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Strategic Role of Foreign Direct Investment in Driving National ESG Implementation: Innovative Pathways for Sustainable Economic Transformation

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ABSTRACT

Foreign Direct Investment (FDI) has long been recognized as a driver of economic growth; however, its role in advancing national Environmental, Social, and Governance (ESG) agendas remains ambiguous. While many countries now integrate sustainability goals into their investment strategies, a clear conceptual understanding of how FDI can support systemic ESG transformation is lacking. Existing studies tend to isolate the economic, environmental, or social effects of FDI, overlook institutional dynamics, or rely on static models, leading to fragmented insights. This conceptual research addresses these gaps by exploring how FDI can be strategically governed to function as a catalyst for national ESG implementation. The purpose of this study is to develop a structured, multi-scalar analytical framework that explains the dynamic interactions between FDI and ESG outcomes across firm-level practices, national policy instruments, and transnational governance mechanisms. Drawing on institutional theory, innovation systems theory, and global value chain governance, the study constructs a conceptual model that identifies four key transformation mechanisms: knowledge spillovers, regulatory convergence, green finance signaling, and policy diffusion. These mechanisms are contextualized through comparative illustrations from the European Union, China, and ASEAN. The study finds that FDI's ESG impact is mediated by host-country absorptive capacity, regulatory alignment, and institutional maturity, and that its transformative potential depends on coordinated governance across multiple levels. The model provides a diagnostic tool for understanding how FDI can transition from a transactional input to a strategic lever for sustainability. In conclusion, this paper contributes to both theory and practice by offering an integrative framework to align FDI governance with ESG objectives. It lays the groundwork for future empirical validation and supports policymakers in designing investment strategies that foster inclusive, resilient, and sustainable development.

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1. Introduction

The contemporary global landscape, characterized by escalating climate crises, persistent social disparities, and eroding institutional cohesion, presents a paradoxical duality in foreign direct investment (FDI)'s role within sustainable development paradigms. While historically lauded for its economic multiplier effects through capital infusion9, contemporary discourse demands FDI transcend its traditional boundaries to operationalize ESG (Environmental, Social, Governance) principles specifically through ecological remediation protocols, equitable resource allocation mechanisms, and anti-corruption institutional scaffolding. Empirical evidence, however, reveals significant discrepancies in FDI's capacity to catalyze ESG alignment at national levels, with Mottaleb *et al.,* [11] and Rahman *et al.,* [5] meta-analysis highlighting critical knowledge gaps in cross-border capital flows' institutional embeddedness.

The core issue this paper addresses is the strategic ambiguity and conceptual fragmentation surrounding the role of FDI in driving national-level ESG transformation. While policy discourse increasingly links sustainable development goals with global capital flows, existing governance regimes remain inconsistent and incoherent across institutional levels. In particular, three unresolved tensions challenge effective ESG-aligned FDI:

i. ESG commitments at the corporate level do not always translate into national sustainability outcomes, reflecting a persistent micro–macro disconnect [8].
ii. Existing studies often isolate the economic, environmental, or social impacts of FDI without capturing their interdependent dynamics [1].
iii. FDI-ESG interactions are typically assessed through static or binary logics (pollution haven vs. green growth), rather than as evolving processes shaped by institutional learning, technological thresholds, and regulatory co-evolution [3].

This paper is conceptual and aims to bridge these theoretical and practical gaps by developing a multi-scalar framework that reconceptualizes FDI not simply as a monetary inflow but as an institutional, technological, and normative ecosystem capable of influencing sustainability transitions. The proposed framework integrates three critical levels of analysis:

i. Firm-level ESG commitments and absorptive capacities.
ii. National policy instruments such as green finance, disclosure regulation, and FDI screening.
iii. Transnational governance mechanisms, including carbon border adjustments and sustainability-linked finance standards.

To ground this conceptual approach, the study draws on comparative institutional analysis from three regional contexts: the European Union’s regulatory autonomy, China’s green financial experimentation, and ASEAN’s cooperative sustainability frameworks. These cases provide empirical anchors for theorizing how diverse governance logics can shape FDI’s catalytic or corrosive role in national ESG implementation [5].

