UNIT 16 MNC's AND ITS GROWING ROLE

Structure

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16.0 OBJECTIVES

This unit will enable you to:

- understand various aspects of multinational firms and their activities;
- familiarise the learners with the functioning of MNCs;
- appreciate their role in economic development and welfare of a country; and
- identify the positive and negative effects of multinational activities.

16.1 INTRODUCTION

'Multinational companies/ corporations', popularly known as MNCs, are one of the prominent features of most of the economies today whether they are developing or developed. It is also one of the important forms of economic organisations, which proliferated and started gaining significance in the post-war period. Popular phrases, such as 'foreign direct investment (FDI)', 'international joint ventures', and 'international mergers and acquisitions' are nothing but references to some of the forms of multinational activities.

To begin with and as a working definition, multinational firms are those who own, control, and manage production processes in more than one country. The significance of multinational activities in the post-war period can be gauged from the fact that the share of MNCs accounts for around 25% of total world output. Some of the MNCs are so large in their geographical spread and so big in size, such as General Motors, and Exxon that their total annual sales turnover can even completely overshadow the national income of some countries. Some of the notable sources or home countries from where major outward investment has taken place are United States, United Kingdom, Japan, Germany, Netherlands, France, Switzerland, and Italy. World's top 100 MNCs hail from United States, Japan, France, United Kingdom, and Germany. At least until 1970's, USA and UK were the largest source of FDI; however, substantial. FDIs flow not only from the developed countries, as mentioned above, but also from developing countries. Some of the world's largest MNCs are

General Motors (USA), Ford Motors (USA), Toyota Motors (Japan), Exxon (USA), Royal Dutch/Shell Group (Netherlands/UK), Daimler Benz (Germany), Nestle (Switzerland), FIAT (Italy), and Renault (France). In the developing world, most of the top-ranking MNCs hail from Hong Kong, China, and Republic of South Korea. Prominent MNCs from developing world are Daewoo Corporation (Republic of Korea), Samsung (Republic of Korea), Acer group (Taiwan province of China), Cathay Pacific Airways (Hong Kong, China), LG Electronics (Republic of Korea), Singapore Airlines (Singapore), etc. Indian multinationals that have made their presence felt abroad are Reliance Industries, Tata Steel, Telco, Godrej, Planet Asia and Microland. Reliance Industries figures in top 50 MNCs (ranks 39th) from developing countries on a ranking based on foreign assets.

According to the latest data, in the late eighties, major host countries belong to Asia, Latin America, and Africa. According to the latest World Investment Report, world's 100 largest MNCs own a whopping 1808 billion dollars in foreign assets, have foreign sales worth 2149 billion dollars, and have more than 5 million foreign employees working for them. Multinational activity and for that matter FDI in developing countries have mainly flown into manufacturing and processing industries. Of late, however, there has been spectacular growth of multinational presence in services sector also. Industry-wise break-up reveals that the industries to which the MNCs have mostly ventured into are electronic/electrical industry, pharmaceuticals, chemicals, automotive, petroleum and mining, and food and beverages industries.

In India, there was hardly any presence of multinationals after mid seventies, when the few existing players were almost driven out of the country. However, over time, multinational activities have again become prominent in the Indian economy. When India ventured into the global era with liberalisation, various sectors were thrown open for private investment, and FDI was specially welcomed. The concentration of FDI in India can be gauged from the amount of FDI inflows in the last few years. According to Press Information Bureau, Government of India, there has been a positive growth of FDI over the last 4 years. The FDI inflow, which was Rs. 13339 crore in 1998, has shot up to more than Rs. 19000 crore in the year 2000. Total FDI inflow into India (till April 2001), has been to the tune of Rs. 55144 Crore. Besides FDI, other forms of multinational activities are also conspicuous by their presence. The multinational companies, which are prominent in India, are: Asia Brown Boveri (ABB), Citi Bank, HSBC, LG, Philips, Samsung, Siemens, Shell, etc. In India, the multinational interest is not confined to only one or few sectors; rather it has spread into many traditional and non-traditional sectors. Approved foreign direct investment and technical collaboration between August 1991 and September 1999 reveals that Power sector, telecommunications, electrical equipment, transportation, chemicals and food sectors are some of the favourites among multinational giants. Among these, power and telecommunications are two major sectors where maximum approvals have taken place. If we go by the trend in approvals in these sectors, infrastructure sector is going to witness substantial multinational value adding activities in recent future.

