THE PROMOTION OF SUSTAINABLE FOREIGN DIRECT INVESTMENT IN SOUTH AMERICA

- Opportunities for cooperation between the European Union and South America

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1. Introduction

Over the last two decades, governments in South America (SA) and other developing countries have placed renewed emphasis on the role of foreign direct investment (FDI) as a catalyst for development. The restrictive and regulatory policies of the 1960s and 1970s have given way to a more liberal approach and even direct incentives for FDI. As a result, there has been a substantial flow of FDI into the region, increasing from US$ 8.957 billion in 1991 to US $26.647 billion in 2002.

The European Union (EU) is both the main worldwide source of FDI (contributing 75 per cent of global FDI) and the main foreign investor in SA.

Although some developing countries have benefited from successfully attracting FDI into their economies, experience shows that this is not always the case. On one hand, many countries of the countries that have opened up their policies have not managed to attract FDI. On the other hand, in contrast to predictions of traditional theory, countries that have successfully attracted transnational corporations (TNCs) have seen scant contribution to their economies.

Moreover, there is a significant number of potentially negative impacts on sustainable development linked to the practices of foreign companies, including increased environmental degradation, a lowering of environmental and labour standards, greater inequality, displacement of national companies (crowding out), low technological capacities, and anticompetitive practices.

All these issues have contributed to the debate on the costs and benefits of FDI. Governments have come to realise that although FDI offers significant potential for sustainable development in their countries, it is not enough to simply attract the investment and wait for the benefits to flow in. It is one thing to be able to attract FDI and quite another to ensure such investment is beneficial for sustainable development.

As a result, developing countries' governments have changed their focus regarding FDI in an attempt to enhance sustainability. Rather than simply seeking to attract as much FDI as possible, increasing emphasis is placed upon creating policies and instruments aimed at maximizing the 'quality' of FDI in terms of its impact upon sustainable development in the respective countries.

However, as yet there is no consensus on which sets of policies and instruments best attract more sustainable FDI and indeed the concept of sustainability itself is the subject of strong debate and ongoing research.

This brief article puts forward various relevant aspects that should be taken into account by South American governments interested in promoting more sustainable FDI and proposes some opportunities for cooperation between the governments of the EU and South America.

For the purposes of this article, the term 'sustainable FDI' refers to FDI that maximises sustainable development benefits while minimising negative impacts.

Given the inherent limitations of this kind of article, on no account does it intend to offer an exhaustive analysis of the terms under which FDI flows from the EU to SA. Instead, it attempts to highlight certain issues that seem relevant and common to the region when promoting more sustainable FDI and hence deserve more detailed analysis.

2. Flow and characteristics of FDI in South America

The table below shows the evolution of total FDI flow to the countries of South America since the 1990s. FDI increased sharply from US$ 8.957 billion in 1991 to US$ 26.647 billion in 2002, peaking in 1999 (at US$ 70.2 billion). The increase in flow from transnational corporations corresponds to the implementation of more liberal trade and investment policies in the region. The fall in flows since 1999 and maintained until 2002 has a number of explanations, including: the slowing down of the global economy, which led to a fall in investments and company profit rates; political and economic tension in several countries of the region; and the end of the privatisation cycles in many Latin American countries.[1] Therefore, while in 1997 South America received almost 10 per cent of world FDI, in 2002 it accounted for only 5 per cent.

Distribution of FDI within South America has been uneven, mainly focusing upon three countries - Brazil, Argentina and Chile - who between them received 82 per cent of FDI in the region between 1990 and 2002. Notably, these three countries are all within the ten developing countries with highest FDI flow worldwide between 1990 and 2002.

FDI stock in the region represents on average 40 per cent of the gross domestic product (GDP) and 21.4 per cent of gross fixed capital formation (GFCF), with considerable variation from country to country. For example, in Bolivia, Argentina and Chile, FDI stock represents a significant percentage of the GDP, with figures over 70 per cent for 2002. Likewise, FDI stock accounts for a significant proportion of GFCF between 1997 and 2002 for countries like Bolivia, Ecuador and Venezuela (See Table 1).

In terms of FDI at sectoral level, figures for 1999 show 52.2 per cent of FDI into Latin America went into the tertiary sector, 32.8 per cent into the secondary sector and 12 per cent into the primary sector. It should be noted that participation in the primary sector (particularly mining) has increased since 1988 (9.6 per cent), a trend that contrasts with the rest of the world where the relative importance of the primary sector is falling.

