

Tri- Sector Partnerships to Manage Social Issues in the Extractive Industries: Application of Theories of Foreign Direct Investment and Development

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This paper aims to provide some theoretical foundation to the emerging concept of tri-sector partnerships for social management in the extractive industries. It considers the partnership model in the context of the costs and benefits of Foreign Direct Investment. It discusses whether a partnership can address market failures related to information needs in the market for skills and technology, and whether it can safeguard acceptable social outcomes.

Summary of emerging lessons

- Existing empirical evidence suggests that Foreign Direct Investment (FDI) brings both costs and benefits for a country. The balance of costs and benefits can differ according to the geographical level of analysis. In some cases the costs are so unacceptable that a cost-benefit analysis seems inappropriate.
- The interaction between FDI and development is a process associated with market failures, which call for intervention to set a framework in which to manage the process of FDI and development.
- FDI in the extractive industries is characterised by the long-term and sunk nature of investments, the importance in total FDI for some countries and the risks it can place on health and safety and the environment.
- In theory, a tri-sector partnership model of social management can improve the developmental impact of FDI and help maintain certain social standards.
- However, there are challenges ahead. In particular, more empirical evidence is needed to assess whether partnerships make a real difference for social and economic development in practice.

Why is the Developmental Impact of Multinationals in the Extractive Industries an Issue?

There has been and still is controversy about the social impact of multinationals in the extractive industries, particularly when operating in developing countries. Whilst developing countries are increasingly seeing Foreign Direct Investment (FDI) as a means for development, serious questions are being raised regarding the social outcomes. Much attention in this respect has focused on the extractive industries. Concerns range from violations of pollution, health and safety regulations, to minimum wage requirements and rising community tensions caused by inequalities in the distribution of local benefits.

In order to benefit from FDI, governments have increasingly liberalised their FDI regime over the past decades. It has become clear that the benefits from FDI to the country are not automatic and that desirable social outcomes for local communities need to be safeguarded. At the same time, multinationals increasingly appear to have an operational (i.e. compliance and risk management) as well as reputational interest in improving social outcomes and developing local capabilities. The question is whether and how the different parties – company, government and civil society – can manage FDI in order that the social benefit of multinationals can be realised for local communities and the host country as a whole.

Foreign Direct Investment and its Impact on Development

There is reasonable agreement that affiliates of foreign multinationals are different from domestic firms. Countries strive to attract foreign multinationals believing that these corporations possess desirable assets that can help to achieve certain developmental objectives. However, multinationals may also have negative effects. Table 1 provides an overview of some of the positive and negative effects of FDI on the development of host countries.

Box 1: Assessing the impact of FDI

Because FDI is associated with direct and indirect costs and benefits, a simple quantitative measure (FDI flows, direct employment, etc.) is not sufficient as a means of assessing the impact of FDI on development. Three alternatives exist. First, there are detailed econometric studies assessing one aspect of the investment, e.g. productivity spillover effects. Second, there are cost-benefit analyses, valuing the costs and benefits of all aspects. Finally, there are qualitative accounts comparing outcomes in similar situations but with alternative policies in place. While the first two approaches are criticised for not being able to construct a 'strategic counterfactual', the qualitative approach cannot address cause and effect satisfactorily. Outcomes of all approaches further depend on the time framework of analysis.

The impact of FDI on development is not static, it is a dynamic process with an important role for host country policies to provide an enabling environment. For instance, there are market failures related to poor information in the market for skills and technologies, and problems caused by the absence of complete markets for the environment. The (development of) demand and supply of skills and technology may not always match, and the absence of markets for pollution leads to a failure to internalise costs related to pollution. Such market failures call for policy interventions to set a framework in which to manage the process of FDI and its effects on the development of the host country.

There are two further aspects frequently overlooked in the process of assessing the impact of FDI on development – both relating to the cost-benefit analysis that assesses the impact of FDI (see box 1). First, a cost-benefit analysis of an FDI project is likely to lead to different assessments depending on the target group, e.g. national economies versus local communities. What may be efficient and effective at the national level may not be so at the community level. For instance, at the macro level, if tax revenues are not channelled directly or indirectly to communities in the regions where the investment takes place, a cost-benefit analysis undertaken at the national level is unlikely to show up such inequalities at the local community level. Similarly, at the micro level, a local 'social investment' programme undertaken by a particular business operation can be 'selective' and may benefit certain local communities only, despite negative effects of the operations being visible in neighbouring communities.

