Discuss typical motivations of governments in attempting to influence FDI flows

Ever since organisations decided to operate internationally through FDI or foreign direct investment, they have seen their operations either encouraged or restricted by either or both host and home government's policy. There are numerous reasons why some governments decide to restrict the flow of FDI and some governments decide to encourage the flow of FDI, reasons I will discuss later in the essay. But before I go into that, I must firstly explain a little about what FDI is and why it is so important to government and the organisations wishing to participate in it.

Daniels, (2001, P.277) in 'International Business' defines a foreign direct investment (FDI) as "a company controlled through ownership by a foreign company or foreign individuals." Although just how much ownership is necessary for a company to control their foreign operations is not clear-cut. But what is clear is that both governments and companies have concerns about the issue of control. From the company's point of view, concerns stem from the fact that governments want what is best for their country, and from the government's point of view, they don't want a foreign company having full control of the FDI, and with it the capability of making decisions that affect the host countries economy. But despite these issues regarding control, FDI "comprises a large and increasingly important part of international companies' activities and strategies. In fact, FDI is now more important than trade as a vehicle for international business." (Daniels, 2001, P.277).

If a company is to survive and prosper in a growing international market, it must satisfy different groups, called stakeholders. They include stockholders, customers, employees, home and host governments and society at large. Because the aims of these groups conflict, it is almost impossible to satisfy them all at any one given time, as the effects of an multi-national companies (MNC) activities maybe simultaneously positive for one national objective and negative for another. But if one party gains from an international transaction, it doesn't mean that the other party must lose. Both parties may gain, both parties may lose, one party may gain and the other lose, it really depends on the individual MNC and its unique philosophy, actions and goals.

Almost all ownership (over 90%) of FDI is by companies from developed countries like the United States, Japan and Great Britain, although FDI from emerging countries is increasing. As well as most ownership belonging to companies from developed countries, most FDI occurs in developed countries as well. This is because they have the biggest markets with more possibilities, lowest perceived risk because of the normal lack of political turmoil, and the least discrimination towards foreign companies because of member of organisations such as the Organisation for Economic Cooperation and Development (OECD). But as we shall see later, many emerging countries are doing their up-most to encourage FDI into their country, for example South Africa, because of the benefits it can have on its society at large.

With over 65,000 companies worldwide having FDI's that encompass every type of business function there is, there is no doubt that as well as being beneficial to many host countries stakeholders, for reasons I will explore later in the essay, in most cases, FDI's are extremely beneficial to the organisations participating. There are three main reasons that many companies look to expanding on a global scale, the first being the opportunity to expand their sales. They manage this by reducing transportation costs that would often make products impractical to ship over great distances. In many cases production costs abroad are lower than in the home country. Sales expansion can also be achieved by utilising economies to scale and capitalising on a possible lack of domestic capacity, i.e. Voltswagon's building of a new plant in Europe after the Mexican plant established to build the new Beetle was pushed towards capacity.

The second major motivation behind company's decisions to use FDI as an alternative to trade or supplement is the likelihood of acquiring resources. "As products and their marketing become more complicated, companies need to combine resources that are located in more than one country." (Daniels, Radebaugh & Sullivan, 2002, P. 246) This can be achieved through vertical integration, which is a company's control of different stages of the supply chain. Advantages of vertical integration may come in the form of large financial savings or a tighter relationship between different parts of the supply chain ensuring that production and marketing continue to flow. Other resource acquisition objectives may include gaining access to cheaper of different resources or knowledge, for example, Powergen have recently set up call centres in India to save on employees wages. Organisations may also gain government investment incentives to invest in that country. This I will expand on later in the essay.

The third and final major motivating factor for companies to operate internationally is the potential to reduce risks. For example, if the home country of a company is suffering from an economic downturn like Russia did in the mid 1990's, a company might consider investing internationally to minimise its exposure to its risky home environment. Some more specific reasons for using FDI to minimise risk include preventing competitors' advantage. An organisation in an oligopolistic market especially may feel the need to do this because if a competitor beats you to it, then an organisation might join the market and overcrowd it to stop the competitor achieving an advantage. It is true that many movements by oligopolists seem better explained by defensive motives. Also, many companies feel the need to follow some of their big customers in an FDI to avoid losing that customers business as well as to stop a competitor becoming the supplier in the new foreign location.