The EU is the main source of FDI worldwide, providing 75 per cent of global flow[2]. In 2000 total FDI from the EU was US$ 773 billion, five times greater than foreign investment from the United States. The EU pre-eminence in terms of investment flow is also reflected in South America, where it has increased significantly in recent years. In 1997 European FDI in Latin America[3] was similar to that of the United States (some US$ 22 billion), but in 1998 the EU took over as the main foreign investor in Latin America with a total of US$ 33 billion, a trend further accentuated in 1999 (US$ 43 billion). This figure represents 39 per cent of total FDI in the region that same year.

In terms of the specific source countries of the FDI within the EU, Spain has been the main European investor in South America. According to 1999 figures, Spain accounts for 65 per cent of FDI, followed by the UK (15 per cent), France (7 per cent),

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[1] Cepal (2003) "*La Inversión Extranjera en América Latina y el Caribe*" LC/G.2198-P, Santiago de Chile, March; Borregaard N. (2003) "*Background Paper Southern Agenda*", RIDES, October.

[2] UNCTAD (2001) "*World Investment Report 2001*", UNCTAD/WIR/2001, UNCTAD, Geneva

[3] This figure also includes Mexico and the Caribbean, but this does not distort the conclusions since three countries, Brazil, Argentina and Chile account for over 80 per cent of Latin America's FDI.

Germany (5 per cent) and Portugal (4 per cent)[4]. The main sectors involved are water services, energy and telecommunications. [5]

TABLE 1: NET FDI INFLOWS IN SOUTH AMERICA (a), 1991-2002
(in US$ million)

	Av. 1991-1995	1996	1997	1998	1999	2000	2001	2002	Part. (av. 1990-2002 (%)	FDI/GDP* (2002) (%)	FDI/GFCF** (av.1997-2002) (%)
Argentina	3,960	5,294	6,711	5,697	23,988	11,657	3,214	1,003	**20.6**	**74.7**	**22.2**
Bolivia	180	493	607	872	1,010	725	662	612	**1.6**	**79.2**	**54.1**
Brazil	2,751	11,648	19,848	26,347	28,576	32,779	22,636	16,566	**51.9**	**52.1**	**21.6**
Chile	1,854	4,913	5,471	4,793	8,988	3,639	4,476	1,601	**9.7**	**69.7**	**28.1**
Colombia	1,358	3,407	6,042	2,983	1,468	2,280	2,328	1,950	**4.1**	**24.0**	**18.9**
Ecuador	403	465	583	830	648	720	1,330	1,335	**2.1**	**39.5**	**30.0 (b)**
Paraguay	155	229	252	240	94	119	79	80	**0.2**	**12.1**	**9.6 (b)**
Peru	1,291	3,355	2,050	1,930	1,939	662	1,064	1,943	**2.9**	**22.1**	**13.2**
Uruguay	91	142	162	164	235	274	318	168	**0.5**	**13.1**	**8.2**
Venezuela	1,079	2,270	5,138	3,766	3,290	4,465	3,448	1,389	**6.5**	**33.6**	**24.1 (b)**
Mercosur and Chile	8,564	21,855	32,030	36,837	61,881	48,468	30,723	19,420	**82.8**		
Andean Community	4,557	10,361	14,834	10,785	8,355	8,852	8,832	7,229	**17.2**		
Total SA	13,122	32,216	46,864	47,622	70,236	57,320	39,555	26,647		**40.1**	**21.4**
Global %	5.8	8.3	9.8	6.9	6.5	3.8	5.4	5.0			

Source: CEPAL (2003); UNCTAD (2003)
*: FDI stock; **: GFCF.
(a): Does not include Guyana or Surinam; (b): only includes until 2001.

To give more of a breakdown of these totals, FDI flows from the EU to Mercosur countries in 2000 totalled € 26.5 million, a figure which has fallen dramatically in recent years (from € 16.5 million in 2001 to € 5.6 million in 2002[6]). According to other sources, in 2002 the Mercosur received 4.3 per cent of the EU's total global FDI and 7 per cent of its global FDI stock. [7]

In the case of Chile, total FDI from the EU between 1974 and 2000 came to US$ 17,284 million - 37 per cent of Chile's total FDI over this period – making the EU the most important source of FDI in the country. In sectoral terms, 35 per cent of the resources are invested in the electricity, gas and water sectors, followed by financial services (29.4 per cent), with the mining sector in third place with 11.5 per cent[8].

As for the Andean Community, between 1992 and 2001 the EU was also their main source of FDI (US$ 22,830 million, 26 per cent of its total FDI). The trend over this period was for growth, with a peak in 1997 (US$ 4,322 million). In 2001, as with the

4 Includes Mexico and the Caribbean.
5 UNCTAD (2001)
6 www.delury.cec.eu.int/Uruguay/ue_mercosurUE%20mayo202004.pdf
7 http://www.europa.eu.int/comm/external_relations/mercosur/intro/index.htm
8 www.foreigncommittee.cl

rest of South America, EU-sourced FDI fell by 33 per cent compared to the previous year.[9]

- **Characteristics of the FDI in South America**

Owing to the relative abundance of natural resources in the South American region, FDI is mainly 'natural resource-seeking',[10] particularly in the mining and forestry sectors, which are export- oriented. However, in the largest countries, such as Brazil and Argentina, the 'market-seeking' transnationals are also relevant, particularly in the manufacturing and service sectors.

