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POSITIVE VERSUS NEGATIVE EFFECTS OF FOREIGN DIRECT INVESTMENTS ON HOST COUNTRIES

Georgeta ILIE

Faculty of International Business and Economics,"Dimitrie Cantemir" Christian University, E-mail: g2009ilie@gmail.com,g2008ilie@yahoo.com

Abstract *Although it is broadly believed that foreign direct investments (FDI) positively contribute to the economic development of host countries, this paper illustrates that the impact of FDI varies greatly across countries by examining the possible negative effects of foreign direct investment on host countries.*

Key words:
foreign direct investment, host country, environment, policies
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F21, F43, O40

Introduction

According to many policy makers and academics, foreign direct investments (FDI) are known to have a positive influence on a host country in its attempts to develop. Not only FDI can finance the direct capital but they also prove to be a source of other economic advantages such as foreign exchange improvement, technology transfer, organizational framework and managerial skills, improvement in the balance of payment, job creation and promotion of the export of the countries. This explains why industrialized and developing countries have provided incentives in order to support foreign direct investments in their economies.

Although this may be true, one should not neglect the existence of the *negative effects* of foreign direct investments as indicated by the countries' realities and by certain research as well. Among these we mention: the crowding out effect of FDI, negative wage spillovers, profit repatriation, the dual economy effect and environmental issues.

In this respect, it is highly important the role played by the efficiency of the host *countries' governments* to *frame policies* in order to use to benefits of spill over in a proper manner. In such case, when setting a suitable strategy towards foreign investments a number of situations must be taken into account, namely: market failures, inaccurate information, different circumstances in receiving countries, different needs and the level of development.

However, all these pro and con arguments for FDI *cannot be generalised.* A lot of *factors* have to be considered such as: the *type of foreign investment* and the firms' long or short *term* objectives.

1. Foreign direct investment and economic growth

The perception of host country governments of the way in which FDI can contribute to their economic and social purposes has changed significantly due to the recent global economic events, such as technological progresses, regional integration and realignment of economic policies and systems.

In order to put into practice the globalization of the international economy, foreign direct investment (FDI) proves to be a very important instrument. By FDI we mean investing real assets in a foreign country, taking part in joint venture, management, technology transfer and "know-how". Many perceive FDI as the key to help the economies of both emerged and emerging markets.

There are cases when FDI could even be the key to change the society as a whole that is why in order to properly appreciate the real long term impact of FDI we must consider the issue from the social, economic and cultural perspective and evaluate in detail all the effects of FDI.

It goes without saying that innovations, technology spill over and increased competition are only some of the *economic benefits* provided by FDI inflows.

Emerging economies are very much looking to attract foreign investment since globalization and foreign investment keep on growing, which can result in a large number of *unwelcome effects* among which we mention: political unrest, job loss, human rights abuses and environmental degradation.

It is common knowledge that over the last three decades the FDI inflows have increased. However, the effects of FDI on the economic growth of the host countries still remain uncertain.

A condition for the FDI's *higher productivity* to hold is that home country has a sufficient stock of human capital. Consequently, FDI has a positive contribution to the increase of the economy depending on the host countries' ability to appropriately attract *the technologies* transferred to them by the transnational corporations (TNC).

The local companies tend to be displaced due to the fact that the foreign companies, being superior in terms of production methods and technologies, compete in the financial and product markets.

It is essential to cautiously consider the effects of foreign direct investment on the economic growth of the host economies. For instance, over the years it has been noticed that foreign direct investment contributes to the growth of the economy by *stimulating the progress in technology* rather than by growing the total capital accumulation in home countries.

There are theories according to which FDI will have a negative impact on *allocation of resources and the rate of growth* as FDI does not accelerate the growth of the economy. Such theories claim that, in general, there is no positive spill over between domestic and foreign firms.

Although the good economic policies may stimulate both FDI and growth, the outcomes do not comply with the perception according to which FDI has a positive effect on growth that does not depend on some other growth determinants.

Furthermore, host countries are provided with finance by TNCs which means that money flow increases in the economy and this leads to an *increase in the aggregate demand*. As a consequence, *prices rise* and an *inflationary situation* in the economy is created. The people then start borrowing and the interest rates rise again. Eventually, the local investment gets crowded out.

As far as large countries are concerned, they have the capacity to affect their trading partners' accumulation of capital, leading to the alteration of the future market conditions. One of the threats related to attracting FDI is that capital movements may be regulated by perfectly discriminatory policy to maximize the wellbeing of the large countries.

In order to make sure that FDI will provide those benefits and local economy will be able to absorb them, Individual strategy needs to be created and properly implemented. However governments as well as market may not be as perfect as required which leads to the question whether market or government failures are more costly for the economy's growth and development.

