The effects of international business and human rights standards on investment trends and economic growth[*]

Introduction

Some countries fear that if they help create a legally-binding international treaty to address corporate human rights abuses they will jeopardize their ability to attract foreign direct investment, at the expense of countries with lower legal standards.

Empirical evidence about the effect of human rights on the level of foreign direct investment reveals that the investment decisions of transnational corporations (TNCs) are not straight-forward, considering a whole host of factors that depend upon their particular situation, rather than a clear cut negative appraisal of regulation. This advocacy brief outlines some of these factors examined in empirical research.

1. Main FDI Determinants

The literature points to several macroeconomic determinants that impact foreign-direct investment (FDI) flows, in addition to respect for human rights, including market share, growth rate, economic development, government consumption, among others.[1]

Another determinant worth mentioning is the labor force quality. There is considerable debate over the impact of human capital and wages on FDI, how to measure them, and which one attracts FDI more effectively. But consider that most of the FDI to developing countries is going to lower middle-income and to Asian countries;[2] one author believes that this trend shows that TNCs also seek a high-educated work force at low cost.[3]

So if these determinants are weak for a particular country, lowering human rights standards won't help that country attract FDI.

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[1] S. Blanton and R. Blanton. "Human Rights and Foreign Direct Investment: A Two-Stage Analysis." *Business and Society*, Vol. 45, No. 4 (2006).

[2] K. Mottaleb and K. Kalirajan. "Determinants of Foreign Direct Investment in Developing Countries: A Comparative Analysis." ASARC *Working Paper* 2010/13. See Figure 1 and Table 2 which analyze statistics from *World Investment Report* (UNCTAD 2009).

[3] M. Akin and V. Vlad. "The Relationship between Education and Foreign Direct Investment: Testing the Inverse U Shape." *European Journal of Economic and Political Studies*, 4(1) (2011).

In fact, the following sections of this brief examine why and how respect for human rights actually attracts FDI, both directly and also indirectly by impacting some of the other determinants that attract FDI.

2. Human Rights

Under the conventional wisdom, transnational firms relocate to countries with repressive regimes because those regimes are presumed to provide political stability. This hypothesis does not hold empirically. In fact, the literature suggests that transnational corporations seek regimes that respect human rights.[4]

Research that studies the effect of human rights on FDI in developing countries reveals two possible mechanisms that explain this outcome: effects on human capital and reputational effects. One study found that increased respect for human rights increased FDI flows directly, but also indirectly by fostering a skilled and healthy labor force.[5]

The same study suggests that regimes that respect human rights attract FDI because it reduces a transnationals's risk of reputational damage.[6] Another study went a step further and found that this reputational effect is stronger for countries with more human rights violations and for those that have signed fewer human rights treaties.[7]

Overall, these findings suggest countries seeking to attract investment should participate in human rights treaties. According to the research, committing to strong human rights protections will help countries develop a sufficient level of human capital that will in turn attract FDI. In addition, countries with poor

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[4] S. Blanton and R. Blanton. "Human Rights and Foreign Direct Investment: A Two-Stage Analysis." *Business and Society*, Vol. 45, No. 4 (2006). This study examines FDI inflows to all non-OECD countries during 1980–2003. To measure human rights repression, the authors used a scale that measures a country's respect for personal integrity rights (detention, imprisonment, torture, and political murder). The authors found that countries that respect human rights receive higher FDI inflows.

[5] S. Blanton and R. Blanton. "What Attracts Foreign Investors? An Examination of Human Rights and Foreign Direct Investment." *Journal of Politics*, Vol., 69, No. 1 (2007). This study examines FDI inflows to all non-OECD countries during 1980–2003. To measure human rights repression, the authors used a scale that measures a country's respect for personal integrity rights (imprisonment, torture, murder). The authors used the level of education and life expectancy (a proxy for health care) to measure human capital.

[6] *Id*.

[7] A. C. Garriga, "Do Human Rights Regimes Affect FDI in Developing Countries" (2013). This study examines FDI inflows to non-OECD countries during 1982–2011. To measure human rights repression, the author used an index that measures a country's respect for physical integrity rights (torture, extrajudicial killing, political imprisonment, and disappearance), and number of human rights treaties ratified (human rights treaties on all subjects, not just physical integrity) to measure a country's commitment to human rights.

human rights records should also participate because doing so will help lower the reputational risk for transnationals and encourage FDI.

3. Labor and Employment Rights

Literature that examines the effect of stringent labor rights regulations on FDI seeks to prove or disprove the "race to the bottom" hypothesis – the idea that FDI moves to countries with the weakest labor regulations. This section examines empirical results for two types of labor rights: the core labor rights and employment protection rights.

