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The impact of codes and standards on investment flows to developing countries

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*[1] which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work[2], in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.[3]

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.[4]

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

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[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

[2] See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

[3] See http://www.ilo.org/gea. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work, "Vision" document*, ILO, 2006.

[4] See http://www.ilo.org/employment.

Foreword

Investors, especially institutional ones, can be a powerful lever for influencing corporate behaviour, and an important force in helping to raise labour standards in corporate practice worldwide. Although investors have been slower to take up labour issues that other areas of SRI, such as environment, interest is growing. But what is the impact on FDI flows? Does SRI improve the potential social impact of investment to developing countries, or merely divert flows to countries which are considered to pose less risk concerning social issues? This paper examines the impact of investors incorporating labour considerations in their investment decisions on FDI flows to developing countries.

Cross-border investment is growing rapidly. Portfolio flows to developing countries have increased to US$ 94 billion in 2006, FDI flows have reached US$ 325 billion in 2006 and we estimate that DFI finance amounted to some US $ 25 billion in 2005. We discuss how these three different types of investment relate to labour codes and standards. Foreign direct investment is sensitive to international investment standards, such as bilateral investment treaties or regional and multilateral agreements, as well as labour codes and standards. We find that the effects of labour standards on FDI vary by where FDI is coming from (UK or US), and by type of labour convention. Socially responsible (SRI) assets under management have increased rapidly over the last few years in Europe, with such funds positively screening for companies that adhere to responsible business practices reaching €100 bn (with a further €60 bn being screened negatively for compliance with the principles contained in ILO labour standards). However, very little of these global funds (0.1%) actually reach developing countries so that an uptake of ESG might lead to fewer developing country investment. Finally, we have discussed a category of investors, DFIs, whose exposure in developing countries is also growing. DFIs are very much engaged with labour standards issues, and examples have been cited where financial closure of deals was prevented by strict compliance to labour codes. Yet in other examples, DFIs try to work with client companies to achieve social objectives by implementing the principles of labour standards in a smart way.

The ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (MNE Declaration) is designed to guide private initiatives, both company policy such as codes of conduct for suppliers, and industry-wide initiatives. It is the only international CSR instrument which has the full backing of workers, employers and government. This tripartite origin makes it both highly credible and yet sensitive to the concerns of enterprises facing tough competition.

The MNE Declaration covers the fundamental principles and rights at work—concerning child labour, forced labour, freedom of association, collective bargaining, and non-discrimination—as well as wages, hours of work, and occupational health and safety. Some of the activities and initiatives taking place in the area of socially responsible investment are focused on many of these issues and investors and analysts may find these principles to be a useful starting point for dialogue with companies and trade unions on how best to protect workers' rights while helping companies to retain, or even enhance, their competitiveness.

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Abstract

Cross-border investment is growing rapidly. Portfolio flows to developing countries have increased to US$ 94 billion in 2006, FDI flows have reached US$ 325 billion in 2006 and we estimate that DFI finance amounted to some US $ 25 billion in 2005. We discuss how these three different types of investment relate to labour codes and standards. Foreign direct investment is sensitive to international investment standards, such as bilateral investment treaties or regional and multilateral agreements, as well as labour codes and standards. We find that the effects of labour standards on FDI vary by where FDI is coming from (UK or US), and by type of labour convention. Socially responsible (SRI) assets under management have increased rapidly over the last few years in Europe, with such funds positively screening for companies that adhere to responsible business practices reaching €100 bn (with a further €60 bn being screened negatively for compliance with the principles contained in ILO labour standards). However, very little of these global funds (0.1%) actually reach developing countries so that an uptake of ESG might lead to fewer developing country investment. Finally, we have discussed a category of investors, DFIs, whose exposure in developing countries is also growing. DFIs are very much engaged with labour standards issues, and examples have been cited where financial closure of deals was prevented by strict compliance to labour codes. Yet in other examples, DFIs try to work with client companies to achieve social objectives by implementing the principles of labour standards in a smart way.

1 Introduction

There is an increased interest in how investors are adopting codes and responding to standards in their international investment decisions. There are several standards relating to investment, including protection of investors and labour and environmental standards. Some are voluntary standards, other are enshrined in international treaties. Some are imposed by host countries (e.g. minimum labour and environmental standards), while others are legislated by home countries. This study aims to examine the investor awareness of social responsibility issues, specifically labour issues, and how these might affect international investment to developing countries.

We distinguish amongst three types of international investors: foreign direct investors, portfolio investors and development finance institutions. Together they account for some US $500 bn of finance going into developing countries. We provide an overview of the trends and composition of these flows (section 2). We then discuss how international investors adopt codes of conduct, particular labour codes, and how investors respond to international standards, both investment protection and ILO labour conventions (section 3). Section 4 discusses the findings and implications.