There are cases when some domestic firms, not only those receiving capital from abroad, benefit from the *incoming capital together with foreign know-how.* On the other hand, there is no clear evidence that FDI always has an advantage over other kinds of investment, like loans for developing local businesses.

2. Effects of FDI on labour and employment

When it comes to opening up for capital mobility and attracting huge amounts of FDI inflows, all these will certainly have a *positive effect on the job offers* of companies and therefore on employment. But the effects of structure and reallocation are not clearly understandable for all types of labour.

In such case, the skilled labour gets benefits from firms' increased efforts towards extra employment, whereas, the unskilled labour does not seem to be so privileged**.** Therefore when job opportunities arise, a lot of people become unemployed as well. This happens particularly in case of less developed countries (LDC) that primarily rely on labour-intensive techniques.

But unfortunately most of the FDI are present in capital intensive industries. TNCs do not aim the labour-intensive industries and so a lot of employees in those industries are thrown out of jobs.

The inflow of foreign capital always *crowds out local investment.* This happens when the domestic markets are targeted by the foreign companies and the domestic companies are not able to compete with the foreign companies.

For such reason, a lot of companies are forced to shut down and consequently people become unemployed. As a rule, foreign companies purchase local companies to shut them down completely and gain monopoly. The outcome is that the employment opportunities created by the TNCs are restricted only to the skilled sector.

Usually, TNCs recruit superior workers, who demand higher wages. As a rule, they *make use of the work force* that exists in the host countries.

Moreover, TNCs take unfair advantage of *low cost labour.* There is no concern at all with respect to working conditions. The wage share of the total output is extremely low. The workers have very little bargaining power and the influence of the trade unions also tends to be minimal.

It is also worth mentioning the untested technology that is used by TNCs and which affects the state of health of the people working in such companies.

3. Effects of FDI on the domestic competition

Foreign companies reduce working positions by means of privatization deals or mergers and acquisitions and invariably utilise their usual providers which could result in *imports increase*. The fact that in the foreign companies wages increase, leads to a similar treatment in local companies but these find themselves incapable of such movement, as they cannot cover this growth with an equivalent increase in productivity.

Henceforth, local companies lose their ability to compete as they find themselves incapable to keep pace with the foreign companies and eventually they are thrown out of the market.

Not to mention the fact that TNCs get their providers from abroad rather than purchasing from the local companies which restricts to a great extent the capacity of the local companies, particularly the small scale and cottage industries.

4. Environmental hazards of FDI

There has been an increased attention to the environmental hazards of globalization for a long time as lots of theories claim that *FDI affects the environment.* Many of the FDI are involved in natural resource sectors of developing and less developed countries.

The greatest problem is that most of these countries have a less strict or non-existent regulatory regime. Not to mention the fact that sometimes countries deliberately endeavour to exclude some regulatory requirements in order to attract FDI. Despite the fact that these countries seem to benefit from positive effects of investment, in the long run, the negative effects of FDI on host country's ecosystems and environment might cause disaster.

Since in such countries *the rules and regulations concerning the environment are very indulgent,* TNCs take unfair advantage of the situation. For example, they exploit the natural resources to the fullest extent possible. Because of that, the air and water pollution has increased considerably.

The key to these problems is to increase host country capacity to regulate and construct international environmental standards. NGO's and other civil society groups from home and host countries can also involve more in the improvement of government regulations and increase of MNE's responsibility on environmental issues.

With respect to the *environmental effects*, there is clear evidence referring to the FDI contribution to the environmental degradation. Environmental protectionnists have shown their concern especially with respect to the environmental impact of FDI because developing countries *are deficient in the policies and regulation that may protect the environment*. Eventually, these regulations will decrease the effects of constant resource use and, no doubt, the host countries' citizens will have the same rights as the developed countries.

5. Impact on current and capital accounts

It has been shown that FDI *improves the foreign exchange position of the recipient country* but only for a limited period of time because after a while they tend to reduce the earnings of foreign exchange on current as well as capital accounts.

Moreover, FDI has a negative impact on the balance of payments due to the harm that it does to the export prospects of the host economies.

In addition to that, the capital accounts of the host countries will have a lot to suffer due to the fact that, as a rule, TNCs send back to their home countries *all their profits and other funds such as royalties and management fees* and, as well as that, because of the huge amount of *imports of capital goods and intermediate products.*

6. Investment incentives and FDI effects

The existence of *investment incentives focusing on foreign firms* does not represent *an advisable approach* since the most important theoretical motivation for financial subsidies to inward FDI tends to rely on external effects such as spill overs of technology and human capital, which does not follow automatically from foreign direct investment.

Following the same judgement, incentives of motivating economic activities should concentrate on those activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training and R&D. Rather than proposing narrowly defined FDI policies, attractive terms to investors should be perceived as part of a country's overall industrial policy and be accessible equally to all investors, whether foreign or local.