More specifically, FDI from the EU is mainly invested in the tertiary sector, which is largely associated with efficiency-seeking transnationals.

An additional distinction relates to the means of entry of the FDI, i.e. through 'Mergers and Acquisitions' (M&A) or 'Greenfield' investments. This distinction takes on relevance in the debate on FDI and sustainable development since the literature suggests M&A is potentially less beneficial to the recipient economy, at least in the short term[11].

Unlike in other developing countries, entry through M&A has been an important characteristic of FDI in South America, closely linked to the privatisation of state-owned companies and deregulation of the services sector. However, this method of entry of capital has become less significant over the last couple of years as privatisation processes in a number of countries in the region have come to an end. The M&As have been the preferred means of entry for European investors, mainly in the areas of services, energy and telecommunications.

Another important characteristic of the FDI relates to the issue of ownership. In South America there is a predominance of investments where transnationals take majority or total control of local business. Joint ventures with national companies are less common. This would suggest that the 'acquisitions' have been more common than the 'Mergers'. The literature on this issue claims the latter to be a potential vehicle for the modernisation and industrialisation of local firms.[12]

3. Some key elements in the promotion of quality FDI

At least three basic elements have a bearing on the attraction of quality FDI in terms of its impact on a country's sustainable development. The first element relates to national policy, both its general framework and policies specifically aimed at encouraging FDI. A second element, connected to the first, relates to the limits and restrictions currently faced by governments when drawing up their FDI policies, particularly those restrictions laid down by bilateral and/or multilateral investment

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9 Statistical Report "*Comercio e Inversión entre la Comiunidad Andina y la Unión Europea 1991-2001*" (Trade and Investment between the Comunidad Andina and the European Union 1991-2001) SG / de 057, 18th March 2003, Comunidad Andina, available at www.comunidadandina.org/estadisticas/SGde057.pdf

10 FDI is commonly classified into types according to the motivation behind the investments. Therefore, market-seeking FDI seeks out large and expanding markets; natural resource-seeking FDI requires access to natural resources and raw materials; asset-seeking FDI looks for either a cheap and abundant or well-qualified labour force, technological assets, innovation or other such created assets; and efficiency-seeking FDI seeks an efficient and competitive production base for export.

11 UNCTAD (2000) "*World Investment Report, 2000*", UNCTAD / WIR / 2000, UNCTAD, Geneva

12 Chudnovski D. and López A.(2002) *"La Inversión Extranjera Directa en el MERCOSUR: un análisis comparativo"* (Foreign Direct Investment in the MERCOSUR: a comparative analysis) in Chudnovski et al eds. "El Boom de Inversión Extranjera Directa en el MERCOSUR" (The Foreign Direct Investment Boom in the MERCOSUR), Siglo XXI and RED MERCOSUR.

agreements and regulations. A third element relates to the scope of the concept of sustainable FDI or good quality FDI. Each of these three points is briefly addressed below.

3.1 Policies and instruments for regulating and promoting FDI

Countries can promote FDI in different ways. These range from simply opening up access conditions for FDI, to encouraging FDI in general without seeking any specific kind of investment, to fostering FDI in a more selective way, focusing on certain activities, technologies or investments. Based on this variation, the UNCTAD has identified three kinds of general strategies or policy frameworks that countries have used to attract FDI.

In the first generation of policies, the governments adopt more liberal policies which reduce barriers to FDI, reinforce standards for dealing with foreign investment and lend a more important role to market forces when assigning resources.[13] In fact, the liberalisation of agreements relating to FDI has been the dominant policy since the mid-1980s in almost all countries, industrialised and developing. This shift is reflected in the fact that of the 1,641 changes made to FDI laws in 165 countries between 1991 and 2002, 95 per cent moved towards greater liberalisation[14].

In the second generation of policies to promote FDI, governments take a step further and actively seek to attract FDI by marketing their countries. This step is reflected in the proliferation of Investment Promotion Agencies (IPAs), with over 164 such entities worldwide to date.