2 Types of investment to developing countries

This paper distinguishes amongst three types of international flows to developing countries:

- *Foreign direct investment* is investment from one country into another by setting up (greenfield investment) or investing in (mergers and acquisitions) a company with the purpose of acquiring a long-lasting stake of more than 10% in that company (some use more than 50%). This should not be confused with outsourcing and franchises which do not constitute a transfer of financial resources or do not constitute a legal ownership arrangement. For example, food multinationals often own factories abroad, however, in the textile and clothing industries, major sourcing companies frequently do not own their manufactures or assembles in countries such as India and Bangladesh. Instead these are often called global value chains, which is are not the focus of this paper.

- *Portfolio investment* relates to private cross-border flows with the aim of investing in other companies and taking an equity stake without a long-lasting stake. This includes institutional investors in developed countries which need to diversify their portfolio and invest in emerging markets.

- *Development finance institutions*. The financial operations of DFIs (including bilateral DFIs such as CDC, DEG, FMO and PROPARCO; regional DFIs such as EBRD, EIB, IADB, ASB and AfDB; and multilateral IFC) include the provision of loans, equity, guarantees and other financial products. There are also differences amongst the DFIs. The state is the sole shareholder in some bilateral DFIs (UK, Germany) and in other cases part owners (France, Netherlands). The regional and multilateral DFIs have subscribed capital from different countries. The bilateral DFIs tend to have operations solely with the private sector in developing countries, while the regional development banks (excl. EBRD but including EIB's external operations) tend to focus primarily on the public sector (e.g. via sovereign loans for commercially run public

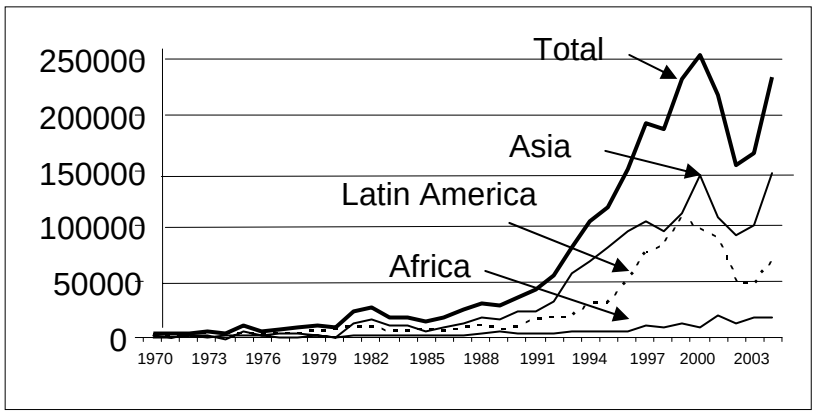
enterprises). While the financial operations of DFIs have often been built by significant aid (ODA) the actual operations of DFIs, especially when they are loans, are counted as *other official flows* (OOF). The purpose of most DFIs (e.g. bilateral DFIs and IFC) is to invest in private sector firms or equity funds in developing countries.

Investment to developing countries– overall volumes and distribution

Foreign direct investment

The level and composition of FDI has changed markedly over time. There has been a rapid increase in FDI in the past two decades, with a decrease more recently for developed countries, though with differences across countries (chart 1).

Chart 1 Inward FDI to developing countries, 1970–2004, million of USD



Source: *UNCTAD*

FDI to developing countries has always been concentrated amongst certain countries and regions. The top eight developing economies have been responsible for three quarters of inward FDI flows since the 1980s: China, Hong Kong (China), Mexico, Brazil, Singapore, Russian Federation, Chile and India. The top 25 developing countries receive 95% of inward FDI. Chart 1 shows that the absolute values of FDI are highest for Asian developing countries, followed by Latin American and Caribbean countries, while African countries received comparatively little FDI. Sub-Saharan Africa received 6% of world FDI in 1980 but its share has since decreased to 0.5% in 2000 and 2.2% at present. This in part reflects that large countries attract a lot of FDI since these economies also have the largest markets. In fact, controlling for market size, the inward stock as a per cent of GDP is 34% in sub-Saharan Africa, 28% in developing countries, and 21% in developed countries (UNCTAD). Several Asian countries (though not the continent as a whole) have been able to attract an even larger value of inward FDI compared to their market size, reflecting their relative success in attracting FDI for export markets

Outward FDI from developing countries has risen sharply over the past two decades and a half from negligible amounts (Aykut and Ratha, 2003). Most FDI has been by Asian firms establishing footholds in other Asian countries but there has also been investment in developed countries such as the EU. China is now a major investor in Africa, and India is the sixth largest investor in the UK. Total investment by developing countries began to rise from about 1% of total foreign investment flows in the late 1970s to 4% in the mid-1980s and 6% by 1990, and after a peak in the 1990s before the Asian crisis, has remained around

6–7% of the total. South–South flows are estimated to have risen from 5% in 1994 to 30% in 2000 of the total FDI inflows to developing countries, see Aykut and Ratha (2003).

