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Do Developing Countries Invest Up? The Environmental Effects of Foreign Direct Investment from Less-Developed Countries

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Summary. — This paper examines the environmental effects of foreign direct investment (FDI) from less-developed countries (LDC). We hypothesize that rather than transferring poor home-country practices across borders, LDC FDI can increase the level of environmental stewardship of host-country firms. We contend that LDC firms find it increasing financially advantageous to signal to consumers, investors, and potential business partners their commitment to environmental protection by adopting sound environmental practices. Furthermore, this behavior can create spillover effects to other host-country firms, leading these firms to also boost their environmental credentials. Our empirical findings lend support to these conjectures.
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Key words — FDI, environment, ISO 14001, LDC

1. INTRODUCTION

Corporations based in developing countries are increasingly investing abroad. [1] As Figures 1 and 2 illustrate, outward foreign direct investment (FDI) stocks and flows from the developing world have risen dramatically in recent years. The tremendous expansion of less-developed country FDI (LDC FDI) has renewed scholarly interest in the drivers of firm internationalization, and raised questions regarding the economic and social effects of such on home and host countries (Lall, 2003; Young, Huang, & McDermott, 1996). In this paper, we examine a crucial aspect of increased internationalization—the environmental effects of LDC FDI on host economies.

Prior research finds that multinational corporation (MNC) home-country regulatory frameworks influence host-country firm behavior (Pauly & Reich, 1997; Vogel, 1995). Rich-country FDI is often viewed favorably because it can convey to host countries policies and practices developed to accommodate stringent home-country regulations (Zeng & Eastin, 2007). This is particularly true with regard to environmental standards (Prakash & Potoski, 2007). Scholarly perspective on LDC FDI is less optimistic. Although a study by the Organization for Economic Cooperation and Development (OECD) finds that "there is no vast difference in approaches to corporate social responsibility between companies in high-income OECD countries and their emerging market peers" (OECD, 2005, p. 4), others suggest that "...the more developed the country the higher incidence of policies in the area of corporate social responsibility" (Welford, 2005, p. 52). If this is the case, then we can distinguish MNCs from developing and transition economies from rich-country MNCs by their lack of knowledge and motivation regarding corporate social responsibility (CSR) issues like environmental protection and fair labor practices (Aykut & Ratha, 2004).

There are three reasons for this less sanguine view of less-developed country MNCs (LDC MNCs). First, the international standards diffusion literature suggests that companies mimic policies and practices developed to accommodate home-country regulations in their operations abroad. If LDC MNCs arise out of weak legal and regulatory frameworks at home, then theoretically they should convey weak regulatory practices to host countries. Second, south-south investment, or investment from one developing country to another, is increasing (Aykut & Goldstein, 2007; Contessi & El-Ghazaly, 2010). If weak home-country regulations engender poor environmental stewardship at home, then weak host-country regulations should compound this effect. The poor state of environmental protection and numerous incidents of corporate environmental mismanagement in the developing world seem to corroborate this view. Third, a relatively large share of LDC MNCs operate in extractive and other resource-intensive industries with poor environmental records, and developing countries often have reputations as bastions of regulatory corruption. Consequently stakeholders are likely to perceive the behavior of these companies, developing country environmental conditions, and the air of corrupt regulatory practices in developing countries as both a cause for and result of unscrupulous LDC MNCs.

The influence of poor home-country regulations coupled with LDC MNCs' mixed environmental record raises important questions regarding the environmental effects of LDC FDI in host countries. Do MNCs from developing countries with relatively weak environmental regulations transfer poor environmental practices abroad? Or, does foreign investment create opportunities for these companies to boost their environmental credentials to the point that they raise the bar for all firms? This paper addresses these questions by empirically testing the effects of LDC FDI on host-country adoption rates of ISO 14001, the most prevalent voluntary corporate environmental regulatory program in the world.