A third and more recent generation of policies seeks to create an ‘enabling environment’ for the FDI as a starting point to then proactively attract investment. This new focus, instead of promoting any foreign investment as in the previous approach, aims to attract FDI from specific industries, companies, investors or even countries. The kind of transnational corporation sought is determined by the impact of the investment upon the development needs of a specific country or region. This approach is becoming widespread, and is reflected in the proliferation of IPAs both sub-nationally and locally. According to a 2004 survey by UNCTAD, most of the IPAs, including those in Latin America, carry out some form of selection process when attracting FDI, either by country, sector or type of investor. This trend towards more carefully selected investments has been reinforced by the fall in DFI flow into developing countries over the last couple of years.

One further ‘pre-liberalisation’ generation of policies could be added to this typology of strategies to promote FDI. This relates to the attempt by some governments (including some from South America) to attract FDI and modify its contribution to the domestic economy through a combination of incentives and regulatory instruments. These kinds of policy were widely used in the past by both industrialised and developing countries. However, such approaches have gradually lost favour, since (alongside other reasons explained later) they conflict with the rules of liberalisation.

By and large, the new focus of FDI seems to suggest a shift in the conventional approach where countries implemented policies to promote global integration, protected foreign investors and minimised government action. As well as increasing the volume of FDI into their country, governments now show a growing interest in improving the quality of foreign investments in terms of their impact upon the

[13] UNCTAD (2001)
[14] UNCTAD (2003)

sustainable development of the country.[15] The governments of developing countries have become increasingly aware that although FDI potentially has an important role to play in sustainable development in their countries, foreign investment does not automatically bring benefits. It is not enough to simply attract FDI and then bask in its benefits; it is one thing for a country to be able to attract FDI and quite another to benefit from such investments. The question of which set of policies and instruments is best able to attract more sustainable FDI and reap its benefits is still open to considerable debate and research.

- **Typology of policies and instruments promoting FDI**

A first group of instruments seek more to regulate FDI than to promote it, but they are interesting in that they modify the impact of foreign investment on local economies. These range from straightforward prohibition of FDI into specific sectors to acceptance of FDI under certain conditions. The most common performance requirements include setting minimum levels of local content, national participation in ownership, setting up joint ventures, export performance levels, technology transfer and employment for the national workforce.

As explained above, these kinds of instrument were widely used by Latin American countries during the boom of industrialisation based on import substitution in the 1960s and 1970s. Their use by both developing and industrialised countries has decreased over time.[16] This decrease can be explained by: World Trade Organisation (WTO) regulations and certain bilateral and multilateral investment agreements; a reduction in foreign trade barriers and a more competitive environment for attracting FDI (making these instruments difficult to implement without losing FDI and hampering competitive performance, and; governments' growing preference for market instruments that achieve specific development objectives.[17] These instruments have also had some negative impacts on the growth and wellbeing of developing countries, particularly the impacts on TNCs' productivity provided by the use of perverse incentives such as the protection against national and foreign competition. Recipient countries' governments frequently offered these instruments as a *quid pro quo* for the use of performance requirements. Evidence suggests that export-oriented policies and restrictions to certain market-seeking investments also create distortions that deny the local economy the advantages of technology and knowledge transfer. Hence the removal of any such restrictions, when accompanied by adequate institutional support, can lead to more sustainable FDI since it allows for greater integration with the national economy.[18] Despite this, there is currently renewed interest in these kinds of instrument due to their potential to modify FDI contribution for recipient economies.

Another set of instruments seeks to attract or promote FDI. These can be broadly divided into two groups, one based on regulations and the other on incentives.[19]

The group of instruments incentivising FDI were widely used in the past by all countries. It included financial incentives (direct aid, soft credit, guaranteed loans), fiscal incentives (tax exemptions and reductions, accelerated tax depreciation of investments, special deductions, exemption from import tariffs, etc.) and indirect incentives (provision of land and specific infrastructure, preferential access to

[15] UNCTAD (2001)
[16] Chang (2003) "*Foreign Investment Regulation in Historical Perspective, lessons for the proposed WTO Investment Agreement*", Third World Network, March
[17] UNCTAD (2003)
[18] Oman (2000) "*Policy Competition and Foreign Direct Investment*" OECD Development Centre, Paris
[19] Oman (2000)

government procurement, guaranteed monopolies, special regulatory treatment, etc.).

The group of instruments based on regulations corresponds to a newer, fairly far-reaching and heterogeneous focus. It ranges from macroeconomic regulations (e.g. consolidation of the country's economic and political stability and the use of appropriate models for political, economic and fiscal change) to macro-organisational regulations, such as those affecting patterns of resource allocation and organisational structure of economic activities (e.g. copyright laws, strengthening of the judicial system, privatisation of public companies, market deregulation, liberalisation of trade and capital flow, international investment agreements, establishment of industrial zones with different laws to the rest of the country, and changes in labour and environmental laws and standards affecting the quantity and quality of resources such as education, health and infrastructure policies).