The sectoral composition of FDI flows has shifted markedly over time. In 1914 70% of US FDI in developing countries was in agriculture, mining or petroleum; 26% was in services; and just 1% in manufacturing. In 1998 these figures were 14%, 59% and 27% respectively (Twomey 2000, Table 3.14, p. 55). There has thus been a marked change from natural resources FDI towards knowledge-intensive activities. Table 3 shows that the inward stock was already skewed towards manufacturing and services in 1990, but increasingly so towards services in the past 15 years in both developed and developing countries. Countries such as India have been able to attract increasing amounts of FDI in high value-added services, though other developing countries (Ghana, South Africa, Mauritius, Caribbean countries), have also attracted FDI.

While FDI to developing countries in the beginning of the 20th century was mainly motivated by exploiting natural resources and building railways, FDI has increasingly been in efficiency-seeking FDI (e.g. textiles and clothing in East Asia from the 1960s, automobile industry in Asia and Latin America), and strategic asset-seeking FDI (e.g. technology activities in Singapore and Malaysia). Now, even the most strategic of functions (such as R&D) are expanding in some developing countries as transnational corporations (TNCs) seek to benefit from pools of talent at competitive costs, particularly in those countries that have actively helped to create this (incl. Singapore, Malaysia, China and India).

Table 1 Inward stock, by sector, 1990–2003 (in US dollars)

	1990			2003		
	Developed	Developing	World	Developed	Developing	World
Primary	145404	24727	170131	428831	143993	594321
Manufacturing	595142	150410	745552	2081645	779112	2876102
Services	717147	157950	875097	4015555	1110757	5153826

Source: UNCTAD

The sectoral composition of FDI differs by developing country and region. Several Asian countries have been able to attract more efficiency-seeking FDI in manufacturing (electronics, textiles) than other developing country regions. Latin America and the Caribbean countries have attracted large-scale natural resources FDI and services FDI through privatisations, and efficiency-seeking FDI in labour-intensive manufacturing (notably in Mexico, Dominican Republic and Central America). Africa has attracted mainly natural resources FDI, though some countries attract relatively more manufacturing (an example is South African automobile FDI, or Asian garment factories in Lesotho) or services (tourism).

The shift in FDI away from natural resources towards efficiency-seeking and strategic asset- and market-seeking FDI has also had implications for entry modes. For instance, privatisations in Latin America have accounted for a number of takeovers through cross-border Mergers and Acquisitions. There have also been an increasing amount of strategic alliances, in particular with Asian countries with appropriate technological capabilities.

Portfolio investment

Portfolio equity flows to developing countries have increased rapidly over the last few years, reaching a record US$ 94 billion in 2006 (compared to US$ 325 billion of FDI), more than 15 times the level of 2001, US $6 billion (compared to US$ 170 billion for FDI),

see Global Development Finance 2007. A growing demand on the part of institutional in**vestors has contributed to the record volume of international equity issues**

Hedge funds have been playing an increasingly prominent role in the primary issuance market. Table 2 shows net portfolio flows, which are concentrated in a few emerging markets.

Table 2 Net Portfolio equity flows to developing countries (2000-2006)

	2000	2001	2002	2003	2004	2005	2006e
Total	13.4	5.6	5.8	24.3	39.9	66.7	94.1
East Asia and Pacific	6.6	1.8	3.8	12.5	19.0	26.1	48.4
China	6.9	0.8	2.2	7.7	10.9	20.3	32.0
Thailand	0.9	0.4	0.5	1.8	1.3	5.7	5.4
Europe and Central Asia	0.6	−0.4	0.1	−0.6	5.3	6.3	10.5
Russian Federation	0.2	0.5	2.6	0.4	0.2	−0.2	9.2
Latin America and the Caribbean	−0.6	2.5	1.4	3.4	−0.6	12.4	11.1
Brazil	3.1	2.5	2.0	3.0	2.1	6.5	7.7
Mexico	0.4	0.2	−0.1	−0.1	−2.5	3.4	3.9
Middle East and North Africa	0.2	−0.1	−0.3	0.3	0.7	2.3	1.6
South Asia	2.4	2.7	1.0	8.0	8.8	12.2	10.0
India	2.3	2.9	1.0	8.2	9.1	12.2	8.7
Sub-Saharan Africa	4.2	−0.9	−0.4	0.7	6.7	7.4	12.5
South Africa	4.2	−1.0	−0.4	0.7	6.7	6.9	12.4