The compensation of the losers by winners associated with an FDI project is therefore an important consideration. Different FDI projects may or may not be approved, and with different conditions, depending on whose interests drive cost-benefit analysis.

Another case where a cost-benefit analysis of FDI may be problematic is where an investment imposes unacceptable consequences for health, safety or environmental outcomes. Such outcomes cannot be expressed in monetary terms or be used in a cost-benefit analysis at either community or national level. Although modern valuation techniques exist, there is a case to impose certain minimum safety or health standards.

Table 1. Foreign Direct Investment and host-country development

	Effects on Development		Possible role of a tri-sector partnership model of social management in the extractive industries
	Positive effects	Negative effects	
1. Employment and Income	Provides employment and incomes directly.	May indirectly crowd-out other employment by replacing existing employment or pushing up factor prices.	Limited direct role, but indirectly to raise employment through improved local linkages (see point 4).
2. Capital	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.	Successful partnerships may facilitate further FDI inflows through better image amongst investors, potentially resulting in lower risk mark-ups.
3. Market access	Firms can gain access to export markets by using global networks of multinationals.	Multinationals can maintain tight controls of export channels.	Limited direct role.
4. Structure of factor and product markets	Entry by foreign firm may lead to more competition.	The entry of foreign firms can lead to further concentration and market power.	Limited direct role.
5. Technology, skills and management techniques	Provides up to date techniques, skilled personnel and advanced management techniques Positive spillover effects on domestic firms through backward and forward linkages, demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on multinationals.	Improves capacity to absorb positive spillovers and enhance linkages with multinationals, indirectly creating employment and productivity.
6. Fiscal revenues	Multinationals can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value added.	If multinationals crowd-out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base. Special tax concessions are an implicit subsidy and in case of lack of transparency can lead to rent-seeking behaviour.	In the medium to long term, may improve the transparency and distribution of fiscal revenues and spending.
7. Political, social and cultural issues	Foreign firms can expose host country to other norms and values, e.g. environmental management, ethics.	Foreign firms may lead to political, social and cultural problems, by imposing unacceptable values (labour and environmental standards) interfering with political regime, and are said to exacerbate existing problems of corruption.	Improves the local relevance and acceptability of environmental and social standards and ethics.

Foreign Direct Investment and in the Extractive Industries

There are several reasons why FDI projects in the extractive industries play a different role in the development of developing countries than FDI in other industries.

First, while the stock of FDI (the outward investment stock of major developed countries in 1997) in the mining, quarrying and petroleum industries amounted to only 8.7 per cent of total FDI, this percentage is entirely different taken from the perspective of many developing countries. For instance, nearly 83 per cent of the stock of U.S. FDI in Nigeria was located in the petroleum industry in 1999, 70 per cent in Indonesia, 32 per cent in India, 30 per cent in Venezuela and 24 per cent in Colombia.

Second, rates of return on FDI appear highest in the primary industries. The rate of return on U.S. FDI abroad in 1996 was 37 per cent in the primary sector in Africa (excluding South Africa), which is double the rate of return on U.S. FDI in other industries in Africa. In addition, home countries of FDI repatriate a substantial part of such profits on FDI in Africa. For instance, 75 cents for every dollar invested in Africa was repatriated compared to 37 cents on average for all countries.

Third, projects in the extractive industries often require large lump-sum investments, which are sunk for a long period and hence such investments are relatively more vulnerable to political and social risks. The increased risk requires high rates of returns and implies the use of a high risk-premium.

Fourth, the negative social and environmental effects of extractive industries tend to emerge first at the site of investment. Projects tend to be pollution intensive, take place in the context of complex social issues (such as land ownership and a dependency by local communities on the natural environment) and often in regions where local government is weak.

Finally, tax revenues are usually collected by national, rather than local, governments, with local authorities dependent on transfers from the national treasury. Hence, the problems of the winners of FDI (in this case the national level) compensating the losers (the local level) are often accentuated in the extractive industries.