Another group of instruments that also falls into this category, since it seeks to improve the investment environment, includes services that the government have begun to offer to foreign investors (for example, 'one stop shop' systems and other post-investment services). Also included in this category are the promotional techniques used by governments to create an attractive image of their country for potential investors with information on the country's efforts to provide a favourable environment for investment.

In terms of the impact different instruments might have upon TNCs' choice of investment locations, the literature suggests that although traditional economic factors are still relevant,[20] other factors such as macroeconomic and political stability play a crucial role in attracting FDI. Moreover, regulation-based FDI promotion, as long as it does not imply a drop in standards, is attracting increased attention since, on the one hand, it has a role to play in attracting sustainable investment, and on the other hand its implementation benefits both foreign investors and the national economy as a whole. One example of this is the policy to improve the level of human resources by attracting FDI with higher value added.

It should be pointed out that the correlation between FDI and labour and environmental standards has been a crucial issue in the traditional debate on FDI and sustainable development. Nevertheless, evidence on the issue is somewhat ambiguous. There is no statistical evidence to show that social or environmental standards have any effect on FDI location decisions and some authors even conclude that should such a link exist, improved standards encourage more investment.[21] There seems to be a need to explore the opportunities that exist to attract FDI through better environmental and social practices.

The use of incentives to promote FDI is much more frequently questioned. On one hand, the rationale is based on an expected benefit from the FDI that does not always materialise (or proves to be negative) or is very difficult to quantify, which can lead to distorted investment decisions. On the other hand, there is a risk that the use of incentives could unleash a bidding war, in which (national and regional) governments compete to attract FDI offering ever more substantial incentives, with a consequent transfer of national resources to transnational corporations. This kind of problem has already been documented, for example in the case of Brazil and Argentina.[22]

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[20] The attractiveness of any country for the different forms of FDI is said to depend primarily on economic factors such as market size, availability of natural resources or cheap labour force.
[21] See Fox (2003)
[22] Oman (2000)

The literature also suggests that incentives have only a marginal influence upon choice of FDI locations.[23] More specifically, it would seem that factors such as incentives and promotion techniques only come into play once the 'fundamental' factors have been provided. The importance of these instruments would increase if the policies and other factors affecting FDI became less differentiated between countries and locations, particularly if these locations were geographically close to each other.

3.2 *Limits to domestic policy options concerning FDI*

Liberalisation of trade and investment regimes has an enormous effect upon how new policies on FDI are formulated and implemented as well as a clear impact on governments' abilities to select and modify the quality of FDI. There is concern that many policies and instruments used to regulate FDI and reap its benefits in the sectors of particular interest to industrialised countries are currently restricted or prohibited by new investment laws.

For example, performance requirements have been identified as a potentially important tool to improve FDI impacts on sustainable development. However, industrialised countries associate these tools with interventionalist policies from the past and question their effectiveness. This concern is reflected in a series of multilateral and bilateral agreements restricting their use. For example, the WTO's Agreement on Trade-Related Investment Measures (TRIMs) prohibits any measures seen to distort trade. The TRIMs also prohibit performance requirements relating to privileges, such as a subsidies, which are in turn prohibited in the WTO's Agreement on Subsidies and Countervailing Measures. Both agreements only apply to goods trading. Services trading is regulated by the General Agreement on Trade in Services (GATS), which offers flexibility in the use of these instruments. On the other hand, there is increasing concern that in the absence of any formal WTO agreement on investments, members are using the GATS as an instrument to liberalise FDI.

At bilateral and regional levels, investment agreements, particularly those involving the US and Canada, also limit the use of such instruments in an even more restrictive way than the TRIMs.

Another concern about these investment agreements between countries relates to the rights they grant foreign investors over conflict resolution. Chapter 11 of the NAFTA agreement is an emblematic example of the issue of expropriation. In practice this provision has meant that governments have had to pay costly sums of money to foreign companies in exchange for protecting the environment or health of the population.[24]

Another controversial issue relates to the proposals to create restrictions on moderate investment subsidies and other methods to promote FDI. This issue takes on particular relevance given the importance of such instruments for developing countries trying to attract FDI in an increasingly competitive environment.

In summary, since there are valid arguments for using these instruments to encourage sustainable development, they should be taken into consideration during the negotiation of regulations affecting investments. Latin American countries need to preserve their right to formulate and implement national policies for FDI that respond

[23] Oman (2000)

[24] See, for example, Araya and Howard Mann (2002) "An Investment Regime for the Americas: Challenges and Opportunities for Environmental Sustainability" in Deere and Esty (eds.) "Greening the Americas: NAFTA's Lessons for Hemispheric Trade" Cambridge, Mass: MIT Press

to their development needs. On the other hand, governments should also be aware of the costs associated with these instruments and consider these in the light of international commitments.