So far in the essay I have explained what FDI is and described what motivations companies have for investing internationally and the advantages of them doing so. But these operations are much more complicated because of the role government can play in attempting to either encouraging or restricting the flow of FDI. In the next section of the essay I will try to explain why FDI can be beneficial or detrimental to both host and home countries, whilst evaluating the impact FDI has on growth and employment economics. I will also attempt to look at the politics that can get caught up in FDI,

So why are so many countries governments concerned by multi-national companies? (MNC's). Firstly, the sheer size of some of them and hence the amount of power that they hold scares a number of governments. Negotiating business arrangements with large companies can be so important to a developing countries especially, that it can often have bigger implications than many treaties between countries. To understand the sheer size of some FDI's, we can look at the example of the sales of Mitsubishi, ExxonMobil and Wal-Mart, exceeding the GNP of countries such as Argentina and South Africa. "In fact, the executives of MNC's often deal directly with the heads of state when negotiating the terms under which their companies may operate." (Daniels, Radebaugh & Sullivan, 2002, P.320) This also underlines the power of MNC's.

MNC's attempt to optimise their own performance by allocating resources to different countries. We have already touched on the fact that this allocation is constrained and altered by government perceptions of the impact of FDI. It seems obvious that if a government perceives an FDI to be beneficial to its country, then it will encourage it, and if it perceives it as detrimental to its country, then it will restrict it. FDI's can have massive impact on the economics of a country, through growth and employment, which makes it imperative to a government to make the right decision regarding FDI. I will now look at the possible motives a government may have for encouraging FDI, followed by looking at the possible motives a government might have for restricting FDI.

"To some extent, almost every country today welcomes inflows of FDI, although some countries welcome them more than others." (Globalisation & Business, Daniels, Radebaugh & Sullivan, 2002, P. 138) The Czech government were certainly trying to encourage FDI into their country in 1998 by offering a variety of incentives including, a five year postponement on corporate taxes followed by tax credits as well aid for half the cost of retaining workers and grants for employing workers in depressed areas. In the Czech's case, we can see that they were encouraging FDI because of the benefits to local employment levels. This is the same for many host countries. An inflow of investment from MNC's can stimulate local development through the employment of idle resources. This is not only concerned with reducing unemployment rates, international investors may be able to supply markets and transport facilities to help the host country sell more. Oil production is a good example of this. Just pumping oil is wasteful, but with the help of FDI and the access to bigger international markets that comes with it, a host country is likely to benefit a great deal more.

FDI can bring about other benefits to a host country. "FDI by MNC's can initiate the upgrading of resources by educating local personnel to use equipment, technology, and new production methods" (International Business, Daniels, Radebaugh & Sullivan, 2002, P.328) When Wal-Mart entered the European markets, it made the existing companies push to improve their efficiency.

There are also a number of potential losses a host country might face as a result of FDI that may mean a restrictive host government policy towards FDI. Host countries may lose out if investments by MNC's destroy local entrepreneurship. And it is widely contended by critics that it does, which as a result effects national development. If the local population feel incapable of competing with MNC's, which is understandable given their size, then their expectation of success, which is the entrepreneurial drive, will rapidly decline. But there is also evidence that refutes this. Some critics claim that the presence of MNC's only acts to spur on the local companies to try and emulate MNC's and their success, thus stimulating more local entrepreneurship.

Another possible motive host country governments may have for restricting FDI is the potential decrease in local R&D undertakings. If a countries R&D is going to result in product leadership, then it needs a fairly high technological base. This would often mean that host countries have to rely too heavily on technology from MNC's to build on those bases. "There is evidence to suggest that dependence on FDI constrains host countries from developing workable R&D." (Daniels, Radebaugh & Sullivan, 2002, P.329). For example, Taiwan, Japan and Korea, who are quite restrictive towards FDI, spend much more on R&D as a percentage of their gross GDP than Thailand and Malaysia, who are less restrictive on FDI. However, countries like Taiwan, Japan and Korea, who are quite restrictive towards FDI maybe discouraging MNC's from transferring their technologies there.

