

Wermelinger, Martin

Research Report

What can governments do to boost FDI for sustainable development?

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Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues

Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Managing Editor: Matthew Conte (msc2236@columbia.edu)

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What can governments do to boost FDI for sustainable development?

by

Martin Wermelinger*

FDI can contribute to achieving the Sustainable Development Goals (SDGs), but FDI benefits are not automatic. Positive contributions can be the direct result of the operations of MNEs, for instance, when they introduce new technologies or better employment practices in host countries. MNE activities also have spillover effects through value-chain relationships with domestic firms, competition, knowledge sharing, and worker mobility. On the other hand, FDI may contribute negatively to the SDGs when MNEs source their inputs irresponsibly, crowd out domestic SMEs, widen the gender gap, or generate significant carbon emissions.

Governments have an important role to play in increasing the net benefits of FDI for achieving the SDGs. For that purpose, governments have different priorities, resources and options at their disposal. There is no single approach for all countries, and appropriate interventions depend on a country's context and development. Five key considerations include:¹

A coherent and coordinated approach is the cornerstone. Many governments suffer from a lack of policy coherence and coordination across ministries and agencies, particularly when it comes to complex and interrelated ambitions such as reaching the SDGs. Involving bodies from across public administration (e.g., through a coordinating council), governments should carefully define what aspects of sustainable development they would like to promote through FDI, taking into account potential trade-offs, and then identify and implement policy interventions. To build consensus, stakeholder consultations and inclusive decision-making processes ("hybrid governance") involving the private sector, trade unions and civil society are key. Governments can also seek to assess the impact of FDI (e.g., with environmental impact assessments, or using [FDI Qualities Indicators](#)) and of related policies to identify bottlenecks in implementation.

Market access is necessary but not sufficient. For instance, [removing high pre-establishment restrictions on FDI](#) in modern services (e.g., ICT, R&D) fosters investment and productivity, with knock-on effects on other sectors. Enabling market access is, however, not sufficient to tackle major societal and environmental challenges. FDI that contributes to the SDGs can be facilitated through domestic legislation that fulfils international standards related to sustainable international (or even more ambitious national) standards. However, striking an appropriate regulatory balance to advance multiple sustainability objectives is complex and benefits from inclusive processes, as stipulated above. This tension exists, for instance, in the labor market: stringent employment protection can increase firms' labor adjustment costs, but also improves job security. Greater labor market flexibility matters for the locational choices of foreign investors and affects job creation and the knowledge intensity of investments. Labor market policy is therefore most effective when negotiated with trade unions and businesses.

Tax incentives and other proactive forms of support may help address market failures that diminish positive impacts of FDI. [Many developing countries use targeted tax incentives](#) that aim to foster investments conditioned on specific criteria promoting sustainable development. Botswana, for instance, allows investors to deduct 200% of their costs for worker trainings from taxable income. South Africa offers accelerated depreciation for equipment used for renewable energy production, which lowers the tax burden for investors. Zambia offers enhanced tax allowances per newly employed disabled person. Other pro-active support can also help: Jordan, e.g., offers vocational training on renewable energy and energy efficiency. Yet, the effectiveness of such support is often not assessed. Regular evaluation is essential to avoid wasteful tax expenditures and use of public resources.

Investment promotion agencies (IPAs) are key players in bridging information gaps and facilitating sustainable FDI. A [recent survey](#) shows that sustainable development considerations are important for IPAs when setting their priorities. 87% of IPAs in the OECD use indicators linked to job creation and skills to prioritize investment attraction, and about 50% use indicators related to decarbonization. The tools used by IPAs include market studies, sector specific events and proactive investor engagement (e.g., one-to-one meetings, email/phone campaigns). IPAs also engage in policy advocacy by transmitting business concerns to policymakers, including with regards to operating more sustainably. Aftercare services for existing investors (such as matchmaking services and business-to-business meetings between foreign and domestic firms) strengthen FDI sustainability spillovers on the domestic economy.

Developing country governments and the donor community should work together to identify solutions that strengthen FDI impacts on the SDGs, building on their [significant existing action](#) for private sector development. Entrenched in [efforts for SDG17](#), cooperation could include supporting policy reforms and implementation, promoting alignment with international standards, reducing exposure to social and environmental risks, and directly supporting the private sector. Using a [new OECD guide](#), donors could map their existing interventions onto recipient countries, assessing alignment with recipient countries' priorities on FDI and sustainable development and identifying potential support gaps. These priorities could be

identified by using the UN's [Voluntary National Reviews](#) on SDG progress or more targeted reviews on sustainable investment policy.²

* Martin Wermelinger (martin.wermelinger@oecd.org) is Head of the Investment Qualities and Incentives Unit, OECD. This *Perspective* draws on OECD, [FDI Qualities Policy Toolkit](#) (Paris: OECD, 2022). The author wishes to thank Russell Curtis, Collette van der Ven and Rob van Tulder for their helpful peer reviews.

¹ The need for a whole-of-government approach to strengthen FDI for sustainable development is increasingly recognized in international policy fora. More than 50 OECD and non-OECD countries adopted, at the OECD Ministerial Council Meeting 2022, the first [government-backed instrument](#) on the subject.

² E.g., OECD, [Investment Policy Reviews](#), OECD, [FDI Qualities Reviews](#) and the [Investment Policy Reviews](#) by UNCTAD.

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