Towards a New Model of Cooperative Development: Enhancing and Leveraging the Benefits of FDI for Emerging Economies

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INTRODUCTION

Over the past 25 years, economists and national leaders have shifted their views on development in a significant way. From the first development model which rejected foreign capital and relied on direct state control, to an abrupt change to a second model that hailed liberalization and private enterprise as the keys to achieving economic prosperity and rising living standards. Along with the liberalization of state controls on economic activity and international trade, foreign direct investment (FDI) was now hailed as the best medicine for a backward economy. However, just as the first model fell into disfavor, uncertainty over the second model is rising. This result can to a large degree be explained by the situation today in which developing countries are attracting an increasing amount of FDI year after year, yet there is a sense that many are failing to realize the expected development benefits of foreign capital inflow.

The paper will explore how the current views toward foreign investment and development are changing. Part I will set the stage by exploring the history of attitudes toward FDI with respect to development. This section will describe how and why foreign investment has rapidly increased in the developing world. It will also survey the current debate over the potential of FDI to contribute to development and the opposing view that most of these contributions go unrealized. Scholars and practitioners offer a number of reasons and theories why this later outcome may be so. The hypothesis set out at the outset of this study establishes that the reason expected spillovers to a developing host economy may not occur is partly due to a low level of absorptive capacity in the host country but also largely hinged on the quality level of the investment. This hypothesis is tested in the final part of this section with a case study of FDI and its impacts on human capital development in Kazakhstan.

Part II begins a search for solutions to this problem of how to ensure that FDI will create development benefits. Investors into foreign markets have always followed a simple formula, *maximize return* and *minimize risk*. At the onset of this part, I will explore the options available to host countries to follow a similar formula, maximize return to their country and minimize the negative risks of FDI. I expect that while the host country may have the greatest responsibility to strike this balance, other parties have an increasingly important potential to improve this outcome as well. These parties include international bodies, home countries of the investors, and the foreign investors themselves. As this section will show, the roles and responsibilities of each are in flux. International bodies have attempted to create a global investment framework for years, and have resulted in the current set of voluntary guidelines, which emphasize promoting development goals over providing protections for investors. Pressure is also mounting at home. Home governments of large corporations, as well as an active and informed citizenry, are creating limitations on the activities of corporations in foreign nations. Finally, investing corporations themselves are seeing the benefits of contributing to the development of their host countries and are increasingly improving their impact voluntarily. These changes reveal promising opportunities for all parties to move together towards a more equitable model of development. I expect that this new model will be based on an international cooperative movement to build protections and assurances for the development of the host country into the investment framework that will move the world closer to a lasting solution to underdevelopment.

I. Shifting development models and attitudes toward Foreign Direct Investment

Achieving development in poor and emerging economies has been a long held goal, one with seemingly no clear solution. However, in our recent history, those engaged in the development quest, including economists, national leaders and private enterprises, have taken on strongly held positions on the correct method to achieve this goal. The commonly accepted development model of the 1980's was characterized by a rejection of internationalization and the private sector. Popular belief at the time held that in order to achieve development, state planning was necessary to correct the market failures that were holding developing countries back from achieving the success of the developed nations. Thus, many developing states closed their economies to outside influence, and focused on state-run enterprises, placing great restrictions and regulations on private business activity. After years of this type of policy most of the developing countries did not show signs of improvement, and even suffered from debilitating debt and a worsening of social conditions. As a result, a new Development model was formed. The second model shifted nearly all the premises of the first model. Borders opened to foreign capital and trade, private enterprises became deregulated, and the markets assumed their role of ordering the economy. Known as the neo-classical model (and also the "Washington Consensus"), this new paradigm limited the role of governments to facilitating market transactions and providing only the goods and services that the market would not supply.[1] Looking back, John H. Dunning (2006) describes this as a static and one-dimensional model,

[1] Dunning, John H. "Towards a New Paradigm of Development: Implications for the determinants of international business," Transnational Corporations, 15: 1 April 2006, p.176.

which has ignored international public goods such as the environment, security, and human rights.[2]

While this model did bring some relief to those developing economies that skillfully managed and expanded their resources (i.e. the Asian tigers), several concerns remain. Impacts such as increased inequality in wealth within countries, exacerbated ethnic conflict, and worsened conditions for the most vulnerable social groups have raised concerns about various aspects of the second model. These concerns have given rise to some alternative development tools, such as the United Nations' Universal Declaration of Human Rights which seeks to codify minimum standards at a global level in order to provide some protection for the vulnerable. Some of the blame for unrealized development outcomes from this model has been placed on the corporations undertaking foreign direct investment. The drastic change from disallowing any FDI, to welcoming it with open arms and also giving foreigners great protections and incentives, has led many to question if this model is indeed ideal for achieving development objectives. According to John H. Dunning (2006) these concerns, largely fueled by today's environment of free-flowing information, has led to a re-evaluation of the neo-classical model.[3]

II. FDI in Emerging Economies

While only a small portion of foreign direct investment flows have been oriented towards developing countries, this is a small piece of a large and growing pie. FDI figures continuously hit all time records as more and more firms are facing the choice of going international or losing out to their competition. FDI flows today also far exceed the quantity of Official Development Assistance (ODA), aid upon which much of the developing world has been dependant on for

[2] Dunning, 2006, p.176
[3] Dunning, 2006, p.182

foreign exchange.[4] Developing countries thus have a great opportunity to attract these much needed investments into their economy. If managed correctly, the valuable gains into human resources and other benefits that can accompany FDI inflows are likely to enhance economic growth and the development of these countries.

Table 1. **OECD FDI outflows by region**

	In USD million				Percentage of total			
	1985	1990	1995	2000	1985	1990	1995	2000
WORLD	61 277	235 836	335 194	1 068 786	100	100	100	100
of which:								
OECD countries	42 055	189 166	263 716	904 349	68.6	80.2	79.7	84.6
Non-OECD countries	19 222	46 670	71 437	137 747	31.4	19.8	21.3	12.9
of which:								
Africa	404	195	3 100	7 267	0.7	0.1	0.9	0.7
Asia*	2 171	12 650	25 106	29 494	3.5	5.4	7.5	2.8
Europe*	8	408	3 570	14 026	0.0	0.2	1.1	1.3
Latin America and Caribbean*	9 101	18 948	23 632	68 374	14.9	8.0	7.1	6.4
Near and Middle East	212	1 056	1 936	1 571	0.3	0.4	0.6	0.1
Unallocated	7 325	13 413	14 093	17 015	12.0	5.7	4.2	1.6

* Excluding OECD countries.
Source: OECD *International Direct Investment Statistics*.

III. Cost and Benefits of FDI

Attitudes toward FDI run the full range of opinions from a strongly pro-FDI position to vehemently against it. At the former end of the spectrum lies the "modernization" approach, which argues that FDI brings necessary and badly needed capital and economic benefits to developing countries in general. This outcome is based on the neoclassical economic theory that expects a liberal international economy to better promote an efficient allocation of world resources, and be most likely to maximize global welfare than alternative economic systems.[5]

[4] OECD, "Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs," 2002, p.7.
[5] McMillan, Susan. Foreign Direct Investment in Three Regions of the South at the End of the Twentieth Century, St. Martin's Press, Inc. New York: 1999. p.3

This group expects that the capital from FDI will boost productive capacity and economic growth in the host country.[6] In sharp contrast, the "dependencia" school warns that FDI can only contribute to a growing dependence on a foreign economy and the loss of sovereignty and economic stability of the host that accompanies this outcome. As Susan McMillan (1999) explains this viewpoint, "multinational corporations and the direct investments they bring with them, are seen as instruments in maintaining the system of dominance."[7] Supporters of the dependencia argument also contend that FDI enhances the risk of political and social unrest, as income can become concentrated in the hands of a smaller and smaller group of elite. Since it could not explain the rapid success of several nations that advanced quickly with a liberal economy (particularly the Asian NICS), the dependencia theory has largely fallen out of favor. However this radical school of thought has been replaced with a more moderate perspective, the "statist" view. This modified position focuses on the "right" policies implemented by a strong state as the key variables determining development.[8]

Another popular opinion, know as the "bargaining" school, argues that the favorability of FDI in a particular country depends on the 'bargain' struck between the investor and the host country government. The bargaining positions of both sides then determine the distribution of benefits from FDI.[9] This school argues that it is possible for FDI to bring significant benefits if it is managed correctly by the host country leaders, a position closely resembling the statist view. As one scholar of the subject has observed, "FDI is a useful tool for development, but is only fully maximized by competent states able to leverage spillovers into development."[10] However,

[6] McMillan, 1999 p.3
[7] McMillan, 1999 p.4
[8] McMillan, 1999 p.5
[9] McMillan, 1999 p.11
[10] Resnick, Adam. "Good Medicine or Snake Oil?" Foreign Direct Investment's Effects on Less Developed Countries," (Draft).

the ability of state governments, particularly those of developing nations, to leverage FDI has been questioned. Some scholars have suggested that countries with strong bargaining power are more likely to experience an outcome similar to that predicted by the modernist school. McMillan (1999) suggests that factors such as low ethnic conflict, initial infrastructure, size and skills of a country's labor force, a domestic capitalist class, mass political stability, and a competent bureaucracy all contribute to enhanced bargaining power of a host state.[11]

In response to this position, another school of thought, known as the "structuralist" school, argues that developing countries lack the power and the necessary expertise to strike any such bargain in their favor, and thus will always lose the bargain over FDI and its spillover benefits to powerful multinational corporations. McMillan (1999) does also contend that: "a host country with a weak bargaining position relative to foreign investors will have more difficulty attracting investment, and in turning the investment flows that do arrive into economic growth and long-term development."[12] Therefore this group, which likely includes the least developed countries, is more likely to experience a dependencia-like outcome from FDI.

At this point in history most open economies, especially poor and emerging ones, consider the attraction of FDI as a critical component of their long range growth plans. Due to encouragement from development partners following the letter of the second development model (The World Bank, IMF, etc.), developing countries have accepted the pro-FDI position, and now compete for the presence of large corporations within their borders. This competition has often resulted in the extension of favorable tax exemptions, subsidies, and other benefits to multinationals. In offering these benefits, host countries expect to gain increased tax income from the foreign businesses, as well as significant positive "spill-over effects" that may result

[11] McMillan, 1999 p.16
[12] McMillan, 1999 p.118

from foreign business activity in their country. As ODA declines, the income potential of foreign capital is growing in importance as a source of funds for supplementing federal budgets and development programs in emerging economies. Additional spill-over effects expected often include the inflow of more efficient and advanced technology (which could advance the productivity of a developing economy), linkage effects to domestic businesses, opportunities for growth of local enterprise, and human resource development in the form of advanced education and training. An increase in outward trade and balance of payments relief can also occur. Host nations hope that together these effects will contribute towards greater domestic economic growth and productivity.[13]

However, some economists warn that FDI can actually harm a developing country. They argue that certain adverse affects are possible which could cause a deterioration of host country balance of payments if a majority of profits are repatriated, a potentially harmful environmental impact if standards are lowered, social disruptions if commercialization is accelerated at an inappropriate pace, negative impacts of competition in national markets, or a loss of political sovereignty.[14] In the worst case, a "race to the bottom" may occur from this strategy if nations are forced to sacrifice their citizens' level of well being by lowering wages and labor or environmental standards in order to attract foreign investors.

A second criticism of FDI focuses on unrealized spillover effects. Economists have offered some explanations as to why this may occur. One explanation points to a lack of absorptive capacity among many developing nations. The OECD explains that a country must have already achieved a certain "threshold" - that is, a sufficient level of development in education, technology, infrastructure, and business/economic health - before it can benefit from

[13] OECD, 2002
[14] Ibid.

the potential spillovers from FDI.[15] Kumar and Pradhan (2002) have also stated that while FDI may bring in benefits such as capital, technology, managerial skills, marketing know-how and market access, the positive externalities for domestic firms may not take place due to poor linkages or poor absorptive capacity.[16] Some economists also suggest that unrealized spillovers can be explained by the *quality* rather than the *quantity* of foreign investment. According to Kumar (2002), the development impact of FDI on a host country may vary according to the extent of new knowledge brought in and diffused within the host country economy, acquired access to new markets, and contribution to local technological capacity building. Therefore he suggests that the varied effects of FDI on host economies could be explained by variations in the "quality" of the FDI received.[17]

In order to test the premise of the still-popular theory that FDI will enhance welfare through income as well as spill-over effects, in this paper I will conduct a case study on FDI in Kazakhstan. Through this analysis I will seek to determine whether certain expected spillovers were realized, and also to explain why they have or have not been realized. When we are better convinced of the reasons for achieving FDI spillovers, then we can begin to arrive at policy conclusions that will aid host country governments, multinational businesses and the international community in enhancing the quality of FDI for greater development impact.