Host countries may also lose out if investments by MNC's take the best resources from the host country, for example, from gaining access to new technology, and transfer it back to their home country and its operations. It may also prevent the host country from gaining the economic benefits of the innovations developed by its people.

"Foreign investment is also accused of undermining indigenous societies by imposing Western values and lifestyles." (Kobrin, 1977, P.5) China was one of the countries that believed that contact with foreigners would harm its culture. China's policy between 1949 and 1979 during the communist rule, was that there would be no foreign investment and little trade. In 1979 it enacted a law on joint ventures using Chinese and foreign investment, and since then has experienced a massive rise in FDI, mainly because of the potential that investors see in China, it being the third largest country with the largest population in the world, and it is currently experiencing an economic boom which is set to leave it as the largest economy in the world as measured by purchasing power.

Some analysts believe that host countries lose out if investment by MNC's restricts the funds available to local companies. Although this point is contested by many critics. "For MNC's to have a material affect on capital availability in a country, requires that the amount of funds diverted to those investors be larger than is typically the case." (Daniels, Radebaugh & Sullivan, 2002, P. 329) Some countries restrict local borrowing and some countries go as far as to prohibit the entry of MNC's believed to harm local companies.

When it comes to the effect of FDI on growth and employment, there is not necessarily a zero-sum game where gains must equal losses among countries. For example both countries may gain from FDI, provided that resources are not necessarily fully employed and that capital and technology cannot be easily transferred from one industry to another. But because FDI brings both capital inflows and outflows, countries have to be careful that the net balance of payments effect is not negative.

For developing countries especially, the capacity to run a trade deficit (where imports are more than exports) is important to developing countries because they typically have more goods and services available for their use than they produce themselves. One of the ways in which countries may run a trade surplus is to reduce capital reserves, but many countries wont have any capital reserves, so they need to find another way of compensating. This can be done by attracting an influx of capital, which used to be achieved in large quantities by unilateral transfers such as foreign aid. But these are now diminishing so many countries are relying more on FDI as its main source of capital inflow to fund a possible trade surplus that a developing country may need to run if it wants to achieve its growth objectives. So this maybe a motivating factor for a country to encourage FDI. China, for example, has received a lot of capital through FDI and has also run a trade surplus for a number of years, so it has a lot of capital reserves to fund various infrastructure projects, including dams, power plants, subway systems, highways and railroads totalling more than $1 trillion dollars.

So under what circumstances would FDI be likely to make a positive contribution to a host country? A number of observations have been put forward by analysts, and although they know that not all MNC activity will have the same effect on growth in the home or host country and that attempting to categorize them could be dangerous, 4 circumstances are generally agreed upon that are likely to make a positive contribution to the host country.

Firstly, FDI is more likely to generate growth when the market is prepared to support business growth. This is more common when an MNC from a developed country invests in a developing country that is unlikely to have many firms that are capable of making the type of investment made by foreign investors from developed countries. " Therefore, foreign investment in developing countries is less likely to substitute for domestic investment; it tends to yield more growth than if it were located in developed countries" (Daniels, Radebaugh & Sullivan, 2002, P.330).

Secondly, when a product or process is highly differentiated, for example, through quantity, brand name, product style and/or some sort of differentiated technology, then local companies are less likely to be able to, whether they want to or not, undertake similar production of their own.

A further situation that is likely to make a positive contribution to a host country is to do with foreign investors access to scarce resources. Certain resources such as capital and access to foreign markets are going to be more easily accessed by a foreign investor than a local company. So instead of substituting for what local companies would normally, foreign investors make the most of these advantages to the benefit of the local economic growth.

And finally, the more advanced the developing country, the more likely that the FDI will generate growth. Investors in the more advanced developing countries are better prepared to absorb new management processes and production technologies than in less advanced developing countries, therefore investors are more likely to invest there.