A Tri-Sector Partnership Model of Social Management

In general, partnerships are characterised by the co-ordination and co-operation between parties in order to deliver certain objectives with each other's consent. Parties involved in tri-sector partnership arrangements to manage social issues in the extractive industries include the government (local authorities, central government departments and/or the industry regulators), civil society organisations (NGOs, community groups and SMEs) and the corporate business. Depending on the way in which the partnership is structured, each partner will have both formal and informal roles to play, and carry different expectations and obligations, see e.g. Business Partners for Development (BPD) Working Paper 5 and box 2.

Box 2: Partnerships

There has been an increasing interest in partnerships over the past decade, and the experience gained also has certain implications in several areas for tri-sector partnerships. In particular, there are various forms of partnerships that can be 'chosen' varying from interactive participation, participation for material incentives or by consultation to passive and manipulative participation. Secondly, mutual accountability is important, but is not always easy for all parties. Finally, the development of a partnership grows as trust between parties evolves. Repeatedly successful partnerships can form the basis of practical steps towards an ideal situation of complete 'trust' and full information on all sides.

Company managers opting to negotiate a tri-sector partnership arrange to manage the complex social issues relating to FDI in the extractive industries appears to be a relatively innovative management technique. The use of the partnership model is, in part, a response to the need of companies to operationalise their corporate social responsibilities at reasonable and sustainable cost.

There are several reasons why a company might prefer a partnership model, rather than deliver local social investment programmes on its own. First, the existence of high *transaction costs* associated with investments could favour a partnership. Such transaction costs may relate to the need to obtain construction and other permits and finding workers with suitable skills and local knowledge to implement the investment. Second, a business is usually not specialised in making social investments (constructing roads, health centres, etc.) and hence building on each other's specialisation can lead to more *efficient* use of resources. Third, long-term co-ordination of supply and demand for social investment programmes at the local level between government and business and civil society can ensure a more *effective* use of resources to bring social development. Finally, the partnership model – particularly a 'tri-sector' model - can also reduce volatility in the relations between parties, leading to improved risk management.

In practice, there may also be additional costs. The costs include the additional resources needed to engage in a partnership as such. Further, a business may not want to lose full control over the investment. Empirical evidence comparing direct and indirect costs and benefits of implementation of investments through partnerships is scarce, and is very difficult to obtain. The problem is that unless there is a natural experiment, there is often no detailed information on the counterfactual: what would have happened in the absence of a partnership. Some encouraging evidence on specific projects is beginning to emerge, see BPD working paper 10.

Using Tri-Sector Partnerships to Enhance the Developmental Impact of Foreign Direct Investment in the Extractive Industries

Table 1 outlines ways in which the tri-sector partnership model of social management might overcome some of the market failures associated with the interaction between FDI and development as well as some of the negative social and environmental consequences. With the retreat of an effective voice of local communities to shape FDI through democratic government, a tri-sector partnership model may offer a way to fill this gap and safeguard acceptable social outcomes. Examples are given below.

Box 3: Linkage programmes

In some countries investment promotion agencies set-up by the government intervene in the market by enhancing linkages between local firms and foreign firms. Such linkage programmes (sometimes sponsored by foreign investors) involve training schemes to enhance the quality of local suppliers as well as 'awareness' programmes making foreign firms aware of the potential of local firms in procurement. Linkage programmes aim to reduce the so-called 'import-bias' that foreign firms procure goods and services abroad because of information gaps, even though local supplies with the same quality and lower costs may be available.

Employment and income. Foreign investors may create employment by extracting previously unexploited natural resources or may take over existing domestic firms and not create employment directly. Partnerships are not expected to play a direct role in this. However, indirectly they may raise local employment by familiarising (foreign) firms with the presence and quality of local skills and suppliers. For instance, in the Sarshatali Coal Mining Project in West Bengal, a BPD project in India, local procurement through a partnership reduced the costs of livelihood assessments and avoided the need for external consultants. Sometimes linkage programmes deal with such information related market failures (see box 3).