[15] OECD 2002
[16] Kumar, Nagesh and Jaya Prakash Pradhan. "Foreign Direct Investment, Externalities and Economic Growth in Developing Countries: Some Empirical Explorations and Implications for WTO Negotiations on Investment," 2002.
[17] Kumar, Nagesh. "Globalization and the Quality of Foreign Direct Investment," Oxford University Press: New Delhi, 2002.

IV. Case Study of FDI Impact on Human Resources of Kazakhstan

A variety of spill-over effects could occur from an inflow of FDI into an emerging economy such as Kazakhstan. In order to simplify this study, I will focus on one of these expected effects, human resource enhancement which is central to any nation's balanced development. Kazakhstan was chosen as the subject of this case study because it has experienced a relatively large and growing flow of FDI. In addition, the narrow time frame in which FDI suddenly entered the economy will allow us to better isolate the effects of FDI on certain aspects of welfare. Kazakhstan opened its borders to investment almost as soon as it gained independence from the Soviet Union at the end of 1991. Since that time, the land-locked Central Asian nation has been an attractive investment destination for western corporations due to its endowment of extractive resource potential (particularly petroleum), liberal investment policies, and large domestic market.[18]

This case study will first examine the history of investment in Kazakhstan and then determine whether expected positive spillovers have taken place since the country opened to foreign investment in 1992, and finally why this outcome has occurred. In the investment section, I will look at data on the FDI inflow trends over time, as well as the national investment policies and laws. Next I will analyze the effects on human capital in Kazakhstan that are generally expected to occur as a result of an increase in skilled employment, technology, and worker training from foreign investment. Here I will determine the trends in human capital indicators (labor productivity, education levels, educational quality, and the availability of a skilled workforce) over the time period since independence. I will then explore some of the factors that have been suggested as impediments to achieving these spillovers. First I will

[18] UN-ESCAP, "Foreign Direct Investment in Central Asian and Caucasian Economies: Policies and Issues," *Studies in Trade and Investment* No. 50, 2003 (ESCAP:Bankok)

explore the development "threshold" argument in order to determine if low levels of development are impeding the realization of benefits from FDI. Next, I will explore the "quality" of FDI that has entered the country, based on the indicators outlined by Kumar (2002). This approach will help us to understand the reasons behind the achievement of spillover effects from foreign investment in an emerging economy. This base level of understanding will lead to policy recommendations on how a country such as Kazakhstan can improve the realization of positive spillovers from incoming FDI.

Foreign Investment in Kazakhstan

Kazakhstan has achieved impressive growth of foreign investment since its independence (see Figures 1 and 2). Since 1993, Kazakhstan has attracted more than $40 billion of foreign direct investment. On a per capita basis, Kazakhstan exceeds all other FDI inflows in the former Eastern Bloc.[19] The primary reason Kazakhstan has been able to attract such a high quantity of FDI is a rich endowment of natural resources, particularly petroleum. According to the Foreign Investors' Council of Kazakhstan, the country has the potential to become one of the world's largest oil producers and exporters in the near future.[20] Kazakhstan also has some of the world's largest reserves of barite, lead, tungsten, uranium, chromites, silver, zinc, manganese, copper, gold, and iron ore.[21]

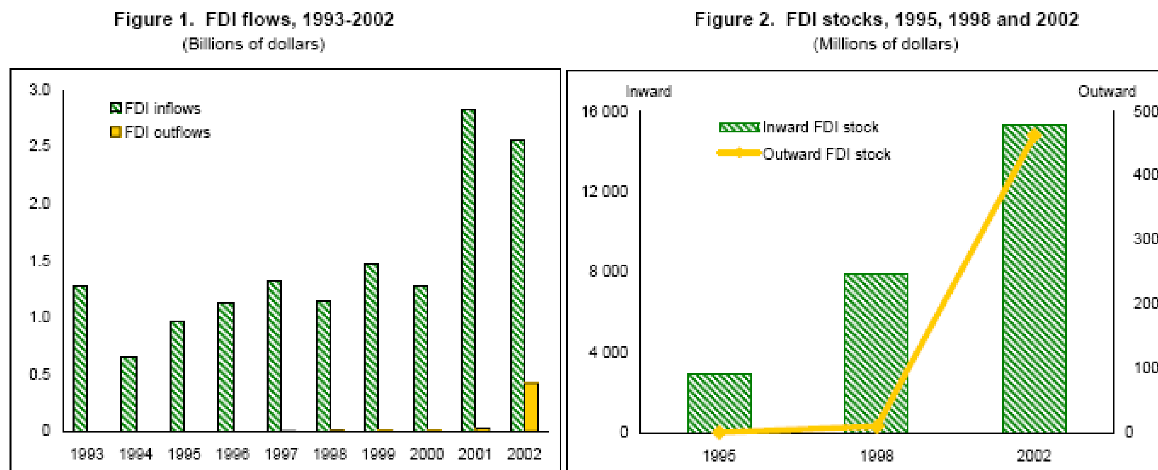
Kazakhstan has also engaged in a number of structural reforms favorable to investment. Beginning in the early 1990's, the government liberalized prices, reduced trade distortions, and privatized small- and medium sized enterprises. The government has also established a basic

[19] The Embassy of the Republic of Kazakhstan in the UK: http://www.kazakhstanembassy.org.uk/cgi-bin/index/201
[20] Ibid.
[21] Foreign Investors' Council, Kazakhstan http://www.fic.kz/content.asp?parent=7&lng=en&mid=7

framework to attract FDI.[22] This includes a formal investment policy committed to stability and predictability, transparent legal norms, protection of investors' legal rights, equal conditions for foreign and local investors, sanctity of contracts, and policies to encourage direct investments to the priority sectors of the economy. A new Investment Law was passed in early 2003. The new Law is intended to improve state support for investments as well as the guarantees for the protection of investors' legal rights.[23] However, in addition, Kazakhstan authorities have recently imposed certain local content requirements on foreign firms.[24]

Kazakhstan has been commended by international agencies and enterprises for these impressive reforms. Yet, the majority of investment in Kazakhstan continues to flow into the oil sector. Despite having reaped impressive revenue from these investments, Kazakhstan is today faced with the challenges of growing and maintaining a competitive and equitable economy. The oil business in Kazakhstan employs a relatively small portion of the population and the State must now focus on how to deliver the benefits of its natural resource advantage to more citizens while enhancing the competitiveness of non-oil sectors.[25]

[22] World Bank 2003 country brief
[23] The Embassy of the Republic of Kazakhstan in the UK: http://www.kazakhstanembassy.org.uk/cgi-bin/index/201
[24] UN-ESCAP, "Foreign Direct Investment in Central Asian and Caucasian Economies: Policies and Issues," *Studies in Trade and Investment* No. 50, 2003 (ESCAP:Bankok)
[25] World Bank, "Republic of Kazakhstan: Country Economic Memorandum, June 2005



Source: UNCTAD – "FDI in Brief – Kazakhstan"

Table 1: Net FDI Inflows of various CIS Countries, 1993-2001

Country	1993-2001 Total Millions of US dollars	1993-2001 Per capita	2001 Total Millions of US dollars	2001 Per capita	2001 Percentage of GDP
Armenia	640	168	70	18	4.0
Azerbaijan	3 773	472	227	28	4.0
Kazakhstan	12 104	872	2 760	185	15.0
Kyrgyzstan	453	92	22	4	0.7
Tajikistan	127	20	22	4	2.0
Uzbekistan	987	40	71	3	0.9

Source: UNESCAP, Country reports on investment climate: Kazakhstan

The Realization of FDI Spillovers in Human Resource Development

According to the OECD, FDI often brings associated benefits such as an increased level of productivity due to the inflow of new technologies and managerial efficiency.[26] These benefits can improve the quality of human capital in the country, spur the development of new enterprises and increase trade activity in the host country. This case study focuses on the human capital development effect of FDI in Kazakhstan, in the form of education and productivity. Human

[26] OECD, 2002.

capital can be enhanced as a result of government efforts to attract FDI by raising education quality and achievement, as well as through investment on the part of a foreign firm on worker training, or indirect technology spillovers and greater productivity that result from FDI. Miyamoto (2003) describes a "virtuous cycle" whereby human resource development first attracts foreign investment. FDI then contributes to further human resource development and the country is able to attract higher value-added foreign enterprises while upgrading the skill contents of existing foreign and domestic enterprises.[27] The rest of this case study will determine whether this chain of events has occurred in Kazakhstan by analyzing labor productivity indicators, trends in educational attainment, and quality levels of education over the time period since independence.

Labor Productivity

The World Bank has noted that despite growing levels of FDI, labor productivity in Kazakhstan has been stagnant (in the case of manufacturing) or falling (in the case of agriculture).[28] The report also suggests that these trends may continue in the event that certain determinants of labor productivity, which include the quality of education, health, and water services, as well as the quality of investment, do not improve. At the current time, Kazakhstan has some of the lowest social indicators in the Europe and Central Asia region.[29] The Asian Development Bank found that 27% of the country is still poor, and persistent unemployment exists in some regions, particularly in the main oil-drilling region.[30] Less than 50% of households have access to a public water supply, sewer or indoor plumbing. Perhaps as a result,

[27] Miyamoto, Koji. "Human Capital Formation and Foreign Direct Investment in Developing Countries," OECD, July 2003.
[28] World Bank, "Republic of Kazakhstan: Country Economic Memorandum, June 2005
[29] World Bank Country Brief 2003: Kazakhstan
[30] Tatibekov, et al. "Globalization, Employment, and Poverty Reduction: The Case of Kazakhstan," Kazakhstan Institute of Management and Strategic Research (KIMEP) 2005.

certain diseases, primarily tuberculosis, are on the rise. Alcoholism and drug addiction are also rising rapidly in the country.[31] All of these factors can dampen labor productivity.

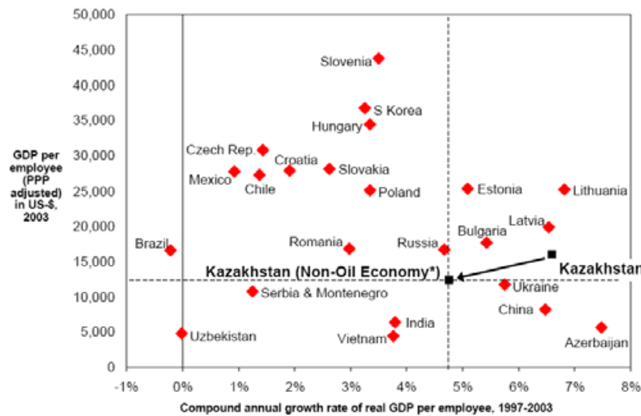
In assessing Kazakhstan's competitiveness, the leading expert on the topic, Michael Porter, has also determined that labor productivity has been modest at best. According to Porter, competitiveness is dependent upon the productivity with which a nation uses its human, natural and capital resources.[32] The presence of high quality human resources is essential. Using GDP created per employee as a measure of productivity, Kazakhstan ranks rather low on the spectrum, especially if the relatively few number of oil sector employees are eliminated (see Figure 5).

Figures 3 & 4: Fluctuations in Labor Productivity in the Manufacturing and Agricultural Sectors (1992-2003)

Source: World Bank, "Republic of Kazakhstan: Country Economic Memorandum, June 2005

[31] ibid
[32] Porter, Michael. "Kazakhstan's Competitiveness: A Roadmap Towards a Diversified Economy," Presentation given in Almay, January 2005.

Figure 5: Comparative Labor Productivity of Selected Countries



Source: Porter, Michael. "Kazakhstan's Competitiveness: A Roadmap Towards a Diversified Economy," Presentation given in Almay, January 2005. (derived from EIU 2004 data)

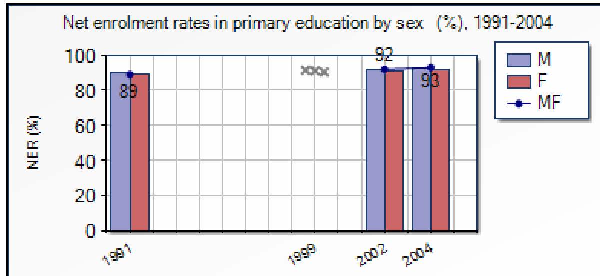
Educational Attainment

In contrast to productivity levels, educational attainment in Kazakhstan is quite high. The United Nations Educational, Scientific and Cultural Organization (UNESCO) estimates that 92% of girls and 93% of boys are in primary school, and literacy is very close to 100%.[33] However, these educational and literacy levels were already impressive at the time of independence. Since 1991, primary enrollment has improved but secondary school enrollment has in fact experience a slight dip (see Table 2). Tertiary enrollment has also slightly decreased over the period, although it is well above the regional average. While high enrollment rates are displayed here, there is little reason to believe that they can be attributed to foreign investment spillover effects since these levels prevailed prior to the entrance of any significant foreign investment. FDI may also be attributed to greater educational attainment levels due to indirect tax payments. Given the large amount of oil revenues collected by the Kazakhstani government, we might expect improvements in social sectors such as education and other social indicators. However,

[33] UNESCO Institute for Statistics, Kazakhstan Country Profile http://www.uis.unesco.org

Kazakhstan spends less of its GDP on education than its neighbors, Tajikistan and Mongolia (See Figure 7).

