

Foreign direct investments and multinational corporations



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In a globalised world and economy, foreign direct investment (FDI) flows have boomed dramatically in recent decades. Factors contributing to the growth of FDI are rapid growth in technological advancement, low interest funds from development banks, bilateral investment treaties and the welcoming developing countries have given FDI its importance in helping the economy growth. This led to the rapid growth of FDI flows around the world in the last 20 years period. FDI outflows increase from \$53. billion in 1980, to a staggering \$1. 4 trillion in the year 2000 (Brooks et al, 2003). Foreign direct investment (FDI) involves the real investments or ownership in the land, inventories, factories and capital goods in foreign countries where investor have control and authority over the invested capital. Examples of FDIs involves investors purchasing a minimum of 10% of the firm's stock or more, setting up a wholly owned subsidiary company, joint venture with another firm and merging or acquisition of another company.

Major market players who are always on the lookout for investing in foreign countries are multinational corporations (MNC). Multinational corporations (MNC) plays an important role in bringing capital and employment to the host countries and since a few decades back, MNCs took a great amount of interest in investing their business in foreign markets because of the various advantages in foreign countries over their home country. In this essay, I will be focusing on the determinants, characteristics, cost and benefits for host and investing countries for FDI and MNC. Determinants & Characteristics

There are various reasons for FDI to arise but one major reason is that investors foresee promising returns of profits of their investments in foreign nations before they invest. Every investor wants to maximize their returns as

much as they can. The determinants of FDI have been first studied by Adam Smith, Torrens and Stuart Mill but Ohlin soon addressed the issue after it. Then what was explained by Ohlin was that FDI was mainly stimulated by the possibility of high profitability in growing foreign markets adding up to the chances of a low tax rate and interest in the host country. (Nonnemberg & Mendonca, 2000). Question why doesn't people of the host country that is so familiar with local rules and culture borrow capital from foreign countries and instead invest in their own home country rather than letting foreign firms coming in to invest. It's because MNC has the technology capital, technology, knowledge and power for it. MNC also have a more stable return of profit and changes little in the returns they make.

Then for a firm to succeed in a foreign market, it must first possess a handful of ownership-specific assets in organization, technology, management, marketing skills and knowledge. Most MNC are blessed with a huge amount of assets to claim the profits that they will yield in foreign markets (Blomstrom & Kokko, 2003). Corporations want to have total direct control of their own management and production. Acquisition of a similar firm doesn't guarantee direct control for the MNC and would expose their trade secrets to the producing companies abroad.

For example BMW, one of the world's great automobile manufacturers wants to invest in foreign countries through horizontal integration, may agree if it takes over a similar firm abroad but when it comes to negotiating licensing agreements, a large MNC such as BMW would always play it safe in fear of giving out to other firms their technology secret. Licensing to foreign producers may also cause deterioration and inconsistency in manufacturing

quality; if that happens, BMW's reputation would go down the drain and lose money instead.

That is why most MNC such as Honda, Toyota and Sony may also face this kind of situation and would always prefer to have full direct control over their investments abroad. (Salvatore, 2007) There is another type of integration pattern that is favoured by many major MNCs. They are the vertical integration. Vertical integration guarantees full strict control by the firm because it is basically an uninterrupted link of process from the start of the obtainment of raw materials to the products being sold to consumer at the end level. For example, if BMW ventures into tyre making, it is making a vertical integration.

Oil industry's giants such as the Royal Dutch Shell, BP and PETRONAS adopts the vertical integration pattern; meaning they are operating along the entire supply chain from the search of oil before drilling crude oil, moving the oil to the world, refining it into petroleum/gasoline, selling fuel to company-owned gas stations and lastly is the sale to consumers. (Hindle, 2009) Other attractive reasons for MNC to invest abroad is that some host countries provide very attractive investments tax incentives, low corporate tax, government encouragement of FDI by providing subsidies.

MNC investing in foreign countries can also evade the tax and tariffs impose when the export their products enters the country. With tariffs removed by investing abroad, while it may be costly to invest and set up at first; in the long run, MNCs returns will be positive. The rapid advancement of the transport system such as railways and aeroplanes also contributed to the

rise in FDI because of the speed and ease of transporting and exporting goods worldwide to anywhere in just hours or days.

The fast communication medium such as internet allows MNC to directly control their subsidiaries around the world and have an international group conference just by turning on their webcams. FDI also is influenced by the trade relations between the host and investing countries and also the geographical proximity. For example Hong Kong have always been the largest investor in PRC along the years. In fact, Hong Kong investments to People's Republic of China (PRC) have gone up high since the early 1980s. Singapore and Macau also came in 6th and 12th place of contracted FDI in PRC (Chantasawat et al, 2004).

Japan for instance is the main supplier of FDI in Malaysia, Singapore, Thailand, and South Korea because of its geographical proximity. Benefits of FDI & MNC There are lots of benefits brought in by MNC into the host countries. They include injecting capital into the local economy and boosting growth that is much needed for developing nation such as improving infrastructures, health care and services, factories, transportation and energy networks.