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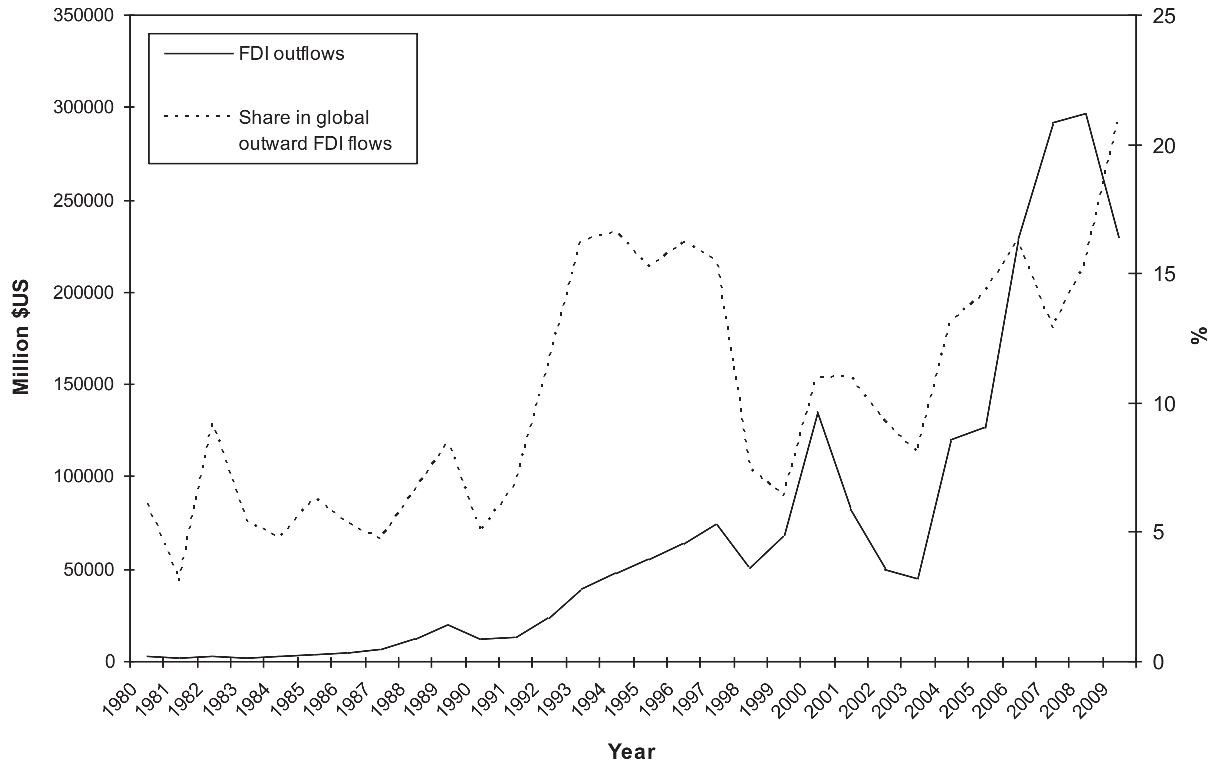

Figure 1. *Developing-country FDI outflows, 1980–2009. Source: UNCTAD, FDI statistics website (http://stats.unctad.org/FDI/).*

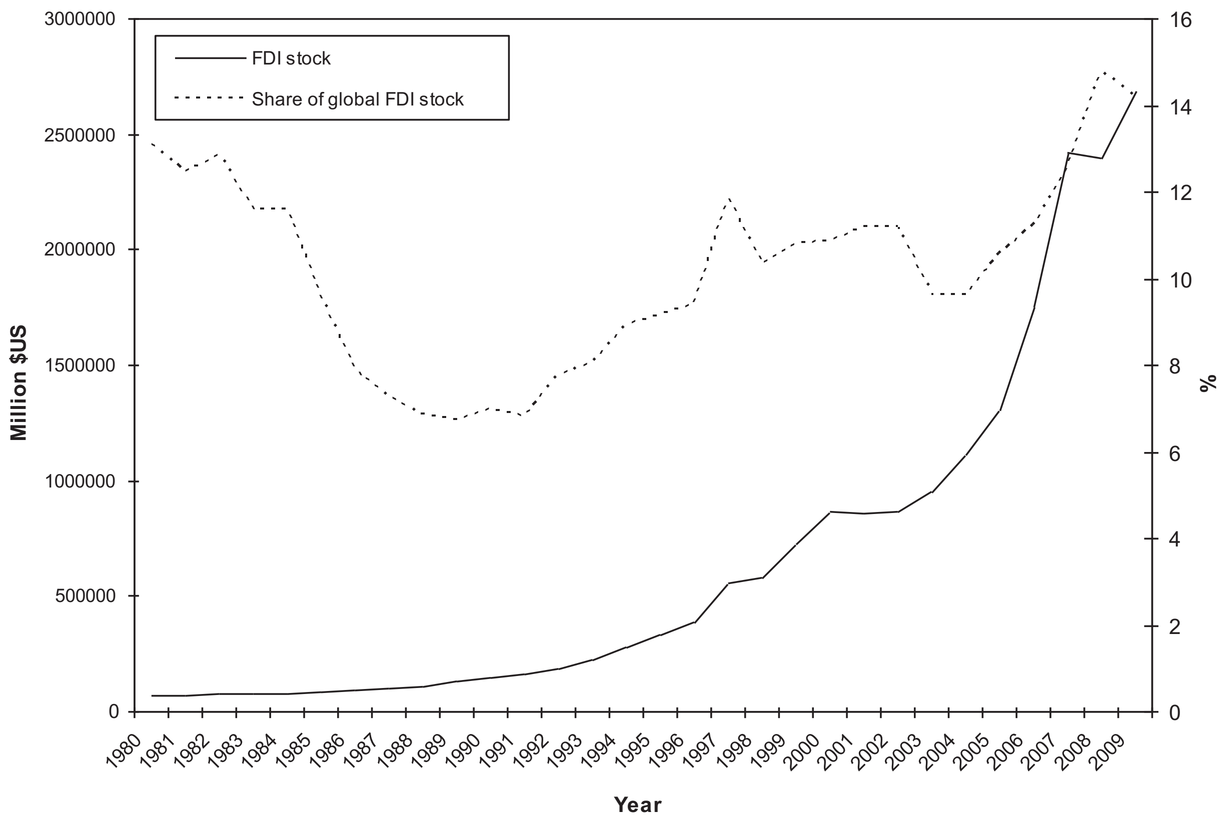

Figure 2. *Developing-Country Overseas FDI stock, 1980–2009. Source: UNCTAD, FDI statistics website (http://stats.unctad.org/FDI/).*

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