

Chapter 2

The Main Features of the FDI Phenomenon

2.1 FDI Definition and Players

According to the definition given by the UNCTAD, FDI is an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in a given economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate) (UNCTAD 2007: 245).¹ As can be observed, two keywords represent the main feature characterizing the definition: lasting interest and control. In fact, a FDI is normally distinguished by the other form of private capital, and particularly from the portfolio equity investment, because it implies long term investment relationship while the latter results more volatile. With regard to the second feature of control, the identification of a FDI by general convention occurs when a minimum of 10 % shareholding in a foreign firm's capital is considered.

FDI is an activity which is normally run by Multinational Corporations (MNCs). In fact, the literature generally refers to MNCs as those firms which undertake FDI as the main motivation of their activity. No single definition of what a MNC is exists.

¹ Other definitions are provided by the International Monetary Fund (IMF) and the Organization for the Economic Cooperation and Development (OECD). The IMF defines FDI as an investment made to acquire a *lasting interest* in an enterprise operating in an economy other than that of the investor, the investor's purpose being that of having an effective voice in the management of the enterprise (IMF 1993: 93). The OECD defines FDI as the category of international investment that reflects the objective of a resident entity in one economy to obtain a lasting interest in an enterprise resident in another economy. Although all these definitions are slightly different from that given by the UNCTAD, they do not show significant changes especially with regard to the basic features of FDI.

However, a basic distinction is usually made between International Firm (IF), Multinational Corporation (MNC) and Transnational Corporation (TNC).²

The actual implementation of FDI may take either the form of greenfield investment, or the form of cross-borders Merger and Acquisitions (M&As), or the form of Joint Ventures (JV). By definition, the first form refers to an investment made “from scratch”, aimed at creating a completely new enterprise in host territorial areas where no previous production, distribution or other facilities exist. This type of investment can be very costly for the investor, but it is well received by host countries, because of its high job-creation potential and its relevant capability to increase the value-added of the host country’s production. As the name implies, M&As are typically implemented via the ownership change of existing enterprises. It specifically refers to investment dealing with the buying, selling and combining of companies. This mode of investment has the advantage of being cheaper than greenfield investment and gives the investor quick access to the market of the host country. Lastly, JV investment is made by a foreign firm under an agreement with one or more firms or government institutions in the host country, as well as other companies outside the host country. All parts in the agreement are committed to bringing their own skills and expertise to the investment operation such as, for example, the knowledge of the local or national market and bureaucracy, technical expertise, financial capability, etcetera (Moosa 2002).

2.2 Classification of FDI

The classification of FDI typically distinguishes the operational view of the source country of the investment from that of the host country. From the view of the source country, or the investor’s view, FDI can be categorized in horizontal, vertical and conglomerate. Horizontal FDI refers to an investment operation aimed at the horizontal expansion of the production. This means that an investor, operating in the source country, decides to produce abroad—in a country which will host the investment—the same or a similar type of product he produces at home with the aim of expanding his market opportunity. What characterizes horizontal FDI is the lack of product differentiation between that produced at home and that in the host country. This kind of investment is typically run to exploit the advantage of a certain power position in the market (i.e. monopoly or oligopoly) a

² An international firm can be defined as a firm which works in importing and exporting goods produced in the domestic market and then exported abroad and vice versa. The evolution of an international firm can bring to the identification of a multinational firm, which refers to a firm producing both at home and abroad (through subsidiaries, affiliates and joint ventures). The further evolution of the firm can identify the transnational corporation. This occurs when a firm evolves at such a point that difficulties arise as to the identification of its home country (Moosa 2002).

firm derives from holding, for example, patents and where the expansion in the home country may contravene anti-trust regulations. Vertical FDI is, instead, undertaken with the aim of gaining the economic advantages that an investor derives from a better management of his organizational chain. In fact, he may consider it advantageous to be as close as possible to the market of raw materials acquisition and/or to final consumers. The earlier case may occur through investment to buy other firms working as raw materials suppliers (backward vertical FDI). The latter may take place through the acquirement of distribution outlets (forward vertical FDI). Lastly and very simply, conglomerate FDI represents a mix of the previous two types (Moosa 2002).