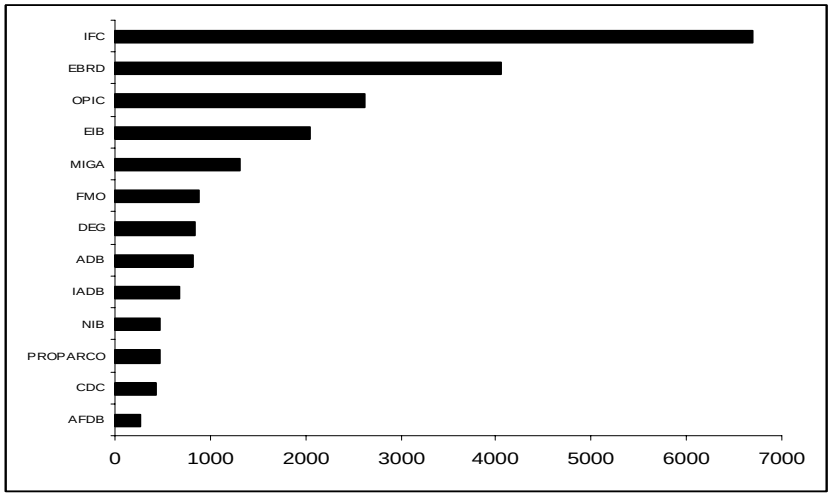
Source: World Bank Global Development Finance 2007

Development finance

Dellacha and Te Velde (2007) find that the level of commitments, size of the portfolio, regional distribution, split in financial instruments, cash availability, returns on assets and equity differ significantly. The IFC and EBRD are by far the biggest in terms of annual commitments to the private sector, followed by the EIB, FMO, and DEG and then the other regional banks and Proparco and CDC. Some concentrate primarily on loans (e.g. EIB, Proparco) other**s primarily on equity (e.g. CDC).**

In 2005, total commitments to loans, equity and guarantees of the main regional, multi-lateral and bi-lateral DFIs totalled US$ 45 billion and US$21.3 billion of this went to support the private sector (Chart 2). The combined committed portfolio was US$ 182 billion in 2005.

Chart 2 Commitments by DFIs to the Private Sector in 2005



Source: Dellacha and te Velde (2007)

The sectoral distribution of the portfolios of all the European Development Finance Institutions (EDFIs), IFC and EIB is shown in table 3. All invest heavily in the financial sector (credit lines to banks or equity funds). IFC's exposure in infrastructure is lower than EDFI but higher in manufacturing/services due to exposure in oil, gas and mining.

Table 3 Sectoral distribution of portfolio

	EDFI 2006	IFC 2007	EIB IF 2003-2006
Financial sector	47%	42%	49%
Industry/Manufacturing	23%	32%	18%
Infrastructure	21%	15%	26%
Agribusiness	4%	7%	3%
Other	6%	4%	4%

Source: EDFI, and IFC and IF annual reports Note: EIB: agribusiness estimated (and subtracted from industry data in annual report), IFC: industry/manufacturing includes global manufacturing and services and oil, gas, mining and chemicals. IF is Investment Facility

Table 4 shows the geographical composition of the portfolios of DFIs. The geographical composition of the EDFI portfolio is much more oriented towards Africa than that of the IFC. A quarter of the EDFI's portfolio is committed to sub Saharan Africa, while the IFC commits only a tenth.

Table 4 Geographical distribution of portfolio (% of total)

	IFC 2007	EDFI 2006
Sub-Saharan Africa (incl South Africa)	11	25
East Asia and Pacific (incl China)	14	15
South Asia	10	12
Europe and Central Asia (and "other" for EDFI)	28	25
Latin America and Caribbean	27	17
Middle East and North Africa	10	6
Total (%)	100	100
Size (volume, bn €), approx	19	12.3

Source: IFC annual report and EDFI

3 How are international investors affected by the principles of labour standards?

The foreign direct investor, the institutional investor or the development financier will take into account a wide variety of factors when making their investment. All want to invest in commercially viable projects which depend on factors such as skills, infrastructure, technology, market size, business environment etc. This section focuses on how the various codes and standards affect international investors.