Figure 6: Primary school net enrollment rates in Kazakhstan by sex, 1991-2004



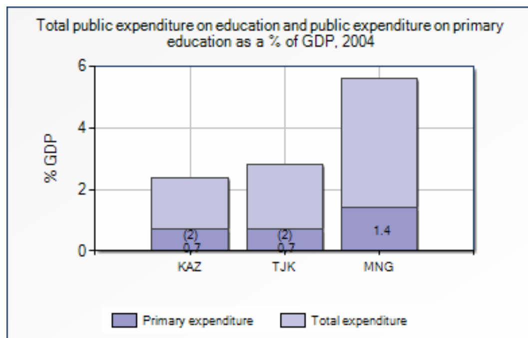
Source: UNESCO Institute for Statistics

Table 2: Secondary School Enrollment in Kazakhstan, 1991-2004

Secondary		1991	1999	2002	2004	2004 Regional average
GER (%)	MF	99	91	92	98	90
	M	(3) 97	91	93	99	92
	F	(3) 101	91	91	97	88
Tertiary						
GER (%)	MF	42	25	39	48	25
	M	...	23	35	40	24
	F	...	26	44	56	26

GER= Gross enrollment ratio
NER= Net enrollment ratio
Source: UNESCO Institute for Statistics

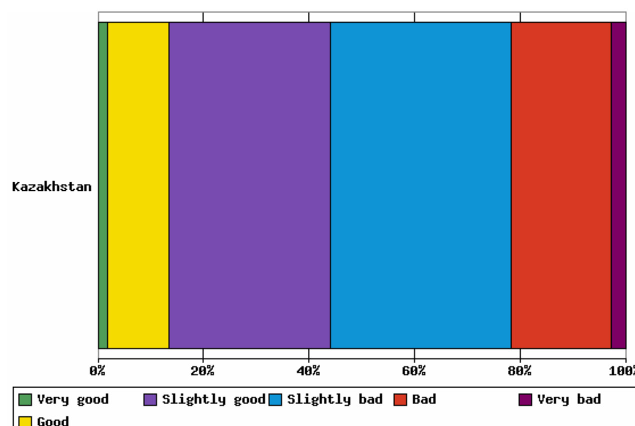
Figure 7: Public Expenditure on primary education in Kazakhstan



Quality of Education and Skilled Labor

Although enrollment and literacy rates are comparatively high in Kazakhstan, the slight dips in educational enrollments that have occurred over the period since independence, combined with limited spending on the part of government, may lead us to question the quality of education available in Kazakhstan. Several indicators lead to the conclusion that educational quality in Kazakhstan is sub par. Tatibekov et al. (2005) note that, "over the years of independence, the primary and high school education has declined in quality in every respect, especially in higher education."[34] In fact, 55.8% of businesses surveyed rated the quality and efficiency of education in Kazakhstan as "very bad", "bad", or "slightly bad" (Figure 8).[35] In addition, Tatibekov et al. (2005) explain that corruption is rampant within the education system, primarily due to low pay rates for teachers, which could have a significant effect on quality.[36] Quality of education will become increasingly important to Kazakhstan as it expands other growth sectors of its economy.

Figure 8: Survey Results from World Bank Business Environment Survey to the following question: "How would you rate the quality and efficiency of public services in education"?



Source: World Bank World Business Environment Survey

[34] Tatibekov, et al., 2005. p.110
[35] World Bank World Business Environment Survey
[36] Tatibekov, et al., 2005.

The World Bank has suggested that growing skill shortages could also begin to constrain Kazakhstan's rapid growth.[37] The number of highly skilled professionals in the country can give us an indication of the skill level available. Of a population of 15 million people, Kazakhstan has only 1,364 technicians (an increase from 1,179 in 1999).[38] Additionally, the number of researchers and people with the highest academic qualifications has been decreasing.[39] This can be attributed to the nation's history, as many skilled and capable workers migrated away from Kazakhstan during its early, more turbulent years. This event has left Kazakhstan with a shortage of skilled labor since its independence.[40] Although the population is educated, Tatibekov et al. (2005) describe a "mismatch" between the supply skills of the workforce and the demand for them because "qualifications and knowledge supplied by the education system were only marginally useful." [41] The limited skill level of the work force is an important factor impeding the country's economic development.

Overall we may conclude that the state of educational attainment (often a proxy for human capital development) is relatively high for Kazakhstan, but the poor quality of education and training has left the Kazakhstani workforce ill-prepared for a modern market economy. There have been little discernible improvements in human capital since the time of independence, which leads to the conclusion that foreign investment in the country has not produced positive human capital spillovers either directly or indirectly.

[37] World Bank, "Republic of Kazakhstan: Country Economic Memorandum, June 2005
[38] UNESCO Institute for Statistics
[39] Tatibekov, et al., 2005.
[40] ibid
[41] Tatibekov, et al., 2005.

Explaining the limited human capital development effect of FDI

The conclusion that Kazakhstan has not received substantial improvements in human capital as a result of high levels of FDI can be explained by two factors. First, Kazakhstan may not have reached the acceptable development threshold that would enable it to absorb significant spillover effects. Second, the FDI that the country has attracted may be of "low quality", a type that is not often associated with positive spillover effects.

The Threshold Argument

The OECD suggests that a sufficient level of development in education, technology, infrastructure, and business/economic health may be necessary for potential spillovers from FDI to be realized.[42] Studies of this "absorptive capacity" argument suggest that the following four elements may prevent FDI from contributing to economic growth and development of the host country: an excessive technology gap, low education levels, lack of financial development and poor institutional quality. In order to determine if a lack of absorptive capacity may explain the unrealized human capital spillovers in Kazakhstan, it is necessary to determine how the nation rates according to these four criteria.

The technology gap refers to the difference in technology available in the host country that may prevent FDI from achieving its expected benefits on economic growth. Li and Liu (2005) use the difference between the U.S. GDP per capita and the host country GDP per capita as a ratio of the later as a proxy of the technology gap. Their analysis suggests that the threshold

[42] OECD, 2002, p.10.

value above which spillover benefits will not be realized lies at about 12.6%.[43] Conducting the same analysis for Kazakhstan yields a threshold value of 18.05%.[44]

Adequate education levels may also be necessary to enable the transfer of skills from a MNE to the general workforce. UNCTAD has found that FDI only has a significant effect on host country growth when the population has received adequate levels of schooling.[45] Additional studies of data on outward investment from the U.S. show that technology transfer from FDI does not contribute to productivity growth in countries with low human capital.[46] A study by Borenzstein et al. (1996) implies that average years of schooling of the male population above 25 must exceed the threshold of 0.52 years.[47] Kazakhstan clearly exceeds this particular threshold. However, the case study shows that while attainment is high, due to quality factors, human capital is still relatively poor in Kazakhstan.

Third, an effective financial sector is necessary if local and foreign firms are to make the investments necessary to improve productivity.[48] Durham (2004) measures financial sector development by the total stock market capitalization relative to GDP. His study suggested that Egypt did not reach the threshold at 89%. Others use the proportion of domestic credit provided by the banking sector to GDP, suggesting that the ratio should exceed 12 or 13% of GDP.[49] In

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[43] Krogstrup, Signe and Linda Matar, "Foreign Direct Investment. Absorptive Capacity and Growth in the Arab World," Graduate Institute of International Studies, Geneva, May 2005
[44] Author's calculations from World Bank WDI based on values for GDP per capita (constant 2000 US$) for Kazakhstan and the United States in 2005.
[45] Krogstrup and Matar, 2005
[46] Saggi, Kamal. "Trade, Foreign Direct Investment, and International Technology Transfer – A Survey," The World Bank, May 2000.
[47] ibid
[48] ibid
[49] Krogstrup and Matar, 2005

Kazakhstan, the former indicator lies around 19% (below the threshold), and the later at 25% (above the threshold).[50]

Finally, a sufficient degree of institutional development may also be necessary to achieve positive spillovers to growth. Institutional development can be measured according to the level of regulatory quality.[51] Krogstrup and Matar (2005) suggest a threshold of -0.84 on the World Bank's governance indicator of regulatory quality which ranges from -2.5 to +2.5. Regulatory quality in Kazakhstan stood at -0.47% in 2005.[52]

In sum, Kazakhstan has not reached the threshold relating to the technology gap, and the results for financial development are ambiguous. The Republic does exceed the threshold for educational attainment and institutional development. While these indicators only give us a very rough sense of the actual development threshold level, they do provide an estimation that is comparable across nations. Where Kazakhstan stands on this spectrum suggests that the threshold argument is unlikely to account for the full explanation of why human capital spillovers have not been realized from FDI over the past fifteen years.

The Quality Argument

In this study we define "high quality" FDI as the type or nature of FDI that is most likely to produced beneficial spillover effects. Determining the level of quality of FDI in Kazakhstan is not a simple task. Kumar (2002) points to several indicators such as the extent of localization of foreign affiliate's output, level of contribution to the development of technology, extent of export orientation, and research and development (R&D) activity of the foreign enterprise affiliated

[50] Author's calculations from World Bank WDI based on values for Domestic credit provided by the banking sector (%GDP) and market capitalization of listed companies (%GDP) for Kazakhstan and the United States in 2005.
[51] Krogstrup and Matar, 2005
[52] Kaufmann, D., A. Kraay, and M. Mastruzzi, "Governance Matters V: Governance Indicators for 1996–2005," The World Bank, September 15, 2006.

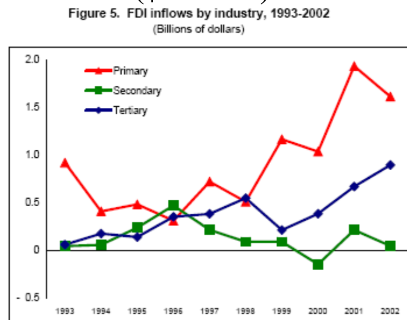
within the host country. These indicators arise from the assumption that deeper levels of production of a foreign enterprise in the host country are associated with an enhanced likelihood of technology transfer and human capital improvement. In the absence of detailed data on several of the above factors, this study will rely on the sector distribution data of foreign investment, which is a proxy for the contribution to the development of technology indicator.[53] Several economists identify this as a significant factor in determining spillover effects. Kumar (2002) suggests that traditional industries contribute less technology and knowledge than new technology-intensive industries.[54] Alfaro (2003) finds the FDI in the primary sector has a negative effect on growth, while FDI in manufacturing had a positive effect.[55]

In Kazakhstan, an overwhelming proportion of foreign investment is located in the extractive industries sector. Of total FDI stock of $15, 353.8 million, $10, 205.7 million is in petroleum alone.[56] This amounts to roughly two-thirds of FDI in the oil and mining sectors. As shown in Figure 10, FDI flows into the primary sector far outpace investment in any other sector. The primary sector is also highly capital intensive. Tatibekov, et al. (2005) believe that since oil extraction is not labor or skill-intensive, it is unlikely to provide much employment.[57] They also point out that FDI into Kazakhstan is unusual, in that it is not attracted to a cheap and well-educated work force but to the presence of petroleum and other mineral resources in the country. This may explain why Miyamoto's hypothesis does not appear to hold in this case. We can thus assume that the lack of FDI spillovers in human resource development can largely be attributable

[53] Kumar, 2002
[54] ibid
[55] Alfaro, Laura. "Foreign Direct Investment and Growth - Does the Sector Matter?" Harvard Business School, 2003.
[56] UNCTAD WID Country Profile – Kazakhstan
[57] Tatibekov, et al., 2005. p. 110

to the fact that a large majority of FDI flows into a sector that has little spillover potential, and is thus of "low quality".