Research on the impact of core labor rights on FDI, specifically free association, collective bargaining, child labor and non-discrimination, suffers many measurement problems and data gaps that it is difficult to make general conclusions beyond what David Kucera found in his groundbreaking paper on the matter: that there is no evidence of a race to the bottom, in fact low labor standards seem to decrease FDI.[8]

In another work, he theorizes how core labor rights can impact FDI indirectly, for example freedom of association can impact political stability, and child labor can impact human capital and economic growth. [9] In fact, a study that examines the channels through which child labor affects FDI found strong evidence that child labor deters FDI by slowing down economic development.[10]

On the subject of employment protection, studies that examine the effect of hiring, firing and work hour regulations on FDI find that more stringent employment regulations have negatively impacted FDI. These studies often use an aggregate measure for employment protection regulations and pool data for developed and developing countries.

For example, studies on OECD-member countries[11] and India,[12] an emerging market known for its strong labor protection, found that rigid labor markets

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[8] D. Kucera. "The effects of core workers rights on labor costs and foreign direct investment: Evaluating the "'conventional wisdom'" (2001). International Institute for Labour Studies, *Discussion Paper*, DP/130/2001.

[9] D. Kucera. "Core labor standards and foreign direct investment." *International Labour Review*, Vol. 141, No. 1-2 (2002). See Figure 2.

[10] S. Braun. "Core Labour Standards and FDI: Friends or Foes? The Case of Child Labour." (2006) SFB *Discussion Paper* 2006-014.

[11] W. Olney, "A race to the bottom? Employment protection and foreign direct investment." *Journal of International Economics* 91 (2013). This study examines FDI inflows to 26 OECD countries during 1985–2007. The author used the OECD's composite index of employment protection rules to measure hiring and firing standards and U.S. affiliates' sales within those OECD countries to measure FDI. The author acknowledged that by using the OECD index, he can't extrapolate the results to developing countries.

discourage FDI. But these studies are not representative because OECD countries and India have stronger employment protection regulations than are typically found in the developing world. These studies also used composite indices to measure employment protection regulations.

A study that disaggregated employment protection regulations by regulation type and analyzed their impact on FDI on developed and developing countries individually, reveals a more complex relationship.[13] Where a particular type of regulation negatively impacts FDI for both developed and developing countries, the negative impact is larger for developed countries. Yet, for developing countries, stringent hiring regulations have a marginally significant positive impact on FDI, and stringent regulations on work hours have a strongly significant positive impact on FDI, up to a certain limit. These findings suggest that developing countries have the space to impose more stringent employment protection regulation.

Overall, these findings suggest that countries eager to attract investment should not be afraid to participate in process of developing stronger business and human rights standards. In the realm of labor standards for example, committing to strong core labor protections is shown to encourage economic development and attract FDI, while committing to strong employment protection regulations is also demonstrated to help attract FDI directly.

4. Environmental Rights

The literature reveals two competing theories about the impact of stringent environmental regulations on FDI. The "pollution haven" hypothesis asserts that companies move to countries with the lowest environmental regulations in order to avoid extra costs associated with regulatory compliance. By contrast, the Porter Hypothesis regards pollution as a waste of resources, so stringent environmental regulation forces companies to use their resources more productively which can help them save costs.[14] Empirical research fails to

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[12] A. Aggarwal. "The Influence of Labour Markets on FDI: Some Empirical Explorations in Export Oriented and Domestic Market Seeking FDI Across Indian States" (2004). This study examines FDI inflows to 25 Indian states during 1991–2001. The author used a composite index that includes wages, nonwage benefits, union membership and labor disputes to measure labor rigidity and the number and share of FDI approvals nationwide for FDI.

[13] H. Parcon. "Labor Market Flexibility as a Determinant of FDI Inflows." *Working Paper* No. 08-07 (2008). This study examines FDI inflows into 165 countries, 124 developing and 41 developed, during 1990–2005. To measure labor market flexibility, the author used the number of ILO conventions ratified by a particular county on hiring, firing, and hours at work, and the World Bank *Doing Business* Database, a survey of actual hiring, firing, and work hours regulations in 150 countries.

[14] S. Ambec et. al. "The Porter Hypothesis at 20: Can Environmental Regulation Enhance Innovation and Competitiveness?" Resources for the Future *Discussion Paper* 11-01 (2011).

definitively support either theory, but research does illustrate behaviors and motivations that are consistent with each hypothesis.

A study on European transnationals [15] found that when these firms make location decisions they value regulatory certainty more than regulatory stringency. This study went on to make two additional findings that support the Porter Hypothesis.