Check Your Progress 1

1) Identify at least three multinationals (along with the name of their home countries) in India who are into automobile manufacturing?

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2) Identify at least three multinationals (along with the name of their home countries) in India who manufacture consumer durables, such as fridge, washing machines etc.?

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3) Name five largest source countries (three from developed world and two from developing world) where major MNCs hail from.

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16.2 MULTINATIONAL ACTIVITIES

Before going into details of the role of MNCs in economic development and their effects, it is worthwhile to know, what kind of activities MNCs perform. For this purpose, let us first know, what are MNCs?

16.2.1 What are MNCs?

A Company whose economic activities spread beyond the boundary of the domestic country is traditionally known as a multinational company. In other words, when a company considers the entire global market for production decisions, it is called a multinational company. MNCs could be multinational 'companies' or 'corporations' as most of these companies' stocks are publicly owned. In literature, 'companies' and 'enterprises' are normally used synonymously, thus Multinational Companies (MNCs) and Multinational Enterprises (MNEs) tend to be used interchangeably. However, there is a subtle difference between them. There are certain partnership firms, which are not organised as corporations; thus MNE is an all-comprehensive definition, which covers all firms operating in more than one country. Another term, which is used synonymously with MNEs or MNCs, is 'transnational companies' (TNCs). It was originally used to refer to those companies, which are owned, and managed by entities belonging to more than one country, for example, Royal-Dutch Shell, which is jointly owned and managed by economic entities in UK and Netherlands. In other words, the location of power is dispersed between two or more countries. In sum, both MNC and a TNC can be defined as an enterprise, which engages in foreign direct investment, and thus owns or controls value adding activities in more than one country (Dunning, 1996). Thus there are many ways of

classifying them, but the practical definition often used is that MNCs are those companies listed on the stock exchanges with majority foreign promoter/joint venture stakes. They could be a part of international operations, wholly or partly owned subsidiaries', not all consolidate their earnings but they are generally grouped together as MNCs.

Besides this definition there are various ways of looking at multinational activities. At one extreme, there could be some firms who might be operating in different countries catering to the local markets as subsidiaries of a parent firm but in an independent manner. There could be another variety where a multinational firm may be operating at a global scale, having branches in different countries, however working more or less in an integrated manner as a globally coordinated network. Thus depending on the way they are arranged, integrated, and coordinated; there has been a tendency to look at multinational activities differently.

Similarly, from an analytical angle, the extent of multinational or transnational activity is gauged from various measures, such as : a) shares of foreign assets a) number of and size of foreign subsidiaries, b) number of countries it has spread into in its value adding activities, c) foreign sales and d) foreign employment, etc. The Extent to which ownership and management is internalised is also considered as a measure of extent of multinationality or transnationality (Dunning, 1996). However, there is no specific rule or benchmark about all these criteria, which can explain the extent of multinationalisation.

Quite interestingly, multinational activities or outward governments of the concerned countries promote FDI. It is done with an (objective) that later on the multinational activities are going to have larger economic and political implications in the long run. With this belief, in some cases, even national governments have ventured into multinational activities.

Check Your Progress 2

1) What do you mean by multinationals?

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2) What is the difference between a 'multinational' and a 'transnational' corporation ?

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3) State whether true or false

   a) Company X from abroad invests in shares of one Indian Company without any controlling interest. Company X can be called a 'multinational. (True/ False).

   b) Company Y from New York has a Greenfield venture in India. Company Y can be called as a 'multinational. (True/ False)

16.2.2 Forms of Multinational Organisations

A MNE could be owned or controlled and managed privately or publicly (state-owned and state-managed). Assets of an MNE can be owned and managed by various possible ways : i) could be owned and managed by entities of one country only, ii) could be nationally controlled, but owned and managed internationally, iii) could be internationally owned and managed.