Figure 9: FDI Inflows by industry, 1993-2001 ($billions)



Source: UNCTAD – "FDI in Brief – Kazakhstan"

Table 3: The Sectoral Distribution of FDI Stock in Kazakhstan, 1993-1999 (%)

Sector	FDI stock
Oil and gas	54.4
Ferrous metals	20.1
Non-ferrous metals	3.8
Energy	3.7
Food	3.4
Communications	2.3
Others	12.4

Source: UNESCAP, Country reports on investment climate: Kazakhstan

Summarized Findings and Policy Implications

This study sheds some light onto the reasons why expected spillover effects from FDI may not be realized. However, a caveat is needed here to account for the shortcomings in the methodology and data. As this is a case study approach, it is limited to explanations of the spillover effects in one country under specific circumstances. Additionally, many of the “quality” factors of FDI were not studied here. Despite these shortcomings, we can draw several instrumental conclusions for the case of Kazakhstan from this study:

- Kazakhstan’s significant natural resource endowment and favorable investment policies have enabled the nation to attract a relatively large amount of FDI since independence.
- Although educational attainment has been historically high in the country of study, the period since independence has shown a significant decline in the quality of education and the availability of skilled labor, and no recognizable improvement in labor productivity.
- Kazakhstan has surpassed the education level and institutional capacity threshold levels, but the technology gap is beyond the threshold identified and the state of financial development is borderline. These indicators suggest that Kazakhstan may not have the absorptive capacity necessary to fully gain from FDI.
- FDI in primary oil and mining sectors does not exhibit significant spillover benefits and is thus considered “low quality” FDI. Since two-thirds of inward investment in Kazakhstan flows into these sectors, the quality argument explains a large portion of unrealized spillovers in Kazakhstan.

These findings establish the need for further research to determine how a nation such as Kazakhstan may be able to improve the development impact of its substantial flows of FDI. Part II of the study will depict a multi-sector strategy for addressing this concern.

PART II – Towards a New Model of FDI for Development

Part I of this report reveals that FDI does not always contribute to the development goals of a country. The case of Kazakhstan has shown that despite large inflows of foreign investment, human resource factors have not improved noticeably since independence. While this is just a single case study, we can assume that this outcome may be common, particularly in similarly structured economies. Additionally, the lack of development progress in the world, as FDI has concurrently increased, also supports this conclusion. However, while certain benefits may remain unrealized, this is not to say that developing countries do not gain from FDI. Foreign investment remains a significant opportunity for developing countries to gain much needed capital, technology, and skills. As some developing country participants have noted at a 1999 OECD conference: "the issue was no longer whether foreign direct investment is good or bad for economic development but rather how to ensure that it contributes in a balanced and sustainable way to the legitimate aspirations of host economies."[58] The importance of this study is to determine the conditions and actions that would allow a developing country to *maximize* on this opportunity, and to realize as many positive benefits from FDI as possible.

Given the concerns over the second development model and the ambiguity over the actual benefits and costs of FDI on a host economy, it is worthwhile to consider potential changes that could contribute to a new model. In order to develop an idea of what such a model might look like Part II of this study will explore options from a variety of angles. Some of these options could include a new set of domestic policies in host countries, new or strengthened international institutions to protect the interests of host countries, or an increase in the pressure applied to foreign investors to improve their impact on development goals. In exploring these questions the paper will also show how the environment in which FDI operates is changing.

[58] OECD. "Foreign Direct Investment, Development, and Corporate Social Responsibility," OECD, 2000. p.9

These trends will indicate whether or not a shift in the development paradigm is in fact occurring, and if this shift coincides with our expectation that a new paradigm will involve integrated participation of all of the above mentioned parties. I will argue that each of these parties has the potential to improve the positive impact of FDI, without compromising the value of investments. In order to prove this point, we will revisit the case of Kazakhstan to view the changes brewing in this emerging economy and provide recommendations.

I. National options to improve social returns of FDI

In discussions over the impacts of FDI on developing countries, many scholars agree that the degree of impact depends largely on the role of the state. As the Asian Development Outlook (2004) suggests, due to the uneven nature of FDI spillovers, "host country policies are an important factor in the distribution of these benefits".[59] FDI holds great potential to contribute to human and economic development, but it is not the magic wand that many leaders hope it to be. The government must aim to attract high quality investment, but also provide the linkages that are needed for any investment to achieve maximum positive impact. In addition, the government could work with foreign investors and other partners to improve the impact of FDI on development.

Given the twofold explanation for the lack of development impact from FDI, national leaders thus have two policy areas to focus on. According to the OECD (2002), challenges relating to FDI "primarily address host countries, which need to establish a transparent, broad, and effective enabling policy environment for investment and to build the human and institutional capacities to implement them."[60] This claim alludes to the threshold argument presented in Part I, the view that the state must raise the quality of human capital, infrastructure,

[59] Asian Development Outlook 2004
[60] OECD, 2002, p.7.

and institutional development itself before its economy will be able to absorb the technology and knowledge FDI can bring. There is no shortage of recommendations from scholars as to which areas should be the focus. Resnick argues that policy should prioritize the areas of education, infrastructure, legal reform, and corruption abatement.[61] The OECD (2002) suggests that policy options exist in three areas: improvements in the general macroeconomic and institutional frameworks, creation of a regulatory environment that is conducive to inward FDI, and upgrading infrastructure, technology, and human competencies to the level where the full potential of FDI can be realized.[62] The OECD (2002) has also claimed that, "Investment in general education and other generic human capital is of the utmost importance in creating an enabling environment for FDI."[63] This process can be seen as a cycle, as more FDI can further enhance human capital through training. Wheeler and Mody (1992) have implied that in addition to the factors mentioned above, poor countries should concentrate on maintaining stable international relations, and ensuring an expanding domestic market.[64] These policies are all included in the general neoclassical development advice given to developing countries. Assuming a nation has the resources and political will to carry out these policies, there is little doubt that they are all positive steps towards development.

The second argument, that some FDI may be of the wrong type or "quality", suggests that governments have a role to play in attracting the right kind of investment and imposing some control over the foreign investors in their country in order to increase their gains. The first question to be address is what kind of investment should the government attract, and how can it do so? The unfortunate reality is that most developing countries have little choice when it comes

[61] Resnick, p. 23.
[62] OECD, 2002 p.24
[63] OECD, 2002 p.14
[64] McMillan p.10

to the type of investors that are interested in their country. Most of these nations attract FDI either through their natural resource endowments, or their plentiful amount of low-skilled labor. The policy choices will differ depending on which endowment is more prevalent. For the former, the primary objective will be to funnel resources, either direct tax payments or corporate contributions, to education and human development activities. At the same time, in order to spur economic change, even these governments are seeking to attract investment into other industries deemed important to economic growth. As mentioned in the first section, primary industry investment may be considered of "bad quality" since it does not transfer a great amount of technology nor does it employ a large number of the population.

Nations in the latter camp have an even more difficult task of guiding investment into higher value added and higher wage industries. Although it can be done, and one can argue that this goal should be of high priority. The examples of the Asian Tigers show how much can be achieved in terms of development by rapidly advancing the level of technology and industry occurring in their region. These nations have successfully transformed themselves into skilled-worker economies, largely through external trade and foreign investment guided by the strict policies of the state. If the government does not play a role in attracting higher value industries, they may end up stuck in a rut of low value investment that will be difficult to emerge from. In the case of Mexico, Resnick suggests that the government may have missed an opportunity to offer investors this type of alternative, and instead continued to rely on maquiladora-type manufacturing. Aside from the missed opportunity to advance like its Asian counterparts, Mexico is also likely to face increasing competition for this type of industry. In the longer-term

competitive global environment, many smaller and poorer countries are eager to attract a growing share of this business for themselves.[65]

States have several policy options available for attracting the "right" kind of investment. Most have been offering a range of investment incentives to foreign investors of all kinds to capture foreign exchange and spillover benefits for years. In order to maximize these, incentives should be focused on particular industries and activities which will advance the skill and technology levels of the host economy. Such incentives can include tax holidays and customs benefits, exchange control benefits, subsidies, guaranteed markets, and exemptions from certain laws and regulations.[66] They can be found in a nation's Investment Law or Investment Code (common among developing countries), or within individual agreements. Investment Codes are intended to structure the sharing of costs and benefits of foreign investment projects between the investor and the State, providing for the relevant guarantees, incentives and controls.[67] The incentives included for investors can be used specifically to attract favored investment that is more likely to enhance the nation's returns. If they are successful in improving the human resource and technological development of the host state, while not harming local business activity, the environment or social objectives, then they should be considered worth their cost.

The second question to be answered is: how can a state attempt to control FDI so that positive spillover benefits will be maximized? Controls can be implemented through the country's law and policies, as well as through the negotiation of individual investor contracts. The rule of law, particularly the Investment Code, is likely the most powerful tool that governments can wield over existing investors. If written and applied correctly, law can

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[65] Resnick, Adam. "Good Medicine or Snake Oil?" Foreign Direct Investment's Effects on Less Developed Countries," (Draft) p. 21.
[66] Salacuse, Jeswald. "International Investment Law: The National Legal Framework" Class presentation.
[67] Jeswald W. Salacuse, "*Undertaking A Direct Foreign Investment*", from Streng & Salacuse, International Business Planning s.19.07-19.08, 19.11-19.14. (1998).

maximize the benefits and reduce the costs of an investment to individual parties. However, host country investment law is mainly used to protect investors, thus giving them greater incentive to invest by increasing return and/or reducing the risks to the investor. According to Salacuse (1998), "with the increased emphasis around the world on market economics and open economies which has developed since the late 1980's, virtually all investment laws have de-emphasized control and greatly increased stress on foreign investment promotion."[68] Yet, some laws do still impose certain limitations such as price controls, performance requirements, hiring guidelines, foreign exchange controls, and local ownership requirements.[69] For example, national authorities may feel compelled to impose performance requirements (often referred to as trade-related investment measures) that require an investor to export a certain portion of its production, restrict its imports, and/or purchase a minimum amount of local goods and services.[70] Host countries may also require the investor to employ a certain percentage of local labor, or to form a joint venture partnership with a local enterprise in addition to following the basic laws and regulations ruling all economic activity in the state.

These measures are meant to increase local benefits from FDI for development and to minimize risks to the host. However, these nations must keep in mind that in general foreign investors are averse to rules and regulations on their activity, and excessive regulation could deter foreigners from investing, or cause them to reduce their financial stake in the county. As Salacuse (2000) has stated, "One person's obstacle is another person's protection," meaning that regulations meant to protect national interests (whether they are warranted or not) will generally

[68] Salacuse, "*Undertaking A Direct Foreign Investment*" (1998).
[69] ibid
[70] Salacuse and Sulilvan, 2005

be viewed as obstacles to be avoided from the point of view of an investor.[71] Additionally, Theodore Moran (2001) has argued that in fact performance requirements such as joint-venture, domestic content or technology sharing requirements actually stifle the benefits to be gained from a foreign investment.[72] According to this argument, such requirements can prevent a foreign affiliate from participating in its parent company's global competitive strategy, thus inhibiting the host country's ability to move to the frontier of advanced technology and processes. According to his research, Moran finds that, "domestic content, joint-venture, and technology sharing requirements create inefficiencies that slow growth and generate, in many cases, a negative net contribution to host country welfare".[73] These findings lead Moran to suggest a "paradigm reversal" for developing countries which, he argues, should now seek to attract tightly integrated operations into their economies and avoid domestic content, joint-venture, and technology-sharing requirements.[74]

In addition to local law, host governments have another tool at their disposal, namely international agreements. International investment law has developed certain customary precedents that apply to foreign investment. Largely these precedents are meant to protect and to promote FDI. For example, since the 1920's international law has recognized the limits on the ability of governments to expropriate foreign property.[75] Customary law has deemed that governments must compensate for any such activity, however, there are no clear standards as to how compensation should be determined.[76] Given this ambiguity and the number of additional risks facing investors, many nations have sought to codify international law into binding treaty

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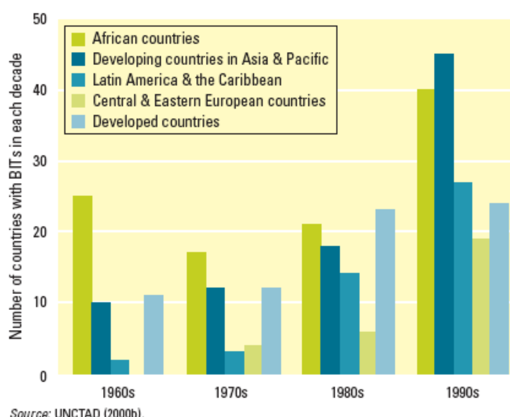
[71] Salcuse, Jeswald. "Direct Foreign Investment and the Law of Developing Countries," 15 ICSID Review Foreign Investment Law Journal 382, 2000.
[72] Moran, Theodore H. Parental Supervision: The New Paradigm for Foreign Direct Investment and Development. Institute for International Economics, Washington D.C. August 2001p.63.
[73] Moran, 2001. p.63
[74] Moran, 2001 p. 63
[75] World Development Report 2005
[76] Salacuse and Sullivan, 2005

form. This option can take the form of bilateral [and regional] investment agreements (BITs). While a multilateral agreement on investment has remained elusive, many smaller scale agreements have been reached for the purpose of improving the investment environment. There are now more than 2,200 bilateral investment treaties, 200 regional cooperation agreements, and about 500 multilateral agreements and instruments dealing with investment climate issues.[77] As indicated here, BITs are the most widely used form of agreement. A bilateral investment treaty is an international legal instrument through which two countries set down rules to govern investments by their respective nationals in the other country.[78] BITs often contain obligations not to expropriate property without compensation, provisions governing repatriation of profits and transfer of funds, standards of nondiscrimination, and mechanisms for settling disputes.[79] They are most often signed between a developed and a developing country partner. According to Salacuse and Sullivan (2005), “BIT law has become the fundamental source of international law in the area of foreign investment.”[80]

