4.5 The Role of foreign direct investment
- FDI and MNCs

Syllabus item: 174 Weight: 3

IB Question

- Describe the nature of foreign direct investment (FDI) and multinational corporations (MNCs).
- Explain the reasons why MNCs expand into economically less developed countries.
- Describe the characteristics of economically less developed countries that attract FDI, including low cost factor inputs, a regulatory framework that favours profit repatriation and favourable tax rules.

Definition:

- Foreign direct investment (FDI)

→ Long-term investment by multinational corporations (MNCs) in countries overseas.

FDI usually occurs in one of two ways:

1) Build new plants or expand their existing facilities in foreign countries (green field investment)
2) MNCs merge with or acquire (buy) existing firms in foreign countries

Main idea 1

MNCs are attracted to developing countries for a number of reasons:

- The country may be rich in **natural resources**, such as oil and minerals
  Ex) Angola, Equatorial Guinea, Nigeria and Sudan
- Some developing countries represent huge and growing markets. If MNCs are located directly in the markets then they have much better access to the large number of potential consumers ex) Brazil, China and India
- The **cost of labour are cheaper** then in more developed countries
- In many developing countries, **government regulations are much less severe** than those in developed countries
  → Making companies easier to set up and reduce costs of production
  → Offering of tax concessions by developing countries' governments attract FDI

The meaning of FDI and MNCs

Main idea 2

Table: The world's top 8 non-financial MNCs, ranked by foreign assets, 2007

Corporation	**Home economy**	**Industry**	**Foreign assets**	**Total assets**	**Foreign employment**	**Total employment**
General electric	US	Electrical & electronic equipment	420300	795337	168112	327000
Vodafone Group plc	UK	Telecommunications	230600	254948	62008	72375
Royal Dutch/Shell group	Netherlands/UK	Petroleum expl./ref./distr.	196828	269470	86000	104000
British Petroleum Co, plc	UK	Petroleum expl./ref./distr.	185323	236076	80600	97600
ExxonMobil Corp.	US	Petroleum expl./ref./distr.	174726	242082	50904	80800
Toyota Motor Corporation	Japan	Motor vehicles	153406	284722	121775	316121
Total	France	Petroleum expl./ref./distr.	143814	167144	59146	96442
Electricité De France	France	Electricity, gas, and water	128971	274031	16971	154033

Syllabus item: 175 Weight: 5

IB Question

- Evaluate the impact of foreign direct investment (FDI) for economically less developed countries.

Advantages and disadvantages of FDI for LEDCs

Main idea 1

Advantages associated with FDI

- FDI **helps to fill the saving gaps** leading to economic growth (Increased savings are necessary for growth)
- MNCs will **provide employment** in the country and, in many cases may also provide education and training → Improve the skill levels of work force and also managerial capabilities
- MNCs allow developing countries **greater access to R&D, technology, and marketing expertise** → enhance the industrialization
- Increased employment and earnings may have a multiplier effect on the host economy, stimulating growth
- The host government **may gain tax revenue** from the profits of the MNC, which can then be used to gain more growth by investing in infrastructure, or to improve public services such as health and education to promote economic development
- If MNCs buy existing companies in developing countries then they are injecting foreign capital and **increasing the aggregate demand**
- MNCs may improve the infrastructure of the economy, both physical and financial, or they may act as a spur for governments to do so, in order to attract them
- The existence of MNCs n a country may provide more choice and lower prices for consumers. They may be able to provide essential goods that are not available domestically
- MNC activities along with liberalized trade can lean to **a more efficient allocation of world resources**

*Since 1978, China has actively tried to attract foreign investment as a way to stimulate economic growth. A significant proportion of China's exports are produced by foreign firms. Through joint ventures with foreign firms, Chinese firms have grown rapidly and successfully and China itself is now the source of a large outflow of foreign direct investment. As China grows, so does its demand for raw materials and much of Chinese FDI abroad is its investment in natural resources.

Main idea 1

Disadvantages associated with FDI

- MNCs often bring in their own management teams, simply using inexpensive low skilled workers for basic production and providing no education or training → **Limits the ability of host countries to acquire new technologies**
- It is argued that **MNCs have too much power**, because of their size, and so gain large tax advantages or even subsidies, reducing potential government income in developing countries. Also, too much power internationally. Their incomes and size allow them to exert too much influence on policy decisions taken in institutions such as the WTO
- Transfer pricing: developing countries with low tax rates encourage MNCs to invest reap little tax reward and developed countries also lose out on potential tax revenue → This represents **a potentially large loss of revenue to governments**. These are difficult to monitor and enforce, particularly for developing country governments
- It is argued that MNCs situate themselves in countries where legislation on pollution is not effective and thus they are able to reduce their private costs while creating external costs → **damage to environment**
- It is argued that **MNCs may enter a country in order to extract particular resources**, such as metals or stones, then strip those and leave
- MNCs may use capital-intensive production methods to make use of abundant natural resources → **will not greatly improve levels of employment** in the county. MNCs should use appropriate technology where production methods are aligned to the resources available
- In most cases, where MNCs buy domestic firms, the owners of the firms being bought are paid in shares (stocks) from the MNC → it is likely that the **actual money will never be used in the developing country's economy**
- **MNCs may repatriate their profits**, which means that they transfer their profits out of the country back to the MNC's country of origin