Finally, since many of these instruments are already prohibited by the bilateral or multilateral regulations, another big challenge is to identify alternative approaches and tools that would allow governments to choose the FDI most suited to their needs, maximise the benefits for sustainable development and minimise negative impacts.

3.3 The scope of the concept of sustainable FDI

The previous point suggests that developing countries are becoming increasingly aware of the importance of the quality of FDI in terms of its impact on sustainable development in their countries. As such they have sought to identify policies and instruments that enable the selection of the type of FDI that maximises the benefits for sustainable development in the recipient country. However, the scope of the concept of sustainable FDI remains very restricted, focusing solely on economic aspects of sustainable development, particularly on attracting FDI of high value added or with positive spillover effects on the domestic economy. The social and environmental aspects of sustainable development have received very little attention. In fact, evidence of developing countries that have sought to select foreign investors with better corporate practice is solely anecdotal.[25] The two assessment criteria that have been paid a certain amount of attention are the creation of local employment and, to a lesser extent, the transfer of environmentally-friendly technology.

The relationship between FDI and sustainable development reaches far beyond its mere impacts on the variable economy. One crucial challenge that arises when attracting sustainable FDI therefore is the need to broaden the parameters with which the contribution to sustainability is assessed in order to include a more integral range of social and environmental variables. Which factors are relevant and how they should be included in the concept of sustainable development varies with each specific country and sector. Any decisions should be based on an assessment of both the impacts of FDI on sustainable development and identification of the priorities and needs for achieving more sustainable development in each specific country, area or sector. An analysis of the interactions between FDI and sustainable development in the countries of South America goes beyond the scope of this paper; however, some important issues are set out in Box 1.

Attracting FDI is not in itself a strategy for sustainable development at a national level. FDI can, without doubt, contribute to achieving certain objectives within a sustainable development strategy (e.g. economic growth, better environmental practice or poverty reduction) and as such it could be used as part of this strategy. Each country must analyse for itself if and how FDI could contribute to their sustainable development strategy. They must also ensure that the use of FDI constitutes the most effective way of achieving their objectives. Only after such analysis should countries identify what type of FDI fits their sustainable development objectives before determining and implementing appropriate policies and instruments to select and attract such FDI and maximise its benefits.

On the other hand, identifying which type of FDI is sustainable requires the establishment of sustainability standards with all the complexities that this involves. Likewise, a change in the way investment promotion agencies are assessed would

[25] Fox (2003) "*CSR and Trade & Investment Promotion – a literature review and discussion of key research questions*", IIED, October.

also be necessary since such assessments are currently based on quantity indicators.

Box 1: The impacts of FDI on sustainability in South America

Literature on the impacts of FDI in South America tends to focus on the economic aspects with very little material available on social and environmental aspects.

Studies on the economic aspects tend to emphasise positive impacts in terms of capital generation, economic growth and reduced volatility.[26] However, there are also cases where the economic contribution of FDI has been scarce, at least in comparison to what traditional theory promised. This is due to the insular or enclave nature of many investments, particularly in the natural resource sector, which translates into low levels of technology and knowledge transfer and a high propensity for importation[27]. Some studies even highlight negative economic aspects such as crowding out local businesses[28] and high levels of transfer of utilities, with their consequent effects on the balance of payments, particularly with the current fall in FDI flows to countries in the region and because transfer of utilities becomes a structural element in the running of the economy.

The environmental impacts have been studied far less. There is general concern over the degradation of natural resources since a large amount of FDI flows into the sector of natural resource extraction[29]. Some case studies, for example, on the mining sector in Chile and Peru and the forestry sector in Chile and Brazil, suggest both positive and negative effects of FDI. Positive effects arise from regulatory and technological benefits through technology transfer or pressure to improve existing technology. Negative impacts essentially stem from scale effects.[30]

In terms of social impacts, the few studies that exist have attempted to link FDI indirectly with poverty reduction brought about by economic growth. However, in South America FDI has also been linked with an increase in inequality. More specifically, studies claim inequality levels in the region are more accentuated in periods of high FDI flow, which would seem to suggest that FDI improved income levels for higher skilled workers but not for less skilled workers.[31]

Although there are no studies that specifically tackle FDI from the EU, there are two significant facts whose impacts warrant further research. The first is that most FDI from the EU comes into the tertiary sector. Some specialists claim FDI into the tertiary sector is less damaging (or more beneficial) for the environment than that coming in to the primary sector. However, this also depends upon the nature of the services in question. The impacts on sustainability of financial services, energy, tourism, water and land or air transport all differ widely. The second fact relates to the means of entry of the FDI. Investments from the EU mainly enter South American countries through M&A, a method sometimes considered less beneficial for sustainability than investments that increase existing infrastructure. One of the main concerns about this means of entry is that rather than adding to existing productive capacity in the country at time of entry it simply transfers ownership and control into foreign hands, often with consequent reductions in labour force or closure of some part of the productive or functional activity. Also, if the acquisition company already has some level of activity in the sector this could lead to market domination. On the other hand, there are documented cases of positive environmental effects brought about by the change from national (state) to foreign ownership, largely due to the use of more environmentally-friendly practices and technologies by the latter.[32]

