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Emerging Markets Queries in Finance and Business

The relevance of Foreign Direct Investment for sustainable development. Empirical evidence from European Union

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Abstract

In contemporary society, foreign direct investment has often been considered as a vital source for development and even for sustainable development, one of the major goals in the world we live today, found among the areas of preoccupation for researchers and policy makers. This is the generous context in which the paper aims to discuss the relevance of FDI for sustainable development, according to its reflection in literature and an empirical research on European Union countries. The methodology uses the analysis and synthesis, data interpretation as well as data comparison. The research results, considered within the limitations determined by the research methodology and the lack of a common understanding regarding environmentally-relevant FDI definition and way of measurement, point out the importance and relevance of green FDI in EU countries, with potential to generate rather positive effects, which ultimately, at country level, are conditioned by a balance between macro and micro factors. Due to the complexity of the subject, the research may offer opportunities for future studies.

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Keywords: sustainable development; foreign direct investment; green FDI, environmentally relevant FDI

1. Introduction

In contemporary society, foreign direct investment (FDI) has often been considered as a vital source for development and even for sustainable development, one of the major goals in the world we live today.

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Worldwide, the scientific community and policy makers are interested to find out the determinants of sustainable development. The paper aims to bring into discussion the relevance of FDI for sustainable development. The paper starts by presenting some reference points from literature regarding foreign direct investment in connection to sustainable development followed by a research on this topic for the European Union (EU) countries. The used methods are analysis and synthesis, data comparison and interpretation. The present paper cannot and does not attempt to cover all topics related to the subject, but it rather aims to set a discussion stage, exploring some of the many ways in which foreign direct investment is connected to sustainable development.

2. Literature review

During the last decades FDI role, importance and impact at micro, macro and global level has been extensively debated in economic literature. Thus, one of the key issues refers to the relationship between FDI and economic growth. Theories and existing literature provide conflicting results as presented by Wan (2010) and Kubny, Lundsgaarde and Patel (2008): on one hand, FDI is considered to contribute to the increase of domestic capital, to create employment and to raise incomes, to promote technology and to generate transfer of skills through foreign technology and know-how, to boost host country economies; investment is seen as the engine of economic growth in the long term (Herman, 2011); on the other hand, FDI may generate negative effects such as the crowding out effect on domestic investment, unfair competition between foreign and domestic companies, as well as “the market-stealing effect” as a result of the poor capacity of absorption, leading to market inequalities or contributing to an outflow of foreign exchange.

However, current trends have shifted the interest from economic growth and development to green growth and sustainable development and, along with these, another question has been raised and has been brought to the attention of scientific community and policy makers: what is FDI impact on green growth, environment and, ultimately, on sustainable development. Yet, there is little known about the conditions and the components which could determine a consistent positive relationship between FDI flows and sustainable development.

If we consider the assumption that FDI supports economic growth, increased incomes, a greater rate of employment and technology transfer, then the answer would be to reduce the impact at the environmental and social level, while increasing foreign direct investment flows (Zarksy and Gallagher, 2003). In host countries, the environmental and social aspects of FDI are less recognized although they play an important role sustainable development. Regarding the environmental aspects, FDI may be either a favourable factor or a distorting one (UNCTAD, 1999), according to specific case studies and empirical analysis of two competing hypotheses: *pollution haven effect* and *pollution halo effect*.

According to the theory of the pollution haven effect (Grey, 2002; Mabey and McNally, 1999) FDI seeks locations with weak regulations, generating weaker environmental standards in host countries. Moreover, close to the pollution haven hypothesis is that of the ‘regulatory chill’ (Fortanier and Maher, 2001; Gray, 2002) meaning that countries prefer not to set stricter environmental standards for fear they might lose points in the competition against other countries in attracting FDI. Still, most of the research done in this respect has found little evidence for widespread, systematic pollution haven effects; still, the hypothesis that stricter regulation may, in some given conditions, shift the FDI location, cannot be completely rejected (Golub, Kauffmann and Yeres, 2011).

The pollution halo effect stands in stark contrast to the pollution haven hypothesis, considering that FDI spreads best environmental management practices and technologies and contributes to the improvement of the environment, reflected in some favorable changes of the consumption patterns, from the environmental point of view. According to Gallagher and Zarsky (2007), foreign direct investment determines three types of greening effects: transfer of clean technologies - more efficient and less polluting in comparison with domestic production; technology leapfrogging – by transferring technologies to control pollution; spillovers to domestic firms – by transferring best practices in environmental management towards affiliates and domestic