Standards, uptake of codes of conduct and international investment

There are different types of standards enshrined in international law (bilateral, regional and multilateral) governing investment, though these tend to cover market access, protection and promotion, but not labour standards:

- There has been a surge in the number of bilateral investment treaties (BITs) from 500 in 1990 to close to 2,400 now. Most developed countries now have BITs in place with all their main investment partners in developing countries. The contents differ, with US BITs more far-reaching (on market access) than most European BITs. However, they do not tend to include labour standards. Empirical evidence on the impact of BITs on attracting investment has been mixed. Some studies have found that the attraction of FDI is positively linked to signing BITs, but that BITs act as a complement rather than a substitute for strong political and legal institutions (Hallward-Driemeier 2003; Tobin and Rose-Ackerman 2005). Others have found a strong relationship between signature of BITs by the US and FDI flows (Salacuse and Sullivan 2005).

- While most regional integration agreements notified to the WTO include narrow provisions to liberalise trade, the new wave (Ethier, 1998) of regionalism that started in the 1990s has included investment provisions in about 20 cases. Labour standards are not included. Te Velde and Bezemer (2006) argue that an increase in regional trade and integration provisions (e.g. relating to investment protection) has led to an increase in inward FDI to the region, but spread unevenly over countries within the region.

- The earliest multilateral discussions on investment date back to 1948. An attempt was made to formulate international principles concerning FDI in the Havana Charter of 1948, but it was rejected. The inclusion of a multilateral investment agreement was rejected at the OECD in the 1990s and more recently at the WTO, despite a proliferation of bilateral and regional investment agreements. However, some multilateral investment provisions do exist, e.g. the WTO Agreement on Trade Related Investment Measures (TRIMs), the Agreement on Subsidies and Countervailing Measures (ACM), and the General Agreement of Trade in Services (GATS), which covers conditions for FDI in services. There is little direct evidence on the impact of individual multilateral investment provisions. They should help to increase the stability of the investment climate, but it is challenging to separate the effects of multilateral measures from other effects (see Te Velde and Nair, 2005, on GATS and FDI in Tourism).

Apart from international law, home and host countries can promote standards in national legislation. *Host-country* legislation, including relating to labour standards, may affect domestic and international investment. Botero *et al* (2004) examine the regulation of labour markets through employment, collective relations, and social security laws in 85 countries. They find that heavier regulation of labour is associated with lower labour force participation and higher unemployment, especially of the young. Their Employment Law Index measures the protection of labour and employment laws as the average of: (1) Alternative employment contracts; (2) Cost of increasing hours worked; (3) Cost of firing workers; and (4) Dismissal procedures. The need for flexible labour markets might be important especially for efficiency seeking investors such as assembly operations who invest in countries for a short period and move on soon after.

ILO (2007) has recently questioned the importance of deregulation in attracting investment. They argue that firms do not always opt for a high degree of external flexibility and high labour turnover, even when allowed under the law, e.g. due to the negative effects

of heavy labour turnover on investment in human capital, in new technologies, and in capturing new markets. Some firms prefer stable relationships that cultivate a worker's experience, lowering screening and training costs. Unrestricted working hours can lead to a socially inefficient level of hours worked for the worker, and restricted working hours may encourage productivity enhancing technologies that benefit the firm as well as economic growth in the medium to long term. Thus there seem to be at least two differing and opposing relationships between labour standards and investment.

Finally, *home* country can legislate or promote the use of corporate social responsibility (and uptake of ESG). Some home country measures (such as anti-corruption measures which have affected US subsidiaries since 1977) are legislated, but the effectiveness of most measures depends on the uptake of voluntary standards by multinational investors and trade associations. There has been a surge in voluntary standards recently, with investors designing codes of conduct for their own operations.

Voluntary codes of conduct come in many forms:

- Codes at company level (e.g. Shell, Primark or Unilever);
- Codes by trade associations;
- Codes by multiple stakeholders (e.g. the Ethical Trade Initiative, AccountAbility, Amnesty's Human Right Guidelines); and

Codes negotiated at international level (e.g. the OECD Guidelines for Multinational Enterprises and the ILO's Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, the UN Global Compact).

The ILO Tripartite Declaration on Fundamental Principles and Rights at Work (1998) calls on Member States to ratify ILO Conventions:

- 87 (Freedom of Association and Right to Organize);
- 98 (Right to Organize and Collective Bargaining);
- 111 (Discrimination in Employment);
- 122 (Employment Policy), along with Recommendations 111 (Discrimination in Employment);
- 119 (Termination of Employment), and
- 122 (Employment Policy).

The Global Compact's labour principles (4 out of a total of 10) are based on the ILO declaration on fundamental principles and rights at work and include:

- Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
- The elimination of all forms of forced and compulsory labour;
- The effective abolition of child labour; and
- The elimination of discrimination in respect of employment and occupation.

Codes of conduct are more prevalent in the extractive industries, textile, chemical, and trade industries (table 5). They are more common in firms from Anglophone countries.