The idea that the behaviour of host countries may vary with the size of the home country is a fairly recent one. Many critics these days point out that, to a degree, the national origin of an investment can explain its behaviour and the response of host countries to it. "Differences of attitude of a host country toward foreign investment coming from large and small countries may be based on differences in the expected costs and benefits accruing to the country from it." (Agmon & Kindleburger, 1977, P78).

So far, I have looked at the relationship between FDI and host countries. But it is not only the host countries government that might have a say in FDI, the home country of the MNC can have a large say on potential FDI operations. There are a number of losses that home countries may face as a result of FDI, and depending on whether the home government perceives them to be too costly or not, will determine if it will try and restrict an MNC from investing there.

The main disadvantage home governments face as a result of one of their MNC's investing abroad is that home country labour claims that foreign production often displaces what would have been jobs in the home country. This has been the subject of much debate in the United States, the home country for the largest amount of foreign licensing and direct investment. Home countries are also likely to lose some of their advanced technologies abroad, sometimes even before they have been developed in the home country in some cases, for example, Boeing's transfer of aerospace technology to China. There is also anecdotal evidence to support the claim that outsourcing production causes wages to decline in a home country. The large number of U.K call centres that have relocated to cheaper cost countries like India, has caused lots of employees in the U.K to either improve their service quality or lose their jobs. But if home country governments want to divert resources form overseas investment to home investment, "home governments will have to make domestic investment more attractive at the same time it makes foreign investment less attractive." (Dunning, 1970, P. 89)

As well as these possible motives home governments have for restricting FDI abroad, there are also certain motives for encouraging FDI overseas. "FDI sometimes depends on countries political motives to reduce security risk." (Daniels. 2001, P. 293) Home countries often encourage their companies to invest in many countries abroad so it becomes less dependant on foreign companies. It may also help the home country hold down prices on production it receives. As well as to gain the supply of strategic resources, governments encourage their companies to make FDI's in order to develop spheres of influence. For example, in the early 1980's, the U.S government encouraged their companies to invest in the Caribbean countries that were unfriendly towards Cuba's Castro's regime, thus making it difficult for the remaining leftist Caribbean countries to gain control. Just as host countries looking for investment provide incentives to companies to do so, home governments provide their companies various incentives to help fore-fill its political plans.

Politics and law can also have a big impact on the MNC and how a government reacts to them. Because of the size of most MNC's and the market power associated with it, host countries have concerns that the MNC will be a foreign policy instrument of its home country government, such as by making them withhold technologies or resources unless the recipient countries follow certain policies. Developed countries are understandably the most concerned by these industrial home countries. Home country governments have also got grounds to be concerned about foreign policy implications as well. "MNC's might become so dependant on foreign operations that they support host country policies and practices unpopular in their own countries." (Globalisation and Business, Daniels, Radebaugh & Sullivan, 2002, P. 142)

MNC's can often caught up in the middle while home and host countries laws come into conflict with each other. When governments apply their laws to the foreign operations of their domestic companies, it is known as extraterritoriality. The U.S has probably been criticized the most for attempting to control what U.S companies do abroad. For example, when the U.S passed the Helms-Burton Act, which basically says 'If you invest in Cuba, you cannot invest in the United States,' European and Canadian stakeholders were furious with the U.S.

MNC's also have a tendency to meddle in local politics so that they can get regulations favourable to their interests. Many critics agree with the host governments here by saying that companies should not concern themselves with local politics at all. But company executives would argue that because they can be one of the major taxpayers and thus have a substantial effect on the economy, that they should be allowed to, for example, make donations to political candidates from that perspective. Host countries also fear that home countries will put pressure on them to treat their MNC's favourably. This form the bases of the deep-rooted distrust that emerging countries have for industrial countries because of the military force commonly used throughout the 19^{th} century to protect their foreign investors interests.

Throughout this discussion we have examined the affects that FDI can have on host and home countries and how the governments of these countries can attempt to influence its flow. We have looked at the various gains and losses that host and home countries can derive from FDI as well as the politics that can get dragged into it. And from all this we have seen some countries are more open to FDI than others, and despite the majority of MNC's insensitivity to national interests and concerns, more governments are steadily replacing obstacles to FDI with incentives as they realise the huge potential benefit economically, FDI can have on a country, especially in the ever emerging developing world.

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