First, European firms tend to enter countries with more clear and stable environmental regulations than those with less clear environmental regulations. The authors suggest that this is because of the need to reduce risks associated with making long-term investment decisions.

Second, European firms are more likely to enter foreign countries with more stringent environmental regulations than those with lax regulatory environments. The authors suggest that this is because European firms are accustomed to operating under stringent environmental regulatory regimes and have learned to approach compliance as a strategic issue.

Another study on multinationals from Japan's highest-polluting industries[16] found that environmental stringency was the most important factor that these industries considered when making their location decisions. This study also observed a positive and significant relationship between stringency of environmental regulations, meaning that these firms seek countries with stringent environmental regulations. This finding holds true when looking at all countries and developing countries as individual data sets (the study did not test developed countries individually).

The authors suggest various reasons that these firms seek stringent environmental regulatory regimes, among them that firms can benefit from

[15] J. Rivera and H.O. Chang. "Environmental Regulations and Multinational Corporations' Foreign Market Entry Decisions." *Policy Studies Journal*, Vol. 41, No. 2 (2013). This study examines the first-time foreign subsidiary location decisions of 94 European Union multinationals listed in the *Fortune Global 500*. During the 2001–2007 period, these multinationals located subsidiaries in 77 developed and developing countries. The authors used World Economic Forum's Executive Opinion Surveys to measure the difference between host and home country environmental regulations in terms of stringency and certainty.

[16] C. Kirkpatrick and K. Shimamoto. "The effect of environmental regulation on the locational choice of Japanese foreign direct investment." *Applied Economics*, Vol. 40, No. 11 (2008). This study examines the location decisions for Japanese firms in iron and steel, non-ferrous metals, industrial chemicals, paper and pulp, and non-metallic mineral products industries during 1992–1997. The authors used length of participation in each of five international environmental treaties as a measure of environmental regulations; to measure location choice they used Japan's Foreign Investing Companies Profiles (1998), a survey that shows new firm establishments, mergers, and acquisitions around the world.

increased competitiveness that accompanies induced technological change, a finding that supports the Porter Hypothesis; that a clean environment is good for the health of their workers' and the local population, an argument that suggests benefits to human capital; and, the decreased risk of exposure to environmental scandals, an argument that suggests concern for reputational risk.

By contrast, a study that observes the location decisions of French manufacturing firms[17] shows a strong pollution haven effect for developed, emerging, and CEE countries, yet stringent environmental regulations attract investments for CIS, and developing countries. Other research suggests that firms avoid countries with weak environmental regulation because it indicates the general level of corruption within a country.[18]

So the location choices of French manufacturing firms could reflect two distinct decision-making processes. They are willing to locate to developed, emerging and CEE countries that have weak environmental regulations because firms perceive that the general regulatory regime in those countries is clear and stable. But those same firms are unwilling to locate to developed and CIS countries that have weak environmental regulatory regimes because firms perceive that the general regulatory regime in those countries is less clear and less stable. These propositions, if true, are consistent with the first study described in this section that found that firms value regulatory certainty above regulatory stringency.

Overall, these findings suggest that there should be no impediment based on detracting investors by participating in the process of strengthening international business and human rights protection systems, particularly with regard to environmental protection. Committing to strong environmental protections signals a country's high regulatory certainty, quality human capital and low reputational risk – factors that multinationals value highly.

Conclusion

[17] S. Ben Kheder and N. Zugravu. "Environmental regulation and French firms location abroad: An economic geography model in an international comparative study." *Ecological Economics* 77 (2012). This study examines the impact of environmental regulation on French manufacturing firms' location choice, 1374 French subsidiaries in 74 countries, during 1996–2002. The authors used the French Subsidiaries-Survey (2002), a census of French subsidiaries, to measure location choice; for environmental regulation they used an index composed of the number of multilateral environmental agreements ratified, number of international NGOs members per million of the population, and energy efficiency (GDP/unit of energy used).

[18] See R. Kneller and E. Manderson. "Environmental Regulations, Outward FDI and Heterogeneous Firms: Are Countries Used as Pollution Havens?"(2009). This study found an inverse and significant correlation between environmental regulation and corruption.

In sum, this brief shows that transnational companies don't necessarily seek countries that have the weakest human rights protections. In fact, investing in countries with strong human rights protections is good business strategy, a strategy that such countries can benefit from in the form of increased FDI flows. In this sense these findings should not deter countries from participating in processes aimed to strengthen international human rights and business protections, especially given the consistent findings that stronger human rights systems can in fact attract, rather than detract, investment.