The economic development of a host country may be assisted by the FDI thanks to its contribution to the increase in *exports* and *productivity*. In practice, the *actual nature of the relationship between TNCs and the host countries* varies between industries and countries. It may be presumed that the features of the host economy's policy and industry environment are very important elements that result in the net benefits of FDI.

The economic grounds for providing with special incentives to attract FDI comes from the idea that it will lead to faster economic increase, produce externalities in form of larger employment, technology transfers,

skills to local industry, boosted productivity or filled 'idea gaps" between rich and poor nations.

In order to *attract the FDI, there must be strong economic logic behind the incentives,* due to the fact that the economic effects of foreign direct investment may be negative at times. The impact of FDI may differ depending on the form it takes. This includes the type of FDI, sector, scale, duration, location of business, density of local companies in the sector and many other secondary effects. Greenfield FDI has more positive externalities; M&A proved to have little positive and often negative impact to host economies. Another issue that is worth mentioning is that FDI might serve not only a way of doing money, but also a way of getting hold of a certain control, both economical and political, in the host country.

7. Further negative effects of FDI on host economics

TNC have been facing a great deal of criticism over the time in particular with respect to their defiance against the passage of laws that prevent socially undesirable practices like minimum wage requirements, health and safety regulations or ignore laws that have already been enacted.

The relationship between the scope of economic growth and FDI represents the point of some other criticism. The entry of TNCs into LDCs might have both positive and negative impacts. On the one hand, the TNCs might *reinvest in the same industries in the host economy* and may extend its market power but, on the other hand, the *repatriation of profits* will drain out capital from the home country.

There is also the risk that TNCs might *support oligarchy* of indigenous local suppliers and partners instead of creating a positive impact on the distribution of income and social development.

Their unsuitable use of capital intensive technology might result in small labour elite while forcing many workers to lose their jobs or be underemployed if the inflexibility of the local labour market fails to deploy them to better productive occupations. Their strict control over technology, export channels and higher management functions may block the beneficial spillovers externalities anticipated in the more optimistic scenarios. This significantly influences the economy as a whole.

In addition, FDI has a negative impact on the balance of payments of the host countries. The TNCs have to cope with a lot of risks like changes in exchange rates, expropriation by the government and a lot of other actions that might be probably taken against them.

FDI seems to be a lot *more costly than licensing and exporting* and more *risky* as well. The stability in political conditions and an open free market represents the key factor taken into consideration by the TNCs when they invest in another country. But this aspect involves a great deal of unpredictability. Besides licensing and exporting, when a company invests in another country, it usually deals with *political risks.* Whether on the one hand foreign investments seem to trigger positive impacts on economy, on the other hand the increasing competition from foreign companies leads to a decrease in the local companies' production which results in rising average expenses of production. Although the local companies certainly seem to benefit from the technology spill over, however the existing competition effect in the market counterbalances all the positive effects for the local firms. The *local companies are required to produce less output* causing an increase in their average expenses.

Moreover, it is also worth noticing the undue advantage taken by TNCs of the liberal tax concessions and increasing investment allowances. Sometimes, it is quite likely that the host country has a higher tax slab. TNCs often increase the price they pay for intermediate goods that are bought from overseas companies, in such way all they do is transferring prices. In fact, TNCs have high profits with overseas companies while in the home countries' they register very low profits. This is a means to avoid taxes by 'profit transferring'.

All these situations explain the concern and prudence shown by many companies with respect to FDI. In case of instability in certain geographical areas, the investor may encounter more problems as foreign direct investment depends to a great extent on the market size and the condition of the home country. In case in which the host country does not have good relationships with their more developed neighbours, this fact may cause some problems to the investors. All in all, it is essential to reflect on the difficulties related to FDI that the host countries' governments are facing. For instance, the governments do not have much control over the operations of the companies that are subsidiaries of foreign companies, situation which may cause some serious problems. The investors do not have the obligation to observe the host countries' economic policies.

Conclusions

According to the studies of the current trends in FDI, it seems that the emerging economies are provided with a disproportionate share of inflows as compared to outflows. The developing countries are very deficient when it comes to *policies, laws and regulations.* So, in the countries dealing with *undeveloped markets* and the

necessary level of education and *infrastructure development* has not been reached, it is almost impossible to make the most of a foreign presence and, as well as that, the impact of FDI on the economic growth will not come up to expectations. Nevertheless, even under these circumstances, an increase in FDI inflows is more welcome than none at all.

However, it has been noticed that in case of those companies that make use of FDI in an appropriate manner by means of creating and implementing technological development and national policies, their efforts will rewarded to some extent. We must understand that TNCs by themselves cannot solve underdevelopment, political instability and poverty issues. These problems cannot find their solutions only by means of the corporations. Therefore, not even a good mixture of public pressure and FDI can accomplish much with respect to the decrease of environmental degradation, human rights abuses financial volatility and cultural tensions.

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