Building on insights from institutional theory, global value chain governance, and innovation systems theory, this paper contributes to the literature in three main ways.

i. It reframes FDI as a dynamic, co-evolving system rather than a static investment channel.
ii. It identifies causal mechanisms such as knowledge spillovers, regulatory isomorphism, and financial signaling that mediate FDI’s ESG outcomes across different institutional settings.

iii. It proposes an actionable conceptual toolkit for policymakers seeking to align FDI governance with climate resilience, social justice, and institutional integrity.

Ultimately, the study provides a foundation for further empirical validation and comparative inquiry. In doing so, it lays the groundwork for a more integrated, context-sensitive, and future-oriented understanding of how FDI can contribute meaningfully to national ESG implementation, beyond compliance and towards transformation. Table 1 below shows the FDI as a sustainability ecosystem.

Table 1
FDI as a sustainability ecosystem

Mechanism	Theoretical Anchor	Evidence
Knowledge Diffusion	Absorptive capacity	EU tech transfer [6]
Governance Upgrading	Institutional isomorphism	China's anti-corruption [4]
Green Finance	Sustainable finance	ASEAN SLBs [2]

1.1 Literature Review

The relationship between foreign direct investment (FDI) and sustainable development has gained increasing attention within academic and policy circles over the past two decades. FDI is no longer evaluated solely for its capacity to inject capital and boost GDP; it is now recognized as a vector that can shape governance systems, environmental performance, and social equity in host countries. This has led to a shift in research focus, from the traditional economic impacts of FDI to its broader implications within the Environmental, Social, and Governance (ESG) paradigm. However, the existing literature remains conceptually fragmented and methodologically siloed, impeding the formation of an integrated understanding of FDI's strategic role in national ESG implementation.

Contemporary scholarship exhibits three fundamental epistemological fissures: persistent micro-macro disjunctures, entrenched disciplinary fragmentation, and insufficient longitudinal scrutiny. These deficiencies impede theoretical evolution while constraining actionable policy design [5,11]. Micro-Macro Governance Decoupling Research on ESG-linked FDI reveals a critical misalignment between corporate initiatives and national frameworks. While multinational enterprises (MNEs) proliferate granular ESG metrics carbon neutrality targets, diversity quotas, sustainable supply chain protocols such measures seldom integrate with host countries' sustainability architectures [8,13]. Corporate ESG disclosures frequently function as reputational signaling mechanisms rather than drivers of developmental transformation, remaining decoupled from domestic regulatory regimes in Southeast Asian economies [8]. Weak institutional embeddedness of ESG-focused FDI is particularly acute in jurisdictions exhibiting regulatory archipelagos [11]. This schism reflects a broader governance paradox: investor ESG assertions rarely materialize as quantifiable national outcomes despite proliferating private governance frameworks [1,3]. Emerging scholarship employs comparative institutional analysis to trace this disconnect. Rahman *et al.,* [13] tripartite examination of China-EU-ASEAN investment regimes exposes heterogeneous policy integration patterns across administrative tiers. Their work underscores the necessity for bridging instruments performance-linked fiscal incentives, ESG-weighted screening filters, and harmonized disclosure frameworks to synchronize corporate conduct with sovereign sustainability commitments [13]. Disciplinary Balkanization the FDI sustainability literature remains fractured across epistemic domains. Economic analyses predominantly emphasize productivity spillovers, export competitiveness, and employment elasticity [9]. Conversely, environmental and sociological scholarship frames FDI through risk lenses highlighting pollution haven formation, labor rights erosion, and community displacement dynamics. These parallel discourses seldom capture ESG's compound interdependencies, neglecting synergistic and antagonistic cross-dimensional effects. FDI's environmental returns are contingent upon institutional robustness and sectoral precision, with green technology transfers yielding net benefits exclusively within conducive regulatory ecosystems [1]. Techno-institutional absorptive capacity mediates sustainable FDI performance: absent skilled labor pools, enabling infrastructure, and innovation networks, capital inflows underperform [3]. This stratified comprehension destabilizes binary FDI characterizations (beneficial/detrimental), demanding frameworks contextualizing investment within governance institutions, financial architectures, and technological regimes [11].