From the view of the host country, FDI can be categorized into import-substituting, export-increasing and government-initiated FDI. Import-substituting FDI is basically determined by aspects such as the market size of the host country and the existence of transportation costs and/or trade barriers. It refers to an investment which enables the host country to become producer of certain products which were previously imported. As a consequential result, imports by the host country, but also exports by the source country, will decline with a potentially realistic improvement of the balance of payments of the earlier. Export-increasing FDI occurs when a country becomes object of interest of an investor, who seeks further or new sources of input factors. In such a case, the host country increases its export of certain products (normally raw material and/or intermediate goods) to the investor's country and/or other countries where his subsidiaries are located. Government-initiated FDI refers to that form of investment which is stimulated by the provision of forms of incentives offered by governments to attract investment in the attempt to improve their balance of payments conditions.

A possible last classification of FDI distinguishes between expansionary and defensive FDI. Expansionary FDI is a form of investment which is aimed at the exploitation of firm-specific advantages (e.g. scale effects, R&D intensity, profitability and technology acquisition, etc.) in the host country and has the additional benefit of contributing to the growth of sales of the investing firm both at home and abroad. Defensive FDI is that investment which is aimed at reducing production costs and, in doing so, seeks cheap labour (or other cheap input factors) in the host economy (Chen and Ku 2000; Chen and Yang 1999).

2.3 The Measures of FDI

With regard to the quantitative aspect of FDI, it can be observed how its measure is generally expressed either in terms of flow or in terms of stock. FDI flows include the capital invested—either directly or indirectly through related enterprises—by a foreign investor in an enterprise, or the capital received from an enterprise by a foreign investor. More specifically, “for associates and subsidiaries, FDI flows consist of the net sales of shares and loans (including non-cash acquisitions made against equipment, manufacturing rights, etc.) to the parent company plus the

parent firm's share of the affiliate's reinvested earnings plus total net intra-company loans (short- and long-term) provided by the parent company. For branches, FDI flows consist of the increase in reinvested earnings plus the net increase in funds received from the foreign direct investor. FDI flows with a negative sign (reverse flows) indicate that at least one of the components in the above definition is negative and not offset by positive amounts of the remaining components". With regard to FDI stocks, we can learn how "for associate and subsidiary enterprises it represents the value of the share of their capital and reserves (including retained profits) attributable to the parent enterprise (this is equal to total assets minus total liabilities), plus the net indebtedness of the associate or subsidiary to the parent firm" (UNCTAD).³ Furthermore, it is important to highlight how FDI flow and stock may take the form of inward or outward investment depending on the direction it takes. Very simply, FDI flow or stock is inward when an investor of a foreign country invests in a considered country. It is outward when an investor from a home country invests abroad (Moosa 2002).

According to Cantwell and Bellak (1998), it is generally referred that the practice of reporting FDI in terms of stock is basically unsatisfactory. Stocks are expressed in terms of their "book value", namely their historical cost, which does not take into consideration their age distribution and makes international comparison almost impossible. Apart from this specific aspect, we must understand that measuring FDI is not straightforward because of the existence of problems especially occurring when the investment takes the form of machinery or contributions of technological capitalization. Furthermore, due to the reluctance of most countries to provide comprehensive information on the foreign operations of their companies for reasons of secrecy, gaps exist in FDI statistics available for source and host countries (Moosa 2002).