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26 Borregaard (2003)

27 Chudnovski D. and López A.(2002) *"La Inversión Extranjera Directa en el MERCOSUR: un análisis comparativo" (Foreign Direct Investment in the MERCOSUR: a comparative analysis)* in Chudnovski et al. eds. "El Boom de Inversión Extranjera Directa en el MERCOSUR, Siglo XXI y RED MERCOSUR" (The Foreign Direct Investment Boom in the MERCOSUR, Siglo XXI and RED MERCOSUR).

28 Nunnenkamp (2002) "*To What Extent Can Foreign Direct Investment Help Achieve International Development Goals?*", Kiel Working Paper No.1128, Kiel Institute for World Economics, Kiel, October

29 CEPAL (1999)

30 Borregaard and Dufey (2002) "*Environmental Effects of Foreign Investment versus Domestic Investment in the Mining Sector in Latin America*" in OECD Proceedings OECD Global Forum on International Investment Conference Foreign Direct Investment and the Environment –Lessons From the Mining Sector, 7th-8th February 2002, Paris

31 Te Velde (2001) "*Foreign Direct Investment and Income Inequality in Latin America – experiences and policy implications"* Overseas Development Institute, April, London

32 Borregaard ad Dufey (2000) "*Environmental Effects of Foreign Investment versus Domestic Investment in the Mining Sector in Latin America". Unpublished material. CIPMA-RIDES, Santiago*

4. Towards the promotion of more sustainable FDI

The crucial challenge in the promotion of FDI for the governments of South America is, on the one hand, to select and attract transnationals whose practices and potential positive local impacts fit with the concept of sustainable FDI and, on the other hand, to implement policies and instruments that help bring about the expected benefits while minimising negative impacts. This is an enormous challenge that requires a particular country or locality to 'pitch' itself attractively to fulfil the needs of different transnationals, while protecting the priorities and requirements of its own sustainable development, without hindering FDI. Such a task requires considerable development of national skills, including: understanding the factors that attract different investors; business and marketing knowledge; and awareness of the development needs of each country or locality.

This territory is still largely unexplored. However, some preliminary studies indicate opportunities for attracting more sustainable FDI that deserve further investigation for each of the countries of the region. Some of these are detailed below.

Various studies indicate the need to keep the so-called 'fundamental' factors in order. Generally speaking, the most successful countries in attracting FDI have been those demonstrating good governance. Moreover, regulations-based promotion of FDI that focuses on creating a more stable and transparent environment for investors could be an effective way of attracting FDI without resorting to lower environmental and labour standards.[33] Likewise, government policies aimed at increasing the quality of human resources in certain key areas in the recipient countries have the potential to attract higher quality FDI and as such deserve further study.

As for incentives, although the literature suggests they have only a marginal role to play in attracting FDI, they do offer an opportunity to promote more sustainable investments and thus warrant further investigation. Although the evidence is somewhat anecdotal to date, the experience of using FDI incentives to achieve social and environmental objectives in countries such as Malaysia, Thailand and the Philippines[34], should be further examined.

It has also been suggested that the trend towards liberalisation of trade and investment has meant that the power of recipient country governments to make policies is becoming increasingly limited, thus obliging them to attract quality FDI in more innovative ways. In this context, the more recent literature that claims that internalising the impacts of FDI on sustainable development could make economic sense – the so-called 'win-win-win' cases – is worth studying.

Focusing on 'green' products as a business tactic, could be a good opportunity for attracting quality FDI. To the extent that consumers become more sensitive and aware of environmental (and social) issues, the transnationals could find it increasingly advantageous to be 'green' and seek to promote an image in accord with this concept. Many Latin American countries could attract more sustainable FDI by promoting their countries as clean and pure environments, giving them a natural advantage in producing certain environmental products (e.g. organics or sustainable tourism). In addition to the FDI's potential direct impact on sustainable development, this approach could also generate further environmental and social benefits through its effects on the supply chain. However, this kind of strategy requires an environmental regulatory framework that corresponds with the image they wish to promote but does not act as an unnecessary trade barrier or accept inadequate

[33] Grieg-Gran (2002) "*Towards Sustainable FDI in Asia*" IIED, April, London, quoting Oman (2002)
[34] See Oman (2002)

environmental or social standards for the country. This approach also demands a suitably skilled supply chain. Although there are cases where transnationals train their suppliers to make the supply chain ‘greener’, governments also have a role to play in providing and facilitating such training within the local market, thus increasing the attractiveness of the country for this particular kind of FDI.