A growing body of work seeks to bridge these disciplinary gaps by introducing hybrid models and interdisciplinary methods. For instance, Xu *et al.,* [9] adopt a regional lens to assess how differences in R&D intensity and institutional maturity influence FDI quality across Chinese provinces. Their work reveals a threshold effect green FDI becomes effective only after local innovation capacity exceeds a critical mass. This insight complements findings from global value chain (GVC) literature, which emphasizes the role of lead firms and transnational regulatory diffusion in shaping ESG standards among suppliers [5].

Third, scholarly work inadequately addresses the dynamic evolution of FDI-ESG interrelationships. Prevailing research predominantly utilizes static analytical frameworks and limited temporal datasets, neglecting feedback mechanisms and path dependencies inherent in institutional transformations. Empirical evidence indicates that ESG regulatory frameworks in various ASEAN and African nations emerged reactively typically after foreign direct investment had reconfigured industrial ecosystems [5]. This pattern suggests FDI's dual role as both catalyst and constraint for regulatory adaptation, contingent upon reform sequencing.

Longitudinal analyses further reveal significant time lags in the materialization of ESG enhancements from foreign investment. China's implementation of green credit instruments in 2012, for instance, yielded measurable environmental improvements only when provincial R&D expenditure exceeded 1.5% of GDP in subsequent cycles [9]. Such empirical patterns necessitate conceptual models accommodating nonlinear co-evolutionary pathways, where institutional learning, technological thresholds, and market responses interact temporally.

Emerging methodological approaches integrate longitudinal designs with theoretical constructs from institutional analysis, innovation systems, and global value chain governance. These frameworks elucidate how context-specific variables including governance efficacy, financial architectures, and regulatory capacity mediate FDI's ESG impacts. They concurrently illuminate transnational actors' critical functions in norm diffusion across borders, encompassing development finance institutions, certification entities, and multinational corporations.

Conceptual developments increasingly prioritize multi-scalar integration, synthesizing firm-level practices, national policy instruments, and supranational governance regimes. By acknowledging hierarchical interdependencies, researchers construct models that more accurately reflect sustainable development complexities within globalized economies. These analytical tools identify strategic leverage points such as targeted fiscal incentives, ESG-linked investment treaties, and harmonized taxonomies that align capital flows with sustainability imperatives across jurisdictions.

In conclusion, while FDI-ESG scholarship demonstrates substantive progress, it remains characterized by theoretical fragmentation, reductionist approaches, and insufficient engagement with dynamic processes. This research contributes a structured conceptual model explicating causal pathways between foreign investment and ESG implementation across institutional scales. Integrating insights from institutional theory, innovation systems, and global value chain governance, the framework addresses micro-macro disjunctures, transcends disciplinary boundaries, and incorporates temporal dimensions providing both theoretical advancement and practical utility for policymakers optimizing FDI-sustainability alignment.

2. Methodology

Given the conceptual nature of this study, the methodology centers on the structured construction of a multi-scalar analytical framework that maps the dynamic pathways through which foreign direct investment (FDI) can contribute to national ESG (Environmental, Social, and Governance) implementation. This approach does not rely on empirical regression models or primary data collection but instead draws on theoretical synthesis, mechanism mapping, and comparative institutional logic. This research adopts a structured conceptual modeling approach [7], integrating insights from three complementary theoretical domains:

i. Institutional theory explains how governance regimes through disclosure mandates, investment screening, and legal harmonization shape ESG-compatible FDI behavior [8].
ii. Innovation systems theory reveals how host-country absorptive capacity, R&D intensity, and policy coordination influence the diffusion of green technology and ESG practices through FDI channels [3].
iii. Global value chain (GVC) governance highlights the role of lead firms, certification regimes, and transnational regulatory diffusion in enforcing ESG compliance among FDI-linked suppliers and operations [5].