Figure 10 – Trends in Participation in Bilateral Investment Treaties



[77] ibid
[78] Salacuse, Jeswald and Nicholas Sullivan, “Do BITs Really Work? An Evaluation of BITs and their Grand Bargain,” 46 Harvard International Law Journal 67 (Issue no.1) 2005.
[79] World Development Report, 2005
[80] Salacuse and Sullivan, 2005

The advantages of BITs and other international investment agreements are twofold. First, such agreements enhance the credibility of the government by increasing the probability that it will stick to stated policy choices. Thus BITs serve as a protection for international investors from changes in the local law and the impartiality of host country decision making bodies.[81] Second, common rules reduce transaction costs, and thus would be expected to encourage additional trade and inward investment. However, several studies have shown that the signing of BITs have no clear correlation with investment inflows.[82] A preliminary study by the UN conducted in 1988 for the 288 BITs that had been conducted to date found "no apparent relationship" between the number of BITs and FDI flows. Later an econometric study carried out by UNCTAD in 1998 concluded that the influence of BITs on FDI flows was weak. However, in a more recent study by Salacuse and Sullivan (2005), BITs that included more stringent investor protections (such as those employed by the United States) were more likely to increase FDI flows. Overall the studies suggest that BITs' ability to attract FDI is ambiguous. It is more likely that other factors such as strong domestic institutions influence FDI flows to a greater extent that BITs.[83]

The primary disadvantage involved in entering into a BIT is the loss of policy flexibility for the host country. In fact, according to Salacuse and Sullivan (2005), "BITs have also displaced, and in some cases replaced the relevant domestic law of the host country in many important respects." In some cases this effect can be positive. While investors and their home countries have sought BITs in order to protect and facilitate their own investments, in affect, these agreements often serve to reduce unnecessary regulations on business and advance

[81] Salacuse and Sullivan, 2005
[82] Salacuse and Sullivan, 2005
[83] Salacuse and Sullivan, 2005

liberalization in the host country.[84] As modernization school argues, increased liberalization can bring vast improvements to a developing country's economy. On the other hand, this effect can be harmful to the host country. In the worst case scenario this could mean a loosening of labor and environmental protections, and other valuable policies in order to attract investment. Additionally, these limitations can prevent host governments from using the legal mechanisms discussed above to guide investments in such a way as to produce maximum local benefits.

Since the rise of international investment agreements, the emphasis has largely lied on protecting the interests and reducing the risk of the investor, so that the host economy will enhance its credibility and thus attract more investment. As the literature has shown, international agreements may not necessarily increase FDI, and even if they did, as the first part of this study revealed, the quantity of foreign investment does not guarantee the realization of certain benefits. This situation has led some to wonder if such contracts could be used to ensure greater host country benefits from the investment. For example, a host country could include provisions in a BIT with a developed nation that its investors must take measures that will result in certain benefits in line with the host's development goals.

There are several reasons why this is an unlikely option for a developing nation. First, BITs have been established as legal documents that largely aim to achieve three distinct goals– protection of foreign investments, investment and market liberalization, and investment promotion. Few BITs set out development as an explicit objective of the treaty.[85] Second, the ability of a developing country government to negotiate more favorable terms in a BIT is also unlikely due to their weaker negotiating position vis-à-vis developed world powers, as was suggested by the structuralist school. Certain scholars (Bergsten, Horst, and Moran, 1978) have

[84] Salacuse and Sullivan, 2005
[85] Peterson, Luke Eric. "Bilateral Investment Treaties and Development Policy-Making," International Institute for Sustainable Development, November 2004.

argued that the ability of a host country to influence foreign investors depends on five variables: i) the ability to monitor investor and industry behavior; ii) the cost of duplicating, or foregoing, what the investor offers; iii) competition within the industry; iv) vulnerability of the foreigner's assets and earnings to adverse treatment by the host government; and v) the ability of the host to discount political tension caused by investment disputes.[86] For many developing nations the cost of duplicating an investor offer is unreasonably high and competition within industries relatively low. Given growing standards of international law, developing countries also have little room for threats. Finally, host country's hands are tied in a way by GATT Restrictions, if they are a member of the WTO and national treatment provisions. The GATT Agreement on Trade Related Investment Measures (TRIMS) has forbidden the imposition of measures inconsistent with GATT Article III on national treatment and Article XI on the elimination of quantitative restrictions.[87] National treatment provisions which commit host nations to treating foreign enterprises the same as domestic enterprises are found in most investment agreements. These provisions are expected by most developed nations and would preclude a host nation from enacting unique responsibilities on foreign enterprises. While developing country hosts may be tempted nonetheless to include certain responsibilities on investors in order to enhance development impact, Peterson (2004) warns that, "What might be termed investor responsibilities by some, might be characterized as (ill-advised) performance requirements by others – and might be prohibited under some treaty models."[88] These policies could be ill-advised to the extent that host nations may erode their credibility and the ability to attract FDI in the future.

[86] McMillan p.14
[87] Salacuse and Sullivan, 2005
[88] Peterson 2004

Conclusions:

This section on national policy outlines four areas of opportunity for developing host country governments to attempt to maximize the benefits of FDI: i) improve social and economic conditions so that absorptive capacity increases; ii) aim to attract higher value-added industries into priority sectors; iii) formulate laws and regulations to extract greater benefits from foreign investors; and iv) negotiate BITs that ensure increased benefits from FDI for the host economy. In evaluating these options, the latter two appear to be the most difficult and potentially counterproductive. Excessive regulation of foreign investors, whether in national law or negotiated in a BIT, may lead to diluted benefits (as described by Moran) and reduced investment. Governments must walk a careful line between policies and regulations that extract the greatest host benefits from an investment, and the need to accommodate and please investors in order to continue the flow of funds into the country. Therefore, the bargain that is made, and the subsequent government action toward any investment, should consider the interests of both parties. It is clear that the first two options seem most capable of bringing a developing nation closer to its goal of maximizing the development potential of FDI. However, given the constrained resources available to developing nations following these recommendations is far from simple. While host governments of a developing country may have the greatest responsibility, as the OECD has suggested above, power and resources lie elsewhere.

II. International Bodies and Multilateral Agreements

The increase in the number of BITs and other International Investment Agreements (IIAs) with a strong bias towards the protection of investor rights has given rise to a recognized need for greater balance between investor and host country rights. One way to improve the balance is

to include investor obligations. However, the previous section has shown how individual nations, particularly poor and weak ones, may have a difficult time imposing additional demands on the same international companies they have worked so hard to attract. Given the high degree of competition among emerging market investment destinations, hosts still must grant special privileges in order to attract and keep investors. As such, national host country policy has tended to favor liberalization and reinforce the support and protection of investors' rights. In fact, from 1991 to 1997, of the 750 changes to foreign investment policy made by countries worldwide, 94% were in the direction of liberalization.[89] While some countries may enjoy greater bargaining power with MNCs and freedom to regulate for the national interest (particularly natural resource-rich nations), most developing countries would lose their competitive advantage as an investment destination if they were to place too much responsibility on investors. For this group of countries, agreements struck in a multilateral arena supported by a reputable global institution represent an attractive option for achieving policy goals a nation is unable to impose on its own.

Similar to BITs, the focus of proposed and existing international investment agreements (IIAs) has also traditionally centered on protecting the rights of the investor. Since the Second World War several attempts to create a global mechanism have been proposed, but none of these were introduced. These include the Havana Charter of 1948, the International Chamber of Commerce International Code of Fair Treatment of Foreign Investment, and the OECD Draft Convention on the Protection of Foreign Property.[90] The most recent attempt has been to create a Multilateral Agreement on Investment among OECD countries. This effort, begun in 1995, failed amid public protest and political differences.[91] Some attribute these failed agreements to a

[89] UNCTAD, World Investment Report, 1998 p.57
[90] Salacuse and Sullivan 2005
[91] Von Moltke, Konrad, "A Model International Investment Agreement for the Promotion of Sustainable Development," International Institute for Sustainable Development (IISD) November 2004. p.iv-v

divergence of opinion over the proper purpose for such an agreement, whether it is to promote investment, promote economic development, or to bind investors to act in the public interest.[92] One factor is clear, the power of developed countries over their developing counterparts has created a system largely biased toward bilateral agreements over a multilateral structure. This system preserves the power structure by limiting developing countries' ability to enhance their negotiating power as a group, and is a likely cause of the existing bias toward agreements heavy on investor protections (as investors are currently predominantly developed-country based) and light on investor responsibilities.[93]

However, while this power structure has been preserved, there has been a rising concern over the increasing power and control of corporations, since their rise to power in the middle of the last century, among the global community. While nations have been granting corporations guarantees and concessions, questions arise over the legal boundaries of companies that seem to be nation-less, and many worry that the ability of sovereign states to control them, and to ensure that their activities are beneficial for both parties, is diminishing. A strong network of NGOs for example, has risen to the fore arguing that this system allows corporations to bypass environmental and social regulations, causing an increase in negative externalities on a global scale. The current system also renders it difficult for host country policy makers to ensure that corporations contribute to their nations' development goals. Kell and Ruggie explain that, "Economic rule making has greatly extended economic rights of corporations in the global arena but other concerns, such as the environment, human rights and poverty, have not received comparable attention." These scholars warn that the resulting imbalance could undo the benefits

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[92] Cosbey, Aaron, Howard Mann, Luke Eric Peterson, and Konrad von Moltke, Investment and Sustainable Development, IISD Winnipeg: 2004.
[93] Salacuse and Sullivan, 2005

achieved by liberalization, which leads them to assert that broader frameworks of shared values and institutionalized practices are needed.[94]

As a result there have been some efforts to regulate corporations, shifting a small portion of the focus to the protection of the host nation. These may come in form of the regional agreements. For example, the European Union has attempted to create a "level playing field", by which the activities of corporations are legally monitored and regulated by the European Commission.[95] Another approach is to create a mechanism of oversight at the international level. Konrad von Moltke of the International Institute for Sustainable Development (IISD) makes the case that these concerns could be incorporated in international investment agreements (IIAs). Von Moltke argues that the scope of such agreements should be broadened, and their goal refocused from investment protection and promotion towards sustainable development. Von Moltke proposes that an agreement be found, "to establish an institutional structure that permits a continuous balancing of investor rights and public goods in a manner that is legitimate, transparent, and accountable."[96] Von Moltke's 'Model International Investment Agreement' would promote quality investment, those that in his opinion, "contribute to economic growth in a host state, make positive contributions to local communities, and are environmentally sustainable."[97] The model agreement would also set minimum levels of conduct upon MNCs to ensure that investments promote sustainable development. With an agreement such as this, host countries would not only have an avenue to ensure their interests are considered, they would enjoy a significant enhancement of their legal power over investors. For example, a host nation

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[94] Kell, Georg and John Gerard Ruggie, "Global markets and social legitimacy: the case for the 'Global Compact,'" *Transnational Corporations* vol 8, no. 3, December 1999, p.101.
[95] Hedley, 1999
[96] Von Moltke, 2004. p.v
[97] Von Moltke, 2004 p.1

can use violations of any such principles in their defense in the event of a case brought against them by a foreign corporation.