The relevance of this particular ‘win-win-win’ approach for the countries of the region to attracting quality FDI requires further research. Other arguments in its favour are listed below[35]:

- Clean technology is generally more efficient, and reduces the use of raw materials and increases recycling of potential waste, leading to lower production costs;
- Better working conditions result in higher productivity and fewer disputes with unions, making it easier to attract and retain employees;
- Changes in legislation (more stringent regulations) could imply significant costs and these are often anticipated by the companies. Transnationals prepared for regulatory changes gain the edge over the competition;
- Companies with sound economic and environmental performance are perceived as less risky for financial markets, thus reducing capital costs. They also have lower insurance premiums;
- Responsible business practices have a positive impact on a company’s reputation and public perception, which will in time affect sales and even facilitate operating permits.

The Clean Development Mechanism (CDM) of the Kyoto Protocol also offers opportunities to promote sustainable FDI and several South American countries have already begun to explore this avenue.

Finally, other significant opportunities for promoting more sustainable FDI in South America include:

- selecting FDI from countries like Denmark and Canada which have obligatory corporate social responsibility codes or guidelines for companies operating abroad.
- countries receiving FDI could insist on investors’ adherence to international standards such as the OECD’s Guidelines for Multinational Enterprises[36] or the United Nations’ “Global Compact”. However, such standards should first be analysed to assess their relevance to the sustainability priorities of each country.
- governments could increase FDI’s contribution to their country’s sustainable development by seeking investments from countries whose governments offer assisted development programmes, e.g. programmes to increase TNCs’ contributions to recipient economies through enhanced technology and skills transfer, particularly in the environmental field.

[35] For further information see Grieg-Gran (2002).
[36] In addition to the OECD countries, Argentina, Brazil and Chile are also signatories of these guidelines.

4. Some opportunities for collaboration between the governments of the European union and South America

Each of these opportunities to promote more sustainable FDI represent an enormous challenge for the countries of South America in terms of their technical, financial and institutional requirements. There are several opportunities for cooperation between the member countries of the European Union and South America in order to increase the quality of the FDI on offer.

One important aspect of cooperation relates to building up capacities within government agencies involved both in the generation of a suitable investment environment and the promotion of FDI. More specifically:

- First and foremost, aid programmes are needed to create an investment climate favourable for sustainable development rather than a fall in standards, particularly in the poorest countries of the region. Priorities include issues of governance, political and economic stability and tackling corruption.
- In connection with the above, it is also important to finance research on the role played by incentives and regulations in attracting sustainable FDI in South America.
- The concept of sustainable or quality FDI must be broadened to include other aspects of sustainable development. The agencies in charge of promoting FDI must be persuaded of the benefits of this. This implies training in 'win-win-win' issues, e.g. the benefits of environmentally friendly technology and life cycle analyses. It also implies the need to finance research on the links between the 'win-win-win' arguments and the attraction of sustainable or quality FDI in the context of South America.
- Broadening the concept of sustainable FDI implies using a wider range of variables when assessing investment projects, which demands increased technical skills and financial resources. This offers an opportunity for both technical and financial assistance.
- Greater knowledge is also required of the links between FDI and sustainable development in the countries of the region, so resources coming from EU development aid bodies could also be used to carry out in-depth studies on these links.
- Finance is needed for programmes to create production links between national and foreign companies in order to increase the benefits of FDI in the recipient country. For example, programmes to help transfer clean technologies and environmental management practices or to make the supply chain 'greener' are an essential aspect of cooperation.

In more general terms, regarding the issue of access to information, setting up associations between the agencies in South American and European countries also offers an opportunity for cooperation. More specifically, European agencies could help supply and disseminate information on the various advantages South America offers as an investment location and help identify potential investors to target.

In terms of the finance agencies of European governments, one point of cooperation relates to financing projects that do not damage sustainability in the recipient country and to improving access to credit for more sustainable projects. In fact, at present, since the sustainable nature of many of these projects means they operate on a smaller scale, the existence of fixed costs when accessing credit means they must face proportionately higher financial burdens.

Finally, although opportunities for collaboration are available largely through development aid agencies, finance agencies and export credit agencies, EU countries could also initiate opportunities for collaboration in the formation of their public policy. Although because of national sovereignty issues EU governments are unlikely to be able to regulate the conduct of companies outside their national borders, setting codes of conduct that induce companies operating abroad to use responsible practices that reflect the sustainability priorities of the FDI recipient countries is a push in the right direction.