Depending on the way they are organised various shades of multinational activities are observed in real world. The characteristic features of all MNEs are that their value adding activities run across national boundaries. The simplest form of multinational activity is international sales, where the firm produces in its own country and sells in some other country. Secondly, their marketing transaction is also carried out across borders. Thus they are part of international operations not only in production but also in market transactions. They have world wide or global approach to markets and production.

The most predominant form of multinational activity is *foreign direct investment* or *wholly owned foreign subsidiaries*. According to World Investment Report quoting OECD definition, "FDI is defined as an investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)". In other words, foreign direct investment takes place when a company from one country invests to attain ownership position of an organisational entity located in some other country. International Monetary Fund (IMF), for its statistical purposes, defines foreign investment as direct when the investor holds at least 10% of the equity stake of an enterprise. As a matter of fact, 10% equity holding is sufficient enough for an entity to have some say in the management. However, sometimes, even entities having lesser stakes play active roles in management and entities having quite a substantial share choose to play a passive role in management. In the case of 'wholly owned foreign subsidiaries', as the name suggests, the firm from a particular country invests in some other country in the form of a subsidiary, where it retains full control of the subsidiary company. In this case, it does not involve any change of ownership; thus the investing or the parent firm retains the full control over the transferred resources from one location to another. It has an equity arrangement where the parent firm (firm from the originating country) owns the right to transfer the resources it commands. In India, the examples of FDI could be Sony India, LG, etc. Another form of FDI is to acquire a local firm (in a foreign country) or get merged with it. In the case of a international or cross-border merger, assets and operations of two different merging firms (local and the foreign firm) form a new legal entity whereas in the case of a cross-border acquisition, control of assets, ownership rights, and management of the acquired firm get transferred to the foreign acquiring firm.

Another notable form of multinational organisation prevalent across the globe is *international joint ventures*. In this type of organisation, the firm from the originating

country enters into a joint venture with an existing firm in the host country. A new entity is formed where two or more than two participating firms own a sufficiently large portion of the equity capital to retain control over the decision-making. In an international or cross-border joint venture the economic entities involved in the joint venture can represent two or more than two countries. Some of the international joint ventures in India are Birla *Yamaha*, DCM *Toyota*, Modi *Xerox*, Kinetic *Honda*, Mahindra *British Telecom*, etc. The next important form of organisation is foreign minority holdings.

Besides looking at the multinational organisational arrangements from ownership point of view, if it is looked at from a wider perspective, multinational activities involve many other organisational forms. In today's, world, various forms of transactional relationships have broadened the definition of multinational enterprises. If transactional relationship is also considered,(i.e. if non-equity arrangements are also taken into account) then at least 5 different types of multinational organisations also are observed in real world. These are.: *licensing, franchising, management contracts, turnkey ventures*, and *international sub-contracting, strategic alliances, etc.* All these organisational forms do not involve equity participation, thus do not entail ownership or controlling right over financial capital. However, depending upon the form of transaction, the parent firm (firm from the originating country) may retain the control over resources and capabilities, such as technology, patents, management skills, entrepreneurship, etc., which can give them certain advantages,

Check Your Progress 3

1) Define Foreign Direct Investment (FDI)?

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2) Identify different forms of multinational activities?

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3) Name five international joint ventures in India and identify the MNC involved in the venture?

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16.2.3 Determinants of Foreign Direct Investment

There are various factors, which act and interact upon the firms to drive them to engage in multinational activities. There are certain motivating factors because of which firms make cross-border investments. The multinational activities can be explained through two different ways: one is to explain the motives for foreign or international production and secondly to identify the economic and behavioural determinants of multinational activities. First, why the firms go for international production or their motives for foreign production will be discussed. Then the economic and behavioural determinants of MNEs will be explained. It will be followed by other push and pull factors responsible for direct investment abroad.