When economy is injected with capital, flow of money is circulated around the economy and when MNC enters into foreign countries for investments, they are reating a large amount of employment for the unemployed. Tax revenue is also collected by the government to improve the country's development and welfare. Locals who are unemployed and have difficulties in looking for a job in the host country can then work at the MNC. Fresh graduates need not fear of being unemployed because of the large <https://assignbuster.com/foreign-direct-investments-and-multinational-corporations/>

opportunities offered by MNCs. MNC also provides good training and education for employees hence creating a highly skilled and efficient workforce.

These skills may be transferred to other areas of the host country. Often management and entrepreneurial skills learned from MNCs are an important source of human capital. Another benefit of MNC investment in developing countries is increased productivity in export sectors. Tybout and Erdem analysed liberalisation's effects on developing countries' productivity from early 1970s to the mid 1990s and found that productivity increased as supply chain and trade increased, but found out it was not related to the overall growth rate (Habib-Mintzberg, 2009a).

In another study of the apparel industry of Bangladesh, the effect of FDI in the country had increased employment opportunities and raised gender equality, but then it had little effect on poverty reduction (Habib-Mintzberg, 2009). According to K. Ritchie, (2002a), the evidence shows that MNC provides a greater amount of training than trainings offered by local firms. MNCs in Malaysia have also been very proactive in technological development and human capital than local firms. K.

Ritchie, (2002b) also shows that from other studies, it shows that MNCs in Southeast Asia are more willing to train if the MNCs are huge, utilise higher technology, involved in export manufacturing, educated labourers, incentives and support from the government. Wages will also rise in the host countries because MNC will come in to invest offering higher wages than domestic firms to attract skilled workers (Kapfer, 2006a). Second as skilled workers are reducing in domestic suppliers; domestic firms will start demand <https://assignbuster.com/foreign-direct-investments-and-multinational-corporations/>

for more skilled worker and will increase the wage to a higher price setting a new market labour wage.

One of MNCs great advantage is that they are able to quickly shift production from areas of high cost to areas of low cost. When MNCs turns to investing in countries experiencing depressions or recessions, it will be helpful in terms of demand for labour and capital as they will both rise up. Cost of FDI & MNC
Apart from the benefits FDI brings, there is also the downside and cost involved in both the investing and host countries. It doesn't always benefit both countries equally.

For example if host country Malaysia charges 40 percent corporate taxes for firms while Japan, the investing country charges 50 percent of corporate tax, it is obvious MNCs can earn a much higher profit in Malaysia if they chose to invest there. But investing countries such as Japan also must collect foreign investments tax of MNCs from Japan investing abroad but it is impossible for them to charge 50 percent of the standard rate of corporate tax so as most countries also has signatories of double-taxation agreement to avoid double taxing cases.

Japan then charges 10 percent on foreign investments. Therefore, the tax amount collected by Japan drops in the investing and rises in the host country. Direct investments abroad are most likely to let foreigners' better access to information about the foreign firms' proprietary technology and knowledge, and the high percentage of spilling it over to the local firms (Kokko, 2006a). When local firms acquired this knowledge and learned how to use foreign technologies, they may be able to challenge the foreign firms and capture market shares from the MNC affiliates.

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When this happens, it can have a detrimental effect for home country exports and employment as well. Nevertheless, MNCs are likely to take into account the cost related in knowledge leakages has been taken into account of the MNCs' foreign investment decisions. Due to MNC wealth and influence, it is uncontested that MNC's are powerful political actors in the globalising world. However, the power that they have may not be obvious because of the intransparent structure of global politics (Kapfer, 2006b).

In fact, some MNCs are so huge and earn such amount of profits that exceeds some of the small countries' GDP. With the big influence of the MNC in the host countries, giant MNCs may be feared by the government. Government must be wise with their trade and investments policies to attract MNCs to invest. Government should also set tariffs to protect MNCs to protect them from major competitions. Most MNCs pull out and threaten to relocate their plants to other countries when government do not pursue desirable policies.

Since government are likely to fear such relocations can lead to weaker economic development, no tax revenue and unemployment in general, they may yield to the demands of MNCs, joining a "race to the bottom" where regulations and controls on MNC operations are gradually taken away. (Kokko, 2006b) However, government can rely on NGOs to constrain the powerful and influential MNCs. It is the recent trend to be recognised by NGO. This alone suggests that NGO may be able to do what most government cannot and is to affect how powerful MNCs run their business. For example the forestry and apparel sectors alone demonstrate the power of NGOs.

How NGOs can help the government is by delegitimize the “ poor standards and inadequate enforcement mechanisms” and effectively gather enough to force MNCs to change their practices. According to (Kapfer, 2006c), consumers and NGOs can affect how MNCs operate and in fact as citizens are more aware of MNCs’ operations, they become more influential. Under such pressure, MNCs would have to conduct quality operations or sacrifice their reputation. But it will not be that effective because it is still up to the government to decide because they are the only entities that can regulate and mitigate MNCs.