Table 5 Sectoral composition of firms issuing codes

Sector	Activity	Number of firms
Primary	Agriculture	3
	Extractive	20
Secondary	Food	7
	Textile	23
	Wood	4
	Petroleum related	12
	Chemical	22
	Plastic	5
	Metal	13
	Electronics	14
	Mechanical product	15
	Office machinery	6
	Vehicles	10
	Others	15
Tertiary	Electricity, gas, water	10
	Construction	6
	Trade	61
	Hotel/restaurant	6
	Transport and communication	12
	Financial activities	10
	Real estate and other business	9
	Others	14

Source: OECD (2001)

Codes of conduct have several shortcomings. For instance, some researchers estimate that 80% of codes are statements about general business ethics without implementation plans (International Organization of Employers). The OECD finds that more than 60% of the company and business association codes in an OECD inventory do not specify any penalties for non-compliance (OECD).

With respect to the labour content of codes of conduct, practice shows that many codes of conduct do not take the ILO Core Conventions into consideration. In a study of 246 codes of conduct in the OECD inventory, there was large variation in the labour issues covered. Three labour issues were covered in more than half the codes surveyed: a general commitment to a reasonable working environment, an agreement to comply with local laws, and protection against discrimination or harassment. The ILO Core labour standards were mentioned in 10 per cent.

Table 6 Labour content of codes

	Percentage of codes mentioning attribute*
Reasonable working environment	75.7
Compliance with laws	65.5
No discrimination or harassment	60.8
Compensation	45.3
No child labour	43.2
Obligations on contractors/suppliers	41.2
No forced labour	38.5
Provision of training	32.4
Working hours	31.8
Freedom of association	29.7
Specific mention of "human rights"	25.0
Monitoring	24.3
Right to information	13.5
ILO codes mentioned	10.1
Promotion	8.8
Reasonable advance notice	3.4
No excessive casual labour	3.4
Flexible workplace relations	0.7

Source: OECD (2001)

Foreign Direct Investment and host-country labour standards

In the past decade there have been a number of papers that attempt to link the presence of labour standards to the attraction of FDI. An important one, Kucera (2001), attacks the "conventional wisdom" that FDI goes mostly to countries with lower labour standards. He applies newly created country-level measures of labour standards – constructed from coding textual information and emphasizing actual worker rights – in an econometric analysis of FDI inflows in the 1990s for up to 127 countries. Labour standards assessed include freedom of association and collective bargaining, child labour, and gender discrimination and inequality. He finds no strong support that foreign investors favour countries with lower labour standards, with the evidence pointing in the opposite direction. While higher standards may lead to higher wage costs which would dampen FDI, they may also lead to higher economic growth, human capital development (e.g. through fewer child labour) and political stability (more freedom to bargain) which may attract FDI. Kucera also reviews a large number of studies on the effects of labour costs, unions, worker rights and political stability on FDI. Most studies are for US FDI (e.g., Rodrik), total FDI, or FDI as per cent of world FDI, and the variable for worker rights is the number of ILO conventions ratified.

Below we update these studies empirically, in a simple way. We use panel data (not one year) for the real stock of US FDI and UK FDI (over 1980-2002, for 97 and 68 countries respectively) which we relate to income, infrastructure measures, a regional integration dummy and labour rights measures from the ILO. This is an extension of the model in Te Velde and Bezemer (2006) where the model and data choices are motivated further. We focus on core ILO labour rights because these are the ones that matter for investors in their codes of conduct.

Table 7 has two key messages. Firstly, columns (3) and (4) show that the effects of core labour right ratifications differs by home country: in the US the effects are actually positive (similar to findings and studies reported in Kucera) and in the UK they are not significant. Secondly, focusing in on the type of core ILO labour rights, the effects vary. Here, both the UK and US respond positively and significantly to more ratifications on forced labour, but both are affected negatively by more child labour regulations, and the US significantly so (consistent with earlier Rodrik findings – see report by Kucera, 2001).

Hence, core labour rights matter and they matter differently depending on the home country.