The idea, as Von Moltke suggests, that corporations have a greater responsibility to the communities in which they operate outside from their general business operations (providing jobs, tax income, products and services, etc), such as ensuring environmental sustainability, has given rise to the corporate social responsibility (CSR) movement. Western companies in the 21st century now face a much longer list of responsibilities that were once listed only on the agendas of governments. Particularly salient to multinational companies today, social responsibility obligations include the respect for human and labor rights, preservation of environmental resources, contributing to community development, alleviating social concerns, and avoiding corruption. UNCTAD suggests that social responsibility obligations are one way to balance the promotion and protection of liberalized market conditions with the need to pursue development policies.[98] Dunning also asserts that all of these areas are avenues requiring new, multi-stakeholder institutional structures.[99] While CSR has been a loosely defined and optional concept, it has been suggested that the inclusion of social responsibilities in IIAs could achieve the balance of investor rights with corresponding investor obligations the world is looking for.[100] For example, in addition to Von Moltke's suggestions, IIAs could require investors to observe development policy goals in their operations, and to act in a manner consistent with them (while taking care not to abuse these standards for protectionist purposes).[101]

While an international agreement with a primary focus of sustainable development appears attractive, for reasons similar to those discussed in the section on BITs, the likelihood that this

[98] UNCTAD, "Social Responsibility," 2001. p.2
[99] Dunning, 2006, p.189
[100] UNCTAD, "Social Responsibility," 2001. p.5
[101] UNCTAD, "Social Responsibility," 2001. p.12

will be achieved is low. UNCTAD admits in a report entitled "Social Responsibility" (2001) that the subject matter of its report is "conspicuous by its relative absence from IIAs".[102] Enforceable development obligations have to date been limited to a small number of investment promotion agreements among developing countries. For example, the Charter on a Regime of Multinational Industrial Enterprises (MIEs) in the Preferential Trade Area for Eastern and Southern African States places MIEs under the obligation to implement a local value-added program, an export program, and a training program.[103] Models such as these could form the basis of social responsibility clauses in future IIA's. However, given existing power dynamics (overwhelming power of developed nations and of MNCs), disagreement over the actual benefits arising from these requirements, lack of international consensus, and the difficulty of altering a wide and deep network of signed agreements, social responsibility obligations are unlikely to appear broadly in IIAs anytime soon.

Given these clear limitations, international organizations have sought different arena to achieve the objective of balancing established investor rights with certain obligations towards host countries. The range of options considered includes regulatory or incentive-based "top-down" initiatives, or "bottom-up" voluntary codes.[104] These attempts avoid placing restrictions on a firm's operations, but instead encourage investors to find other practical ways to contribute to development goals. A significant effort toward this end following the former method is represented by the effort begun in the 1970s by the United Nations to create a "UN Code of Conduct on Transnational Corporations (TNCs)". This code of conduct was to serve as a collective international approach "to managing the systemic costs and benefits of a global

[102] UNCTAD, "Social Responsibility," 2001. p.17
[103] UNCTAD, "Social Responsibility," 2001. p.19
[104] Dunning, 2006, p.189-190

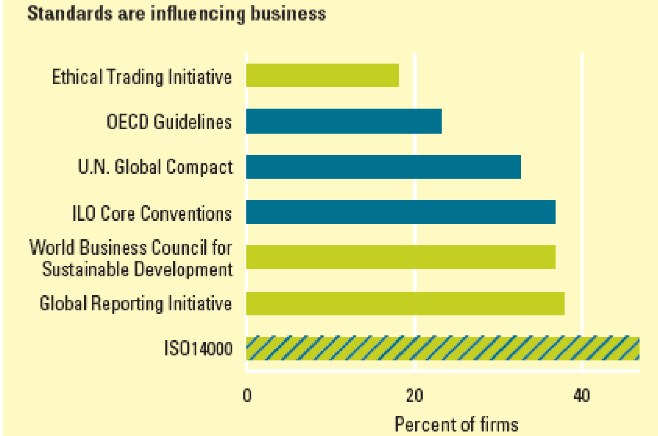
economy driven by transnational business operations".[105] The Code listed the obligations of TNCs across a wide range of issues ranging from the respect for the sovereignty of the host state, respect for human rights, and abstention from corrupt practices, to observance of tax and anti-monopoly laws.[106] The Code also included language directly relating to the development of the host state: "adherence to economic goals and development objectives, policies and priorities"; "the duty, by TNCs, to allocate their decision-making powers among their entities so as to enable them to contribute to the economic and social development of the countries in which they operate", and "contribution to strengthening the technological capacities of developing countries in accordance with the practices and priorities of these countries".[107] Ultimately leading to the demise of the Code was dissention among its creators as to whether this was to be a binding and enforceable agreement, or a voluntary set of guidelines. As a result, the twenty-year process of trying to achieve some effective legal resolution of the goals of transnational corporations and those of host governments was brought to an end.[108]

While the UN Code of Conduct was never applied, it did give rise to a series of new documents with a similar purpose. Given the first experience, it became clear that the most widely acceptable and timely answer to this problem lies in the creation of non-binding international standards, the "bottom-up" method. This strategy is an attempt to codify appropriate conduct on the part of corporations, while still allowing flexibility as the concepts further develop and acquire broad-based support. International institutions such as the UN and OECD have realized that investment agreements among nations are not the only option for establishing the social responsibilities of foreign corporations. As a result, non-binding

[105] Hedley, 1999
[106] UNCTAD, "Social Responsibility," UNCTAD Series on issues in international investment agreements. United Nations, 2001. p.5
[107] UNCTAD, "Social Responsibility" 2001 p.6
[108] Hedley, 1999

international statements of norms and guidelines for international investors are on the rise. These corporate codes of conduct, as described by the World Economic Report, "outline basic principles of behavior for firms, including corruption and respect for environment and labor norms."[109] These statements have arisen in various forms. Some, such as the OECD Guidelines for Multinational Enterprises, are agreed upon, signed, and promoted by a group of government representatives. Others, such as the UN Global Compact, involve the direct participation of corporations. As stated in the World Economic Report (2005), "Efforts to promote international cooperation in matters related to the investment climate are not limited to arrangements between governments." Given their non-binding voluntary status, the incentive to sign codes such as the UN Global Compact relies on the individual enterprise's concern over its international reputation. The figure below suggests that these codes are gaining weight with the world's corporations. However, one apparent problem with this strategy is that the rapid proliferation of codes and absence of a single globally-accepted set of standards creates confusion and perhaps misses an opportunity to send a clear and consistent message.

Figure 11: Percentage of Firms Influenced by International Standards



Source: World Development Report 2005

[109] World Economic Report 2005 p. 184.

While their messages may vary, some of these standards include key provisions that guide corporations on how to contribute to host country development. The OECD Guidelines for Multinational Enterprises, which was first produced in 1976, calls on enterprises to "contribute to economic social and environmental progress with a view to achieving sustainable development"; to "encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice"; and to "encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees".[110] (For a complete list of the OECD Guidelines General Principles, see appendix) The OECD Guidelines have been recommended by 36 OECD and non-OECD governments.[111] However, despite their influence over more than 20% of firms (Figure 11), some criticize agreements such as this one as ineffective. Alan Hedley writes that, "Besides being limited to the 24 countries that belong to the OECD, they [The OECD Guidelines on Multinational Enterprises] have not made much of a policy impact on TNC activity, apart from employment and industrial relations issues."[112]

A more recent attempt toward codifying the obligations of investors was initiated by the United Nations (UN). The UN Global Compact, launched jointly among the UN, large corporations, national governments and parts of civil society, sets out three accepted values relating to labor, the environment and human rights, each broken down into 10 principles of corporate conduct, derived from international labor, environmental, and human rights law.[113] Signatories are asked to incorporate these values into their mission statements and to translate

[110] UNCTAD, "Social Responsibility" 2001 p.7-8
[111] OECD, 2002 p.31
[112] Hedley, 1999
[113] Dunning, 2006 p.192

them into corporate management practices.[114] Kell and Ruggie (1999) describe the Global Compact as one small step in the direction towards righting the imbalance between economic globalization and governance.[115] If it succeeds, they argue, the Global Compact can help to close the gap between the strictly economic sphere and the broader social agenda. Dunning also supports this argument by suggesting that if properly organized, such multi-sector partnerships could play a more important role in addressing specific development goals.[116]

The main argument against such an approach (according to proponents of social responsibility) rests on the non-enforceability of these international codes and guidelines. Given the continued increase in FDI and the failure of voluntary codes of conduct to induce significant change, some have called for stronger measures and even a revolution in world governance. This might involve, as Hedley suggests, "universal and binding norms and standards regarding the activities of transnational firms negotiated and adopted by all nation states".[117] This may be necessary because, as Hedley further asserts, "…voluntary instruments are simply insufficient as a mechanism to structure and regulate the world economy." Yet, while this may be true, given the complications and differences of opinions surrounding IIA's, voluntary codes and standards are currently the best alternative the international community has been able to agree upon. In addition, UNCTAD suggests that these types of non-binding agreements may act as "soft law," and command greater respect and authority than one might first assume. This argument lies on the observation that voluntary codes are effectively enforced when adopted by some major multinationals, who in turn require subcontractors and partners to abide by them. Kell and Ruggie (1999) also make the assertion that "challenging TNCs in particular to become good

[114] Kell and Ruggie (1999) p.104
[115] Kell and Ruggie (1999) p.101
[116] Dunning, 2006 p.192
[117] Hedley, 1999

corporate citizens that accept responsibility commensurate with the power and rights they enjoy ensures that corporations from developing countries are not punished for lacking the capacity to act in the same way."[118] It is in this way, that developing countries can derive more engagement from foreign firms without having to enforce regulations that "national treatment" would require domestic firms to follow as well. These scholars argue that an initiative such as the Global Compact can serve all of these purposes.

Conclusions:

While the current frameworks of agreement have enhanced the stability of the world's investment climates, it is clear that there is a current need to work towards a greater balance of investor and development rights on an international scale. This can be accomplished by broadening the agenda surrounding foreign investment from purely economic terms to include social and development considerations. How this might be accomplished is a difficult question. Any proposed solutions must be careful not to create protectionist opportunities, or stifle the economic benefits from global investment with inappropriate requirements (e.g. the Moran argument).

This analysis shows that the most promising way to achieve this goal, at least in the near term, is by establishing recognized, yet voluntary, global standards for social responsibility. Incorporating such factors into a universal investment agreement is unlikely to succeed in the foreseeable future. For the most part, businesses object to allowing their operations to be subject to legal accountability for the observance of social responsibility obligations.[119] Given the current power structure, such an agreement would be very difficult to negotiate. Instead, statements of codes and standards established by international institutions are paving the way

[118] Kell and Ruggie (1999) p.104-105
[119] UNCTAD, "Social Responsibility," 2001. p.55

towards a universal acceptance of the responsibilities of international corporations. The processes for establishing codes such as the OECD Guidelines and the UN Global Compact have generated a wider consensus as to which responsibilities should appear on the agenda. With such codes as guidelines, governments, individuals, and NGOs can hold corporations to account. Moving forward, the global community needs to work to standardize these obligations by simplifying them into one collection of universally-excepted guidelines. For such an effort to succeed, UNCTAD suggests that standards should be "multilaterally agreed, monitored and applied through procedures that are themselves transparent, accountable, and socially responsible."[120] As the world become mores accustomed to these standards, the guidelines could be used as a non-binding addendum to IIAs, in order to introduce a degree of soft law and moral obligation on investors.[121]

III. Home Country Attitudes and the New Roles and Responsibilities of Investors

Von Moltke's proposed model International Investment Agreement established that host states, home states, and foreign investors each have rights and obligations in relation to foreign direct investment.[122] Although these rights and obligations are net yet codified in a globally recognized treaty, they are beginning to take hold as generally accepted practices. As the rights and obligations of host countries have been discussed in a previous section, we now turn to the roles of the home country and the foreign investor.

To begin, the home country (where the investor is based) has the responsibility and the power to govern the enterprise. As the OECD asserts, "The way private enterprises behave and are

[120] UNCTAD, "Social Responsibility," 2001. p.54
[121] UNCTAD, "Social Responsibility," 2001. p.55
[122] Von Moltke, 2004. p.1

governed is important in maximizing the benefits of FDI for economic development."[123] Therefore effective governance from home could significantly improve an enterprise's net positive impact abroad. There are several ways in which today's multinational corporations are governed. These include traditional means of corporate governance such as the oversight of the board and its stockholders. Corporations are also largely governed by the rules and regulations imposed on them by their home state. While they may be investing in foreign countries, corporations are also still bound to these laws. In order to ensure that their national firms are creating positive impact abroad, states can regulate corporations with this goal in mind. This will require the government to remain aware of its corporations' activities, and to keep an open ear to the concerns of the global community and citizens organizations (i.e. NGOs). Enacting minimum standards of social responsibility at home can also have a significant effect on a corporation's activities abroad.