2.4 The Effects of FDI

After having insofar referred the main featuring aspects of FDI, we can now move onto giving a broad look at the effects it generates. The FDI dynamic involves the transfer of various elements (financial capital, technology, labour skills, etc.) from a country (the source of the investment) to another (the destination or recipient of the investment). This process implies the rise of costs and benefits for the countries involved. Due to the existence of a general disagreement—based on the existence of different views pro and con the globalization phenomenon—it is not really clear what costs are endured and what benefits are gained by the countries. This is

³ These definitions are gathered from the UNCTAD web-page in the source and definition section available at <http://unctad.org/en/Pages/DIAE/FDI%20Statistics/Sources-and-definitions.aspx>.

particularly true from a quantitative view. However, the FDI effects issue is basically treated from the host country's point of view. According to Moosa (2002), the effects of FDI on an investment host country can be of the following type: economic, political and social. In short, the social issue mainly concerns the creation of enclaves and foreign elite in the host country, as well as cultural and behavioural changes as a consequence of a sort of "contamination" resulting from the contact between the foreign and local entities. The political effects refer to the question of national sovereignty. It is natural to think that—and this could be particularly true in Less Developed Countries (LDCs)—because of the relevance of the interests implicated by the management of a MNC, a threat for the national political autonomy of the host country could exist. The economic effects are distinguished in macro and micro effects as shown in the scheme below.

The earlier are often referred to in the same terms as a rise in foreign borrowing. If there is unemployment and capital shortage—that is the typical case of LDCs—FDI (which is provision of capital) leads to an increase of output and income together with a reduction of unemployment in the host country. In this sense FDI has a beneficial effect on the balance of payment, but its effect in terms of trade is indeterminate since this will depend on whether the impact of increased output falls on import substitutes of export. The micro effects, instead, concerns structural changes in the economic and industrial organization. Broadly speaking, they refer to individual firms and individual industries, particularly those exposed and associated with FDI. Within this context, for example, a relevant argument is whether FDI leads to a more competitive economic environment. It must be highlighted, however, that the issue of the economic effects of FDI has very often failed to consider those associated to the natural environment. At least this is true up to the late 1990s when the sensitivity for this specific aspect began to appear in the reports of some international organizations. We have inserted the environmental component in the Fig. 2.1 as an adaptation of the discussion of the already-mentioned author, who has the merit of having summarized the state of art of the literature previously produced.

With specific regard to the relationship between FDI and the environment, we must highlight how it can be considered as a subset of the FDI literature and, especially in the last decade or so, it has been abundantly treated by academicians, politicians and experts. This has generated a massive production of writing, whose analysis is not straightforward. From a methodological point of view, two basic ways of empirically analysing the issue can be observed in the literature. The first looks at the statistics of FDI flows, environmental data and information on the environmental regulatory systems of various considered countries or areas in the attempt to identify the existence of some linkages between the two aspects. The second considers the behavioural aspect of firms to understand how they make their investment location decision and if environmental factors play a role in this process. Relevant information on these issues can be found in various UNCTAD reports and especially in two of them (UNCTAD 1999, 1993). The first, which is still now generally recognized as the most comprehensive study of the environmental performance of MNCs, basically refers that larger companies are more