Table 7 Differences between UK and US FDI, 1980–2002

	Log of real stock of FDI			
	US FDI	UK FDI	US FDI	UK FDI
	(1)	(2)	(3)	(4)
Log of real GDP in host country	0.81	0.49	0.85	0.50
	(19.3)**	(12.9)**	(21.5)**	(13.8)**
Phonelines per 1000 inhabitants	0.005	0.003	0.004	0.003
	(8.3)**	(4.51)**	(7.0)**	(4.92)**
Roads	0.08	0.22	0.13	0.24
	(1.43)	(3.96)**	(2.80)**	(4.69)**
Regional Integration dummy	0.56	0.97	0.52	0.98
	(5.04)**	(8.56)**	(4.35)**	(8.50)**
ILO			0.21	-0.01
(sum of core ratifications, max=8)			(7.87)**	(-0.33)
Freedom of association and collective bargaining (ratified, 0/1 dummy)	0.16	-0.06		
	(1.04)	(-0.37)		
Elimination of forced and compulsory labour (ratified)	0.92	0.35		
	(7.07)**	(2.03)*		
Elimination of discrimination in respect of employment and occupation (ratified)	0.64	-0.16		
	(4.18)**	(-0.95)		
Abolition of child labour (ratified)	-0.76	-0.12		
	(-5.43)**	(-0.66)		
No of observations	1015	506	1015	506
No of countries	97	68	97	68
R-squared	0.57	0.37	0.55	0.37
Robust standard errors	Yes	Yes	Yes	Yes
Estimation method	OLS	OLS	OLS	OLS

Notes: OLS robust standard errors within parentheses for OLS estimations

** (*) denotes 5% (10%) significance level

Regressions are missing the point to some extent because of the level of aggregations involved. Ideally, one would examine FDI in employment intensive assembly operations in developing countries as that would be more sensitive to labour standards but such data are not available for a sufficient number of countries. Also, it would be useful to distinguish between types of investors. Efficiency seeking investors depend on low wages, and might therefore be affected negatively by labour standards (directly) while strategic asset seeking investors go to countries with good quality labour on which they want to build.

But the regressions do have one important point which is born out in practice: that the type of home country matters. Experience of talking to investors, many UK and US investors *are* interested in applying the principles of ILO core labour standards (and many say so in the codes of conduct), while some other foreign investors (e.g. some Asians) have less regard for labour rights in assembly operations in countries ranging from Southern Africa to Latin America. This is an issue that needs further examination.

Portfolio investment and ESG (environmental, social and governance) codes

Eurosif (2006) shows that core SRI Assets Under Management in Europe has reached €105 billion and broad SRI has reached €1.033 trillion by the end of December 2005. This focuses exclusively on the self-reporting of asset managers and self-managed pension funds, including both institutional (94%) and retail assets (6%), with particular screening methods:

- Core SRI includes assets managers that screen positively seeking to invest (and have ethical exclusions in place) in companies with a commitment to responsible business practices (on ESG practices), or that produce positive products and/or services.

- Broad SRI includes core SRI plus managers that have simple exclusions, including norms-based screening, and engagement and integration. Norms-based screening is negative screening of companies according to their compliance with international standards and norms such as issued by OECD, ILO, UN and UNICEF.

There is substantial growth in SRI over 2004-2006, even after accounting for the overall growth of the European equity markets (36% real increase in European broad SRI over that period). Some segments of SRI have become accepted practice in several countries. The Dutch (core SRI of €41 bn) and British (core SRI of €31 bn) are leading the way.

Norms-based screening (e.g. based on ILO labour standards) is on the increase, with growth in simple screens (of which norms-based screening is one) of 45% over the period 2004-2006. Assets under management for norms-based screening totaled €61 bn. This amount is in additional to core SRI investors that are actively seeking to invest in SRI companies, which would probably have mentioned ILO labour standards anyway. The EUROSIF study also finds that the broad SRI market is estimated to be as high as 10-15% of total European funds under management.

However, as IFC (2003) reports, despite the growth of SRI in developed countries, very few of these funds are actually reaching emerging markets let alone low-income developing countries. In fact, it might be that funds tied up as core or broad SRI may fail to consider developing countries because they would be risky or screened out.

Indeed assets held under management by SRO investors in developed countries was less than US$1.5 bn, which is around 0.06% of all SRI assets worldwide. Assets held in developing countries by social investors based in developing countries amounted to US$1.2 bn, or nearly 0.04% of all SRI worldwide. Thus, the sum total of SRI assets in emerging markets is approximately $2.7 bn, or 0.1% of the $2.7 trillion in SRI globally. By comparison, 25% of FDI stocks are in developed countries, though this share is probably less for portfolio investment. The key point is that with all the growth in SRI funds, there is so far very little evidence that SRI funds actually reach developing countries. By this logic, more codes of conducts for fund managers might actually be bad for attracting FDI into developing countries, although we do not have data over time to verify this.

