standards series put out by the International Organization for Standardization that sets standards for consumer and industrial products. Few codes, however, have any internal or external compliance mechanisms. Increasing compliance requires, at minimum, that companies measure environmental impacts and disclose information to regulators, impacted communities, and the public. Useful internal governance tools might include environmental auditing and reporting, environmental management systems, and independent certification. Useful external governance tools might include mandatory information disclosure and third-party certification.

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## Key Recommendations

- The U.S. should articulate a clear set of goals for international investment policy via a widespread public policy debate.
- U.S. policy should veer away from a single-minded focus on liberalization and be grounded in a policy framework that integrates environmental, social, and security objectives.
- The U.S. should pursue domestic policy innovations in corporate governance, such as mandatory information disclosure and third-party verification, which increase the environmental and social accountability of U.S. TNCs.

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## Websites

### Global Corporate Accountability Project

<http://www.nautilus.org/cap>

### Corporate Watch

<http://www.igc.org/trac>

### Mineral Policy Center

<http://www.mineralpolicy.org>

### New Ideas in Pollution Regulation, World Bank

<http://www.worldbank.org/nipr>

### OECD

<http://www.oecd.org/daf/env/index.htm>

### Sierra Club—Human Rights and Environment Project

<http://www.sierraclub.org/human-rights/nigeria>

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