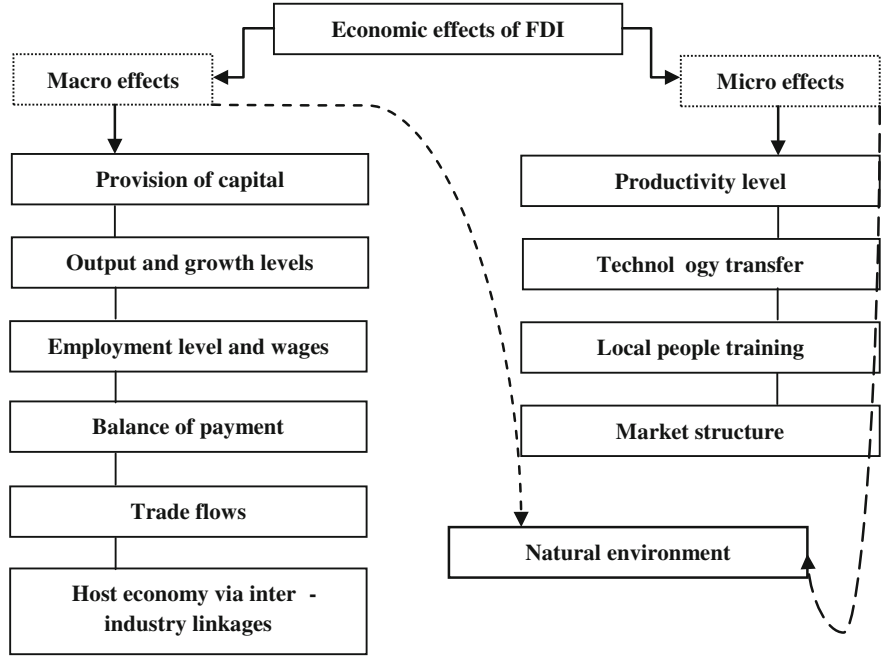


Fig. 2.1 Economic effects of FDI. *Source* built and adapted from Moosa’s (2002) discussion

likely to have better management performance. The second contains a useful update of the previous and a valuable discussion on the environmental effects of FDI in emerging economies. Additional information can be found in some other useful works produced by the OECD, where the research developed is categorized into four macro themes, which we will refer to with the aim of presenting a methodologically clear discussion of the specific literature. However, for the convenience of our discussion, we group the issues analysed on the FDI-environment relationship into three thematic areas: (1) the environmental effects of FDI flows; (2) the competition for FDI and its effects on environmental standards; (3) the cross-border environmental performance (OECD 2002a, b, 1997).⁴ The

⁴ A fourth area can also be considered, which is represented by the regulatory impact of investment rules. Although this is referred to be the most recent area of work, so far it has basically focused on understanding whether or not investment and environmental protection are pursuable as a common achievement. Furthermore, most of the work carried out in this field of discussion has taken into consideration the analysis of investment models and agreement regulations such as those in the North American Free Trade Agreement (NAFTA), the OECD Multilateral Agreement on Investment (MAI), and Bilateral Investment Agreements (BITs) (OECD 2002b). Since the rationale of the studies conducted in this field seems more focused on the analysis of the juridical content of agreements (e.g. Ignacio 2003) and takes a different direction from the scope of our work, we purposely fail to report a more extensive description of it in the conviction that a sufficient note can remain in these few lines.

next chapters will focus on this framework to build up a better understanding of the relationship between FDI and the natural environment.

2.5 Some Concluding Considerations

In this chapter we have highlighted the main aspects and facts of the FDI phenomenon. By referring to the technical literature, we have analysed its definition and classification, and understood its measures and players. In addition, we have briefly observed the economic, political and social effects it generates in investment host or receiving countries. For the specific purpose of this work, however, a more detailed attention has been paid to the first type of effects. The analysis of those works focusing on the economic effects of FDI highlights how the natural environment (which can be broadly seen as a supplier of input factors of production and a receiver of waste and residuals from production processes) is very often left unconsidered. As has been commented, this is particularly true up to the late 1990s when a renewed sensitivity for an environmental reflection on issues such as trade and investment began to appear in the reports of major international organizations. The analysis of the literature on the FDI-environment relationship produced insofar is not straightforward because the quantitatively relevant production of the last decade is very fragmented. As has been said in the previous sections, however, the works produced can be methodologically grouped into three main veins of discussion: (1) the environmental effects of FDI flows; (2) the competition for FDI and its effects on environmental standards; (3) the cross-border environmental performance. In consideration of these three discussion areas, the following chapter will present an updated literature review of these issues which are the core subject of our argument.

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The Relationship Between FDI and the Natural
Environment

Facts, Evidence and Prospects

Pazienza, P.

2014, IX, 62 p. 1 illus., Softcover

ISBN: 978-3-319-04300-5