This triangulated theoretical base provides the conceptual scaffolding necessary to overcome the micro–macro disconnect, account for institutional heterogeneity, and explain dynamic co-evolution of FDI-ESG linkages. By doing so, it enables a more nuanced, layered understanding of how ESG-oriented FDI transitions from aspiration to implementation across governance levels.

2.1 The Model Development Followed a Four-Stage Logic

The four stages build on each other in developing the model.

i. Problem framing: Synthesizing literature gaps namely, the micro-macro disconnects, disciplinary silos, and lack of temporal modeling.
ii. Conceptual mapping: Classifying variables into three levels which is micro (firm level), meso (national policy), and macro (global institutional regimes).
iii. Mechanism specification: Identifying four core FDI-to-ESG transformation mechanisms knowledge spillovers, regulatory convergence, green finance signaling, and policy diffusion.
iv. Contextual validation: Anchoring the model in three illustrative regional cases, the EU, China, and ASEAN to demonstrate mechanism diversity and institutional variation.

This stagewise logic ensures internal coherence and relevance to real-world ESG policymaking scenarios, where multiple stakeholders act under diverging incentives and time horizons. Table 2 below show Multi-Scalar Analytical model components.

Table 2
Multi-Scalar Analytical model components

Level	Key Constructs	Theoretical Basis	Illustrative Case
Micro	ESG Disclosure Incentives, Absorptive Capacity	Innovation Systems	China's Green Credit Scorecard [12]
Meso	FDI Screening, Tiered Reporting Regimes	Institutional Theory	EU's Regulation 2019/452 [6]
Macro	ESG Spillovers, Carbon Border Adjustments	GVC Governance	ASEAN's Circular Economy Framework [2]

2.2 Mechanistic Pathways

Knowledge Spillovers: FDI transmits ESG-relevant technologies, norms, and routines. These spillovers are conditional on the host's absorptive capacity, which is shaped by local innovation infrastructure, skills, and digital readiness [9].

Regulatory Convergence: Institutional isomorphism occurs as countries adapt their ESG regulations to attract or screen FDI, often aligning with OECD or EU standards [13].

Green Finance Signaling: The availability of sustainability-linked loans, green bonds, or ESG-indexed foreign capital acts as a market signal influencing FDI allocation [3].

Policy Diffusion: Through global value chains and bilateral agreements, ESG frameworks in one jurisdiction can indirectly influence policy learning in others.

These mechanisms are not mutually exclusive. In practice, they often interact to form reinforcing or conflicting dynamics. For instance, strong green finance infrastructure may amplify the effect of regulatory convergence, while weak absorptive capacity may neutralize the potential of knowledge spillovers. The framework thus invites future empirical studies to explore the conditions under which these mechanisms co-occur or conflict, and to what extent they produce measurable ESG outcomes.

2.3 Boundary Conditions and Applicability

To ensure analytical clarity and contextual specificity, the model incorporates boundary conditions along three dimensions:

i. Spatial: Applicable to the top 20 FDI recipient countries, where ESG policy experimentation and institutional diversity are most pronounced [10].
ii. Temporal: Focused on the period from 2000 to 2025, encompassing major inflection points in ESG policy (e.g., Paris Agreement, EU CSRD, China's green taxonomy).
iii. Institutional: The model assumes a minimum threshold of institutional maturity for example basic legal infrastructure for ESG enforcement and national coordination capacity.

This framework is not intended as a predictive model but as a strategic diagnostic tool. It enables policymakers, scholars, and investors to understand the enabling conditions under which FDI becomes an agent of sustainability transitions. By offering a typology of mechanisms and boundary conditions, the model assists stakeholders in adapting ESG-compatible investment strategies to their national contexts.

Future research may extend this framework through empirical operationalization, agent-based modeling, or comparative QCA (Qualitative Comparative Analysis) approaches. These methodological extensions can validate the framework's assumptions and refine its explanatory power in diverse institutional settings.

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