Capital. Successful partnerships at local level may help to improve further FDI inflows or domestic investment into previously unexploited natural resources or into other industries by improving the image of the region or country. The resulting decrease in the risk mark-up is expected to play a minor role amongst other determinants of investment, e.g. the presence of mineral resources in the extractive industries.

Market access and market structure. Partnerships are not expected to play a major role in facilitating market access and structure. However, partnerships that include industry regulators could be used to minimise restrictive business practices and anti-competitive behaviour more effectively.

Technology, skills and management techniques. Social investments in local health (e.g. the local health centre in Las Cristinas gold mine, a BPD project in Venezuela), skills and infrastructure improve the capacity to absorb positive spillovers from and enhance linkages with businesses. The concept of absorptive capacity plays an important and positive role in the theory of FDI and development (see box 4).

At the same time, businesses also have an incentive to make social investments through partnerships over and above the developmental needs of the local people. Such investments will improve local skills, motivation and health of the local workforce, and thus create more efficient labour inputs and higher quality local suppliers on which businesses become increasingly dependent. Efficient labour inputs and the availability of quality local suppliers improve business efficiency, while the consent of the local communities provides a 'social license to operate'.

Social investments that improve local skills and infrastructure play a dual role. They act as 'determinants' of FDI by improving business efficiency, and also affect the effects of FDI on development by influencing the quantity and quality of linkages and spillovers between local and foreign firms.

Fiscal revenues

A tri-sector partnership may lead to enhanced transparency in the distribution of tax revenues in the medium to long-run. This ensures that local communities, neighbouring and other communities benefit to the same degree thereby taking into account pre-investment conditions of communities.

Political, social and cultural issues. Through tri-sector partnership arrangements, civil society is empowered to deal more directly with local concerns on social outcomes of (foreign) investment. The partnership opens new avenues of communication with government, enabling the representatives of communities to press for a regulatory

Box 4: Absorptive capacity

FDI does not automatically lead to country or community development. What has become clear is that a certain minimum level of absorptive capacity is needed to capture spillover effects (e.g. new technology or new management techniques) from FDI. The absorptive capacity can be shaped by different actors and depends on the presence of a skilled local workforce, technological competencies of local firms and physical and telecommunications infrastructure. For instance, local training programmes enhance the quality of the local labour force, benefitting the foreign investor as well as improving the capacity of local firms to absorb positive spillovers.

framework to be set by government to ensure that social benefits are realised in the region of operations and/or that the social provisions provided by the company for its staff are also channelled to the local population e.g. provision of education, health care, infrastructure. The partnership approach in the Sarshatali Coal Mining Project appears to have increased the relevance of social investment to the needs of local communities.

The above virtuous circle of FDI and development (enhanced development, improved business performance, and further FDI inflows) is brought about by co-operation of all sides, not by confrontation. Confrontation leads to social and political unrest, which may damage the reputation and hence the value of a company's intangible assets, reduce the development of local capabilities and indirectly hamper any attempt by government to attract further FDI inflows. Partnerships in various forms can facilitate the co-operation and development of trust between the different parties. Perhaps there are lessons to be learned from the many experiences of improved labour relations through social partners representing employees, employers and government. Such evidence is usually not quantitative, but anecdotal and qualitative.

Concluding, tri-sector partnerships can play a role in managing the developmental impact of FDI by addressing certain market failures that characterise the interaction between FDI and economic and social developments of host-countries and safeguarding acceptable social outcomes. In particular, tri-sector partnerships appear to raise employment indirectly, improve the capacity to absorb technological or other spillovers, enhance the transparency of fiscal revenues, and deal more directly with local concerns on social outcomes (see table 1). While initial evidence is beginning to emerge, we need further evidence to determine the importance of the role of partnerships in enhancing the developmental impact of FDI.

Future challenges

- Tri-sector partnerships can improve the social and economic effects of FDI. However, not much work has been done to incorporate tri-sector partnerships into the theory of FDI and development. We also need more empirical evidence to assess whether partnerships make a real difference for social and economic development in practice. Encouraging evidence is beginning to emerge from BPD (see the Working Papers series).
- This paper generalised on the roles and drivers of partnerships. However, it is possible that roles and drivers of partnerships differ by partner, by FDI project and over time, and in the future it may necessary to account for this heterogeneity.

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