According to existing literature, there are mainly three types of motives such as 'resource seeking motive', 'market-seeking motive', and 'efficiency-seeking motive', which drive the firms to make direct investment abroad. The immediate motive to venture across borders is to acquire certain resources, which is available at lower real cost and provides definite advantage to the enterprise. For a long time, availability of natural resource has been one of the important motives of FDI. Historical account suggests that reliable source of minerals and primary products have been the prime motive behind FDI for the early investors of some of the developed countries. Though over the years, the relative importance of natural resources as motivator for FDI has declined it has not lost its absolute significance. Apart from availability of natural resources, firms look for avenues for producing at lower cost. Thus availability of cheaper labour is an important determinant of FDI in many value-adding activities. Market seeking motive is also crucial, as a firm wants to survive and grow in a particular market. Thus a firm constantly seeks to stay competitive in the existing market or look for ways to expand its own market. Hence, multinational activity is resorted to gain direct access into hitherto unexplored market or when an alternative route to a market, such as export, is no longer profitable. Thus, opportunity of virgin market and/or opportunity to expand further, prompt firms for foreign direct investment and other forms of multinational activity. Another dominant motive for FDI or multinational activity is to reap the benefits of economies of scale, scope, and risk diversification through common governance of geographically dispersed activities.

In literature, there are various theories of foreign direct investment. One of the most prominent explanations of international production, which has gained academic popularity, is Dunning's 'Eclectic Paradigm'. Though the eclectic paradigm seeks to explain the FDI it does not distinguish between various modes of entries to foreign countries. It primarily explains the Greenfield ventures. Dunning's eclectic paradigm suggests that foreign direct investment (FDI) takes place when following three factors are existing simultaneously, namely, i) ownership specific advantages, such as patents, proprietary technology, etc., ii) locational advantages of host countries, such as huge market in the host country, or lower cost of local resources, etc., and iii) internalisation advantages. The first one reflects firm-specific determinants, whereas the locational advantage is specific to particular country, which explains why FDI flows to some countries and not others. Thus OLI (taken from the first letters of the above mentioned advantages) paradigm addresses the following questions such as: a) *which* firms do undertake FDI, b) *where* do the firms go for their direct investment and c) *why* do they internalise their advantages through direct investment instead of selling it off. Thus a combination of factors determines the forms of production and the way market is being catered and serviced.

However, pure motives apart, there are certain pull and push factors for which the firms get attracted to different countries beyond their own national boundaries. The pull factors, which work in this direction, are the policy frameworks by different countries to attract FDI. It is a simple fact that FDI cannot flow to a country if the country concerned does not consciously choose to attract FDI or facilitate FDI. Thus the countries need to be open enough and create opportunities by allowing FDI to flow in. There should be proper inducement mechanism to attract FDI. The policies, which are advantageous in all its facets such as international agreements on FDI, technology transfer, joint venture, etc., attract greater multinational activities or involvement. Trade policies related to tariffs and non-tax barriers (NTBs) also play a greater role in determining movement of international investment and value-added activities. Depending on the trade policy of a host country, a firm can choose to export, or license out, or may invest directly. Domestic tax policy is another aspect, which determines the FDI flow. Besides all these, privatisation moves in many countries, particularly since 1990's, have boosted the multinational activities too. Thus privatisation policy, which reveals the government's intention to open up and withdraw from certain areas, determines the movement of FDI. Another related matter is domestic policies on the structure of market, especially the competition and merger and acquisition policies. Domestic policies aimed at foreign subsidiaries, and the entry and exit rules are also crucial determinants of FDI. Domestic policies geared towards a level playing field with fair and equitable treatment to multinational investors and provision of international means of settlement of investment related disputes facilitates direct investment and promotes multinational activities. Policy related matters apart certain investment specific pro-active measures, such as promotion of investments through investment generating activities, investment incentives, post-investment services, and smooth investment facilities, free of administrative, bureaucratic complexities, and provision of necessary infrastructure have gained significance over the years as important factors for outward direct investment. Finally, given the fact that the MNCs apart from repatriating profits, pose the threat of nationalisation; what ultimately matters for their operations is the domestic political and economic stability.