A strong example of a home government asserting this responsibility can be found in the case of Unocal in Burma. Unocal, an American corporation, had been receiving a great deal of international criticism for its investment in a natural gas pipeline in Burma (a Southeast Asian nation generally recognized to be run by an illegitimate and brutal dictatorship). The company's defense of the pipeline against potential attacks from anti-government gorillas was reported to have exacerbated refugee problems and caused a marked increase in human rights abuses against Burmese citizens. In response to a growing protest movement against Unocal in the United States, the U.S. Congress passed the Cohen-Feinstein amendment to the Foreign Operations Appropriations Act of 1997, requiring a ban on any new U.S. investment in Burma.[124] Many agreed that this was a necessary step to prevent human rights abuses and to cease support for the

[123] OCED, 2002 p.30
[124] "The Burma Pipeline" Harvard Business School Case Study, 1998.

brutal dictatorship. This example shows how the government's awareness can mitigate unfavorable corporate activities in foreign nations.

While not recognized as an obligation, upon entering into a BIT the developed country (largely the source of investment) is encouraged to promote and facilitate investment into the host state.[125] This can be viewed as second area of influence a home government can have on the sustainable development of its partner. In fact, home countries have an interest in enhancing good quality investment into their partner. This interest lies in the home country's international development, security, and environmental preservation goals, as well as the interest to enhance the competitive position of its own industries. As their partner grows and prospers, the home country's corporations will find greater, more profitable and less risky investment opportunities. In order to facilitate this, home countries can provide firms information about investment opportunities in their partner's economy and assist in forming relationships among business and host government leaders. The U.S. government provides a large degree of this service through the Department of Commerce and its Embassies. In addition, to further develop the relationship between the nations, home countries can also play a role in developing the capacity of host countries to manage foreign investors, improve their development threshold, and maximize their gains through an increase in targeted aid assistance.

Aside from the oversight of its government, corporations are being increasingly held to account for their actions in foreign countries by NGOs and concerned citizens in their home country. When the neoclassical development paradigm was first adopted the influence of civil society organization was a far cry from what it is today. Dunning explains that this was because the 'awareness factor' and the 'radius of concern' were not well developed.[126] Today, due to an

[125] Von Moltke, 2004. p.23
[126] Dunning, 2006 p.179

unprecedented level of access to information which has been fueled by advances in technology, citizens and organizations can now become acutely aware of corporate actions in foreign markets and this has effectively widened their radius of concern. Civil society groups were able to convince the U.S. government to prevent further investment supporting the brutal Burmese dictatorship, and they have also raised awareness about corporate labor abuse in a number of cases. All of these pressures are changing the perceived responsibility of a corporation operating in foreign markets. Kell and Ruggie (1999) argue that the dynamic interplay among civil society actors and firms also holds potential to bridge the imbalance between economic globalization and the governance structures that it has left behind.[127]

Finally, the realm of responsibilities that investors now take on themselves is also growing. Von Moltke suggests that today, investors have a general obligation to contribute to the development of the host country, and to ensure that their activities do not conflict with the host's development strategy.[128] While foreign investors generally have the right to equal treatment and to earn profit from their investors, there is increasing acceptance that developing host nations also have a right to development. These obligations can also be justified by the investors' use of publicly provided labor, resources, and infrastructure. As a result, foreign investors today are encouraged to go beyond following local laws and paying taxes, to contribute to the sustainable supply of local resources through the transfer of knowledge and techniques.[129] This can be achieved through by imposing self-regulation. Jeremy Oppenheim writes that, instead of seeking concessions, "companies would be better off encouraging rational tax systems, equitable social policies, sustainable environmental regulations, balanced controls on short-term capital

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[127] Kell and Ruggie, 1999 p.103
[128] Von Moltke, 2004. p.16
[129] ibid

movements, and transparent rules."[130] He also argues that aggressive tax breaks for foreign investors could result in underinvestment in infrastructure and education, which are necessary for long-term productivity. Additionally, should a corporation voluntarily follow this course it could avoid reputational damage in home markets. The last, and most business-salient, portion of this argument is that by following this approach, investors will not only be earning profit from foreign investments, but they will have a greater opportunity to contribute to the development of emerging regions, which is where the world's future growth is most likely to be concentrated.[131] As Oppenheim explains, "By becoming the allies of social progress, such corporations will not only accelerate the sustainable growth of these countries but also create an enduring competitive advantage by winning the battle for trust and legitimacy."[132]

In addition to these natural areas for investor responsibility, foreign firms are increasingly adopting principles of corporate social responsibility (CSR) and applying them in the countries in which they do business. As discussed in the previous section, these principles encourage firms to go above and beyond normal business practices, and to incorporate social and environmental factors alongside economic decisions. CSR can take many forms. In its early phases, CSR mainly consists of charitable donations and employee volunteer efforts in the local community of a business. As the practice has become more widespread and institutionalized, companies are reevaluating each impact of their operations, from human resources to process design, in order to minimize the negative externalities and maximize the enterprise's positive impacts. In order to show that they are socially responsible, many companies have adopted codes of conduct and other means of self-regulation. The OECD remarks that in fact, "The time has long gone when

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[130] Oppenheim, Jeremy. "Corporations as global citizens**:** Global corporations and the developing countries where they invest actually have symbiotic objectives." The McKinsey Quarterly, 2004 Number 1.
[131] Oppenheim, 2004.
[132] ibid

companies were dealing merely with laws and legal compliance: self-regulation can be more challenging than mere compliance."[133] These codes can significantly affect the credibility of a corporation at home and abroad. However, as Kell and Ruggie (1999) warn, "the plethora of voluntary initiatives and codes, including labeling schemes, that have emerged over the past years at the corporate, sectoral and national level have several shortcomings: they are selective in content due to the absence of uniform definitions; many lack transparency and provide for inadequate representation of their supposed beneficiaries; and it is not clear to whom they are accountable."[134] It is for this reason that the argument for an international standard is strengthened.

However, in many instances, CSR initiatives should be tailored to the relevant circumstances. In a foreign developing market, CSR activities should be focused on contributions that the business can best provide and that are strategically linked to the enterprise's goals and the needs of the community/nation. These activities could include training programs for local workers, a preferred position for small local suppliers, building and improving surrounding infrastructure, and contributing expertise to the host nation's educational programs. By assisting their hosts in this way, corporations will be helping them overcome the threshold hurdle that often prevents these nations from realizing benefits of foreign investments.

For an example of this kind of initiative we turn to the story of Chiquita in Central America. A corporate giant in the international fruit business, Chiquita was facing a significant threat to its license to operate by environmental activists in the region where it sourced its fruit. In response, the company formed a partnership with one of its greatest critics, the Rainforest Alliance, to improve the company's impact on sustainable development. Chiquita began to alter

[133] OECD 2000 p.14.
[134] Kell and Ruggie (1999) p. 106

its practices so that it could meet the standards set by Rainforest Alliance's "Better Banana Program" (BBP). The BBP was a certification standard that covered wildlife conservation, ecosystem considerations, soil erosion, water conservation, integrated waste management, integrated pest management, fair treatment and good conditions for workers, and the establishment of strong community relations. While improving its impact on sustainable development, the large corporation also realized significant business benefits. Chiquita found that certification had contributed to increased productivity and reduced costs from efficiency. Chiquita is also reaping business benefits from an improved brand reputation.[135] This case shows how firms can greatly improve their overall development impact by taking voluntary steps. These steps, as seen here, can often be encouraged by NGOs or governments. Similarly, several foreign investors are also adapting their operations and contributing to local community development.

Conclusions:

Helping developing countries to achieve their development goals is in the interest of foreign investors and their home country governments and citizens. While some NGO's have pursued this objective for a long time, it is a more recent phenomenon that this goal has been integrated into what was once a purely economic agenda, foreign direct investment. Governments of developed nations have also attempted to contribute through international development assistance. However, given today's global environment of instability and insecurity, governments face a more urgent need to face this problem and do so they need to consider all avenues to assist in development. One of the areas with the greatest potential for

[135] Morgan, Guy. "Chiquita and the Rainforest Alliance: A Fruitful Partnership," *The Corporate Citizen*, Issue 1. Boston College Center for Corporate Citizenship, 2006. p.34-37.

impact is foreign direct investment. Governments can act to prevent negative consequences of their enterprises abroad, as well as provide incentives and encouragement for these enterprises to contribute effectively to development. In addition to the development-focused NGOs, now more home country citizens are aware and concerned about their employers' and other national enterprises' impacts abroad. This knowledge has fueled a rise in the number and the power of citizen groups. Their interplay with corporations is an effective source of balance that has elevated development concerns.

Finally corporations themselves can and do act voluntarily either out of their own interest to strengthen their business or to avoid future criticism and pressure from governments and citizens groups. However, in addition to ad hoc voluntary corporate action on these issues, an international and uniform platform is also need to push companies to act favorably in developing markets and to advise them on how to do so. In sum, these avenues (home country governance, citizen pressure, and CSR), in combination with a set of globally-recognized set of international standards, hold the greatest potential for maximizing the positive benefits of FDI on developing nations.

Part II of this study has begun to frame the elements of a new model for achieving development goals from FDI. The preceding analysis of the roles of the government, international institutions, home countries and investors has revealed a justification for the realignment of responsibilities for this objective. While the role of the host country is still very important, it is clear that developing nations are limited in their abilities to implement beneficial policies. The location of power and control in this world has shifted from sovereign states to corporations themselves; therefore corporations must also assume a large part of the

responsibility to ensure that their investment activity will bring positive spillovers into their hosts. These private corporations can be guided by international institutions who are working on establishing a universal set of criteria and guidelines for corporations investing overseas, as well as by their home country governments and stakeholders. This evolving cooperative dynamic is already being tested in a number of developing nations. In order to gain a stronger understanding of how this framework can work in a developing nation, we now revisit that case of Kazakhstan to compare the changing roles of investment actors and to apply the above findings to the nation's challenges.

IV. Another Look at Kazakhstan – The potential impact of policy changes and CSR

As a developing country rich in natural resources, but poor in human capital, Kazakhstan has a few options available that may improve the impact of FDI on human resource development and other potential spillover benefits. It could choose to reap the profits from its efficient extractive industry and redistribute them towards human development goals. It can also attempt to attract FDI into more beneficial industries and work with existing investors to enhance their developmental impact. Improving the country's threshold and also the quality of FDI in this way is likely to enhance the spillover effects of FDI on human resource development, the challenge first introduced in Part I of this report.

Given the results of the analysis conducted in Part II, we can derive recommendations on further actions the country can take to accomplish these tasks and enhance the impact of foreign investments. In this study we have determined that host country governments have a limited amount of policy space in which to control the impact of investments. Host countries should be advised to invest in their human capital, institutional and physical infrastructure, and to attract

beneficial investments, but they should be cautious in imposing regulations. We have also found that bilateral trade agreements and/or an IIA are unlikely sources of assistance on this matter. Instead, international codes and guidelines are available as tools the government can use to pressure and monitor corporations. Home governments, citizen groups, and the CSR activities of foreign investors can also be mobilized to achieve an underdeveloped nation's development goals.

In terms of national options to improve the developmental impact of FDI, Kazakhstan has used most of the options discussed. The first, investing in the quality of human capital, infrastructure, and institutional development, has been made possible due to large royalty flows from the energy sector. In order to manage oil wealth and supplement the national budget the country created the National Fund of the Republic of Kazakhstan (NFRK). While government spending has increased, advisors warn that spending must be of high quality, and low volatility. It also must be managed carefully in order to avoid overheating of the economy.[136] According to the World Bank, Kazakhstan has added human capital development to its list of main priorities (which also includes agriculture, transport and housing). Specific goals for education reform include moving to a new concept of lifelong learning, and making Kazakhstan's education system appropriate to the "global educational environment".[137] While these are positive steps toward enhancing the absorptive capacity of the economy, Kazakhstan will need to follow through with a well-funded, targeted and effective overhaul of the education system in order to see real results in human capital development.