Table 8 SRI Market Assets (2003)

	Number of Funds	Emerging Markets Assets ($US millions)
Developed Country Retail Mutual Funds with Emerging-Markets Assets		
United States	2	21.5
United Kingdom	6	3.6
Canada	9	13.6
Europe	0	0.0
Australia	1	0.6
Asia**	5	.41
Subtotal	23	39.7
Institutional SRI***	15	1,440
Total	**38**	**1,479.7**
Emerging Market Retail Mutual Funds		
Brazil	1	4.7
Korea	2	18.8
Malaysia	1	39.0
South Africa	5	228.2
Subtotal	9	290.7
Institutional SRI****	8	956.0
Total	**17**	**1,246.7**
Total Emerging Market SRI	**55**	**2,726.4**

IFC (2003)

Development finance institutions and labour standards

Most DFIs have adopted social policies and apply labour principles to their lending operations. However, while it might be accepted that better labour standards are associated with companies with better performance, the interpretation of labour principles varies. This is not simple, e.g. in the case of a credit line to a bank which may lend to a shopkeeper with a 12 year old son in his shop.

The IFC implemented new performance and policy standards in 2006 requiring its private sector borrowers to comply with requirements based on the principles contained in ILO's core and other labour standards. ILO standards are included in the Equator principles which are also being used by a group of major private sector banks engaged in infrastructure project financing. When projects have environmental or social consequences, they are categorised as an A project which requires a long consultation process.

Not all bilateral DFIs have followed the IFC equator principles, with the exception of FMO (the Dutch DFI) which has signed up to the equator principles. FMO's social policy (which goes beyond the equator principles) contains criteria relating to working conditions and conditions of employment. These criteria have notably been based on ILO conventions addressing what are known as the *Core Labour Standards* and the *Primary Labour Conditions*. Institutions such as FMO identify labour risks and provides labour/social due diligence. In one example, a loan to a company in Colombia was cancelled by the recipient

when FMO's social due diligence required the company to abide by certain labour practices. However, the outcome was entirely different in another case. FMO's annual report (2006) argues that high social risks are typical in the Asian textile sector, as inadequate labour conditions are common. FMO carried out a labour audit to ensure that the textiles company it was going to lend to was meeting the principles contained in international labour standards. After initial scepticism, the textiles company scored high in the audit, with only minor, easily mitigated issues identified. The labour and economic impact also scored highly.

Other DFIs such as the German DEG also have a labour policy. When a social risk is identified, a social action plan is designed and monitored. Such a system might allow loans to be realised while labour standards are being improved gradually over time. This relates to a general point that it may be difficult for some companies to meet immediately high labour standards. Smaller firms especially may need a period in which they can improve, while still obtaining the loan. Smaller DFIs work much more with SMEs than IFC. Depending on the labour risks, different ways (ranging from a social action plan to relying on national laws and regulations) can be used by DFIs to require the company to adhere to labour standards. The DFIs have the mechanisms to engage with client companies on labour (and other) standards.

4 Discussion and implications

Cross-border investment is growing rapidly. Portfolio flows to developing countries have increased to US$ 94 billion in 2006, FDI flows have reached US$ 325 billion in 2006 and we estimate that DFI finance amounted to some US $ 25 billion. All of these investments are spread over many developing countries and sectors, albeit concentrated in some. We have presented evidence for how these three different types of investors relate to labour codes and standards. The picture is not yet complete as we used different types of evidence for each investor, but some emerging findings are as follows.

Foreign direct investment is sensitive to international investment standards, such as bilateral investment treaties or regional and multilateral agreements. Of course, market size and economic fundamentals are crucial, but rules play a role. Foreign direct investors are also affected by labour codes and standards, but not always in the way predicted by some. For instance, the number of ILO conventions ratified in a country would, according to the findings here (and elsewhere), lead to more inward FDI although some conventions are negatively related, such as child labour and US FDI. Importantly, the effects on FDI vary by where it is coming from (e.g. UK or US) and suggests it also important to understand of how others, e.g. Asian and South African investors respond to labour standards. Policy on standards may also need to relate to the home country. We also need more evidence on the breakdown by type and sector of investor.

SRI assets under management have increased rapidly over the last few years. In Europe alone, core SRI actively/positively screening for companies that adhere to responsible business practices amounted to €100 bn. Funds screening negatively for compliance with the principles contained in ILO labour standards amounts to another €60 bn. However, very little of these funds (0.1%) actually go to developing countries so that an uptake of ESG might lead to fewer developing country investment. Of course, this needs to be properly tested using data over time(if the data become available), in much the same way as is being done for FDI.

Finally, we have discussed a category of investors, DFIs, whose exposure in developing countries is also growing. DFIs are very much engaged with labour standards issues, and examples have been cited where financial deals could not be closed due to the client's unwillingness to remedy violations of workers' rights. Typically, DFIs try to work with client companies to achieve the social objectives by implementing the principles

contained in international labour standards in a smart way, to prevent screening out some of the countries which need FDI the most. The fact that most DFIs are partly or wholly owned by government, focus on private enterprise development, and the bilateral DFIs concentrate on SMEs, makes them ideal agents to promote the implementation of principles of labour standards—not abruptly, but intelligently.

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