The next option discussed involves the attraction of high quality investment into beneficial sectors and activities. At present, the government of Kazakhstan is actively taking steps to attract

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[136] World Bank, "Republic of Kazakhstan Country Economic Memorandum Getting Competitive, Staying Competitive: The Challenge of Managing Kazakhstan's Oil Boom," Report No. 30852-KZ, June 2005.
[137] ibid.

investment into sectors such as production infrastructure, manufacturing, construction, tourism, agriculture and telecommunications.[138] Within specific investment contracts the government often uses such incentives as the deduction of cost of fixed assets brought in from aggregate annual income, relief from the property tax and land tax, exemption from customs duty, and state grants in kind (not to exceed 30% of the volume of capital investment).[139] In addition, the Law "On the State Support of Direct Investment" provides for incentives such as state assets and concessions, income, land and property tax holidays for five years with additional periods at reduced rates, and duty and VAT exemption for imported machinery and inputs for varying periods. The legal framework is in general very favorable to foreign investment. All sectors of the economy are open to foreign investment, and foreign investors are allowed to participate in privatization. The Agency of the Republic of Kazakhstan for Investment (ARKI), and the Foreign Investors' Council provide support for foreign investors.[140] Additionally, the latest Law "On Investments" (enacted in 2003) guarantees legal protection of investors' activities in the country, guarantees the conditions of contracts between investors and the Government, the use of income and the rights of investors, and provides a mechanism for the settlement of disputes. The law also ensures Government support on investment, which includes creating a favorable investment climate, stimulating investment in new production operations, expanding and renovating existing ones.[141]

In terms of controls and regulations placed on investments, the nation has some legal mechanisms in place meant to protect the nation and improve its benefits from investment. These

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[138] Tatibekov, et al. "Globalization, Employment, and Poverty Reduction: The Case of Kazakhstan," Kazakhstan Institute of Management and Strategic Research (KIMEP) 2005.
[139] UNCTAD WID Country Profile: Kazakhstan
[140] OECD, "Foreign Direct Investment in Kazakhstan" OECD GLOBAL FORUM ON INTERNATIONAL INVESTMENT: New Horizons and Policy Challenges for Foreign Direct Investment in the 21st Century, November 2001, Mexico City, Mexico.
[141] UNCTAD WID Country Profile: Kazakhstan

include a law “On Labor” to ensure that worker rights are protected, which went into effect January 1, 2000.[142] Additionally, in recent years, Kazakhstan has implemented stricter controls on investment. For example, as of June 2002, foreign investors are now subject to ‘regulations for the purchasing of goods (works, services) required for petroleum operations’, also know as the “local content requirements”. These requirements oblige petroleum producers to “buy goods manufactured by Kazakh entities within Kazakhstan provided that such goods meet certain requirements,” and to “give preference to the employment of local personnel.”[143] While these policies may enhance the human resource development impact of foreign extractive firms in the short-term, they may also deter further foreign investment, as corporations generally prefer to operate without such restrictions which may add cost and reduce efficiency. These policies also run counter to GATT rules and the Agreement on Trade-Related and Investment Measures (TRIMS) an issue Kazakhstan will have to address as it comes closer to the potential of WTO membership.[144] In addition, as described above, performance requirements such as these are likely to diminish a foreign investment’s impact on development by limiting investors’ ability to make decisions based on economic factors.

Kazakhstan has become a party of a large number of bilateral investment treaties. A U.S.-Kazakhstan BIT entered into force in 1994 which assures investors of MFN and/or national treatment, fair and equitable treatment, acceptance of top foreign management personnel, protection from expropriation, unrestricted capital transfers and convertible currency, and generally accepted dispute settlement procedures. The only exceptions include ownership of land

[142] OECD, “Foreign Direct Investment in Kazakhstan” OECD GLOBAL FORUM ON INTERNATIONAL INVESTMENT: New Horizons and Policy Challenges for Foreign Direct Investment in the 21st Century, November 2001, Mexico City, Mexico.
[143] UN-ESCAP, “Foreign Direct Investment in Central Asian and Caucasian Economies: Policies and Issues,” *Studies in Trade and Investment* No. 50, 2003 (ESCAP:Bankok)
[144] Ibid.

and other natural resources, ownership of real estate, ownership or control of television and radio broadcasting, air transportation, and preparation of stocks and bond notes issued by the Government of Kazakhstan.[145] As suggested in the analysis above, developing nations rarely include social and development provisions in a BIT. The BIT with the U.S. was the first to enter into force. As of June 2006, Kazakhstan has entered into a total of 35 BITs with countries in the CIS region as well as Europe, Asia and the Middle East.

While Kazakhstan has taken some significant positive steps to improve absorptive capacity and to attract investment into value-added industries, recent events have shown that it has also taken some counterproductive policy steps. As the findings in this study reveal, the Kazakh government should limit the use of requirements and controls and instead allow market forces to function on their own in regards to the activity of foreign investment in the country. As opposed to controls, leaders can make use of incentives that would encourage, but not force, foreign investors to display good corporate citizenship principals and to contribute towards training and developing the education system as well as other development goals. On the international stage, Kazakhstan should make use of international agreements and join the international effort to codify good corporate citizenship. The government can also work with the home governments of its major foreign investors to collaborate on improving the development impact of FDI. According to the World Bank, incentive schemes must also benefit the investor, as stated in a country economic memorandum, "Only schemes that are win-win for the government and the operators (in the sense o f truly reducing the operator's costs, while generating an increased amount of spillovers for the non-oil economy) will qualify as an

[145] Kazakhstan Bilateral Investment Treaty: http://tcc.export.gov/static/doc_exp_005571.asp

economically viable proposition."[146] Finally, creating and facilitating partnerships among the State, NGOs, and corporations investing in the country can also contribute to greater cooperation around shared development goals.

In fact, some instances of this can already be found in Kazakhstan. Chevron-Texaco, one of Kazakhstan's major international investors, formed a partnership with UNDP (the United Nations Development Program) in Kazakhstan in 1997. The common goal of the partnership was to build local entrepreneurship and support local private sector development.[147] This goal had both business and development components, with each partner seeing eye-to-eye on the benefits. Together, Chevron-Texaco and the UNDP established a small business support center in Atyrau (a major oil drilling region). They also began to provide micro credit to would-be entrepreneurs in the area.[148] By 2002, 208 business plans had been completed, 71 of which were financed by the partnership (which also included Citibank at this point) and over 530 jobs had been created in the area. Chevron-Texaco was also able to significantly increase the amount of goods and services it was able to source locally from around 0% in 1993 to over 38% by 2002.[149] While this one project may make only a small difference in Kazakhstan's overall development goals, more activity can create a much greater impact. Exxon is also funding the project Partnership: Health of the Capital's Children. This project supports training provided by the Kazakhstan Association of Family Physicians to primary care doctors in the management of childhood illnesses at home.[150] Additionally a local stakeholder engagement initiative carried out by AES

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[146] World Bank, "Republic of Kazakhstan Country Economic Memorandum Getting Competitive, Staying Competitive: The Challenge of Managing Kazakhstan's Oil Boom," Report No. 30852-KZ, June 2005.
[147] "Partnerships for Enterprise Development: Building the foundations for local sourcing and sub-contracting in Angola and Kazakhstan The ChevronTexaco –UNDP Experience." Can be accessed on the Global Compact website: http://www.unglobalcompact.org/docs/issues_doc/7.5/7.5.2/chevron_pre.pdf
[148] ibid
[149] ibid
[150] Baker, Mallen. Business Respect - CSR Dispatches No. 82, 16 May 2005: http://www.mallenbaker.net/csr/nl/82.html

in constructing an ash disposal area, led the company to build a drinking water supply for a nearby village, and to provide at-cost coal. This is evidence that CSR is taking hold in Kazakhstan, particularly among international corporations. Mallen Baker has found that 71 percent of international private companies in Kazakhstan said they had a CSR policy (21 percent for state companies).[151] Private initiative appears to be advancing this objective, however additional support and encouragement from the Kazakhstan government, as well as home country governments and international institutions, could significantly increase the gain from FDI.

With this information in mind, Kazakhstan should be advised to incorporate incentives into its policy structure that would induce its foreign investors to help improve the level of human resources in the country in cooperation with other actors, and to abide by international principles of social responsibility. Since Kazakhstan has established its reputation as a FDI-friendly environment, this policy will not be as difficult as it may be in other emerging nations.

Final Conclusions

In this report I have attempted to show the weaknesses in the existing development paradigm which asserts that free markets and unilateral state-led liberalization of foreign investment alone will ensure a significant development impact from FDI. While such policies have successfully attracted profit-seeking multinationals to developing and emerging markets, bringing with them a host of potential benefits and opportunities, liberalization alone has not assured the realization of these benefits worldwide. As the supporting case study of Kazakhstan has shown, large investment flows do not always create the spillover benefits of human resource

[151] Ibid.

development that they are expected to. As several economists have speculated, many other variables need to be considered in addition to the amount of inward investment flows. The case study showed that an insufficient level of institutional and human resource development likely prevents the nation from absorbing positive developmental impacts from foreign investment. Another impediment appears to be the nature of the FDI in the country, which in the case of Kazakhstan is heavily oriented to the primary energy sector. While only one case study was conducted, creating more certainty around potential explanations for the lack of spillover benefits allows for the deliberation of a more effective policy approach. Identifying the policies and actions that can be taken to maximize positive development impacts is critical to leverage the sheer amount and potential of FDI particularly at a time of slowing official development assistance flows.

In order to explore possibilities for improving this situation, the study considered that a new participatory model could improve the strong foundation built by the neo-liberal paradigm. Working on the assumption that a host government is not the sole actor in this challenge, this study surveyed the roles of international institutions, the home government of a foreign investor and its citizens, and the foreign investing corporations, in addition to the host nation. This study revealed the following:

- The largest responsibility of the host state in maximizing FDI benefits lies in the development of a strong human resource, institutional, and infrastructural base that can absorb FDI spillovers.
- Host states can also work to attract high quality investments into priority economic areas through the use of legal guarantees and incentives.

- Host countries have little additional policy space to regulate investors because they risk loosing investors to competing nations, or diluting the potential impact of a foreign investment.
- Developing nations also lack the power to bring many of these considerations to the negotiating table over bilateral investment treaties or contracts with corporations.
- While attempts have been made towards achieving an international investment agreement that would include development goals, little recognizable progress has led to the conclusion that this is an unrealistic expectation in the short-term.
- International codes and standards addressing development and other social concerns hold promise in guiding the international debate, and also in guiding corporations on how to enhance the 'responsibility' of their actions in developing countries.
- Home governments of the foreign investor and civil society organizations hold tremendous influence; they can provide the carrots and sticks that are sometimes necessary to encourage companies to act responsibly in foreign markets.
- Foreign investors themselves are assuming greater responsibilities to act responsibly and to cooperate with other actors to enhance the development impacts of their investments.

These findings suggest certain aspects of a new model for maximizing development gains from FDI. This new model is likely to be based on an international cooperative movement where each party – host governments, international bodies, home governments, NGOs, and corporations - will all play significant roles. Revisiting the case of Kazakhstan at the close of the study reveals that this process is already beginning. The Government of Kazakhstan recognizes its responsibility to develop its internal policies and infrastructure so to be ready to take greater

advantage of foreign economic operations within its borders. It is also taking serious steps to diversify its economy by creating incentives to attract high quality investment into other sectors outside of the oil industry. However, given the findings of our study there is concern that the government is still relying too much on investor controls which are likely to be counterproductive. As the government is doing a reasonable job with its responsibilities, foreign enterprises are beginning to do theirs as well. Several corporations have made significant community investments and mutually reinforcing partnerships with the NGO, government and international sectors. These signs bode well for the improvement of spillover effects into the social and economic development of Kazakhstan.

Once the majority among these parties recognize their responsibilities towards development, and join the cooperative global struggle to bring sustainable economic and human advancement to the large majority of the world's population, then this model can truly be put to the test. As history has shown, the world is willing and able to significantly alter its opinions and positions when faced with facts indicating the failure of an old paradigm. Unlike the shift from the first to the second development model, this new shift will not entail a complete reversal of policy. It will however require all actors to take a broadened view of the development agenda and who should take responsibility for it. Evidence that this will occur is promising. We need only to look at examples such as the Chevron-Texaco partnership with the UNDP in Kazakhstan described above. This case shows that cross-sector cooperation can achieve great impact on ensuring that the growing levels of FDI into the developing world will increasingly contribute to the development goals that the entire global community should share.

Appendix - The OECD Guidelines for Multinational Enterprises: General Principals, 2000

Enterprises should take fully into account established policies in the countries in which they operate, and consider the views of other stakeholders. In this regard, enterprises should:

1. Contribute to economic, social and environmental progress with a view to achieving sustainable development.

2. Respect the human rights of those affected by their activities consistent with the host government's international obligations and commitments.

3. Encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice.

4. Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees.

5. Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues.

6. Support and uphold good corporate governance principles and develop and apply good corporate governance practices.

7. Develop and apply effective self-regulatory practices and management systems that foster a relationship of confidence and mutual trust between enterprises and the societies in which they operate.

8. Promote employee awareness of, and compliance with, company policies through appropriate dissemination of these policies, including through training programmes.

9. Refrain from discriminatory or disciplinary action against employees who make *bona fide* reports to management or, as appropriate, to the competent public authorities, on practices that contravene the law, the *Guidelines* or the enterprise's policies.

10. Encourage, where practicable, business partners, including suppliers and subcontractors, to apply principles of corporate conduct compatible with the *Guidelines*.

11. Abstain from any improper involvement in local political activities.

Source: The OECD Guidelines for Multinational Enterprises, Revision 2000.

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