The implication of the above analysis is that it can facilitate FDI to move in to the host country but whether FDI will really occur or not depends on other aspects/ factors too. Thus an FDI- or multinational- friendly policy framework could be a necessary condition but may not be sufficient enough for FDI to really occur in a particular country.

The most important push factor is the competitive pressures in the home turf, which compel firms to venture into foreign territory. Besides this, there are certain activities where stages of productions can be physically separable. Particularly, in those types of activities, it has almost become a global phenomenon to move the production site to some country where the cheap labour is available for a particular stage of production. For example, in computer industry, stages of production, which are labour intensive, are being shifted to low-cost manufacturing bases and the critical stages of productions are carried out in the home country. Venturing into foreign soils sometimes becomes imperative to avoid tariff walls raised by certain countries, which earlier were catered through exports. In this scenario, the best option could be to invest abroad directly. Along with globalisation waves of 90's and the privatisation moves, another development, which is giving rise to accelerated FDI, is bilateral treaties for investment and growing regional integrations, and business facilitations to reduce intra-region business transaction costs.

Check Your Progress 4

1) What are the main motives for which a firm engages in international production?

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2) What does the 'eclectic paradigm' seek to address?

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3) Identify five different domestic policies of a host country which can have effect on foreign direct investment?

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16.3 ROLE OF MNCs IN ECONOMIC DEVELOPMENT

MNCs are often considered as engines of growth by the global institutions. Potentially, the MNCs can contribute in various areas such as capital formation, human resources, environment, technology, and trade of home as well as the host countries. Through their linkages with local companies, they can contribute to capital formation and boost the efficiency. Presence of MNCs can help generate employment, bring in world-class managerial skills, provide training, and can have learning effects also. It is also believed that MNCs can help utilise underemployed or unemployed resources. Thus MNCs help in growth and employment and the gain for the host country can come through optimal use of resources and up gradation of the quality of resources. Given the lack of resources in less developed countries (LDCs), the investment by MNEs can come as a boon and lead to further growth. However, lack of linkages can lead to creation of enclave economics

It is a known fact that MNEs are a huge repository of modern technology, established R&D, and can be a boon for industrial upgrading. Parent firms usually provide the best managerial skills and practices, technology, and equipments to firms in host countries. Unless some degree of management control is allowed, technology owners are normally reluctant to make their technology available. Thus in multinational

activities where the investor retains some management control over the resources, host countries have the benefits of access to best technologies available. It not only provides modern technology but also brings in cleaner environment-friendly technologies.

MNEs as organisations provide resources of various kind, provide capabilities, and even markets. They help to create not only jobs and wealth but also supply foreign currency through their involvement in different types of ventures. Presence of MNEs also leads to expansion of export and low cost imports. Last but not the least, MNEs bring in world-class, time-tested global standards. Multinational activities not only contribute to local value added, but also enhance the competitiveness and capabilities of the local resources.

MNEs can have significant political, economic, and social impact on an economy. First of all, MNEs help in easing trade deficit in terms of capital flow for a host country that runs trade deficit. It is observed that initially the balance of payments effects of MNEs is favourable to host country and unfavourable to the home country. However, it gets reversed later. There are certain genuine fears of host countries. It is said that local entrepreneurs are at a disadvantage vis-à-vis MNEs when it comes to raising resources. Thus they have the potential to wipe out the local entrepreneurs or companies and have the capability to take away the best local resources available. After a certain level of development in a country the involvement of MNEs can even lead to reduction in R&D activities in the host country.

The effect of MNEs does not remain confined to host countries alone. It can have impact on the home country also. It leads to job losses in home country due to FDI in some other country. One of the arguments cited is the possible loss of technological superiority of the home/ country. Another possible effect on the home country could be the loss of tax revenue due to the shifting of operational bases of the companies from the home country to some other country where the tax structure is lenient or the tax incidence is low. Further, the MNEs can have the potential to make government's control virtually ineffective by accessing the international capital markets and circumventing the domestic monetary policies.

In spite of local customs and macro-economic policies controlling/regulating the employment, MNEs have the potential to impact on various aspects of labour force or employment such as level and growth of employment, reward/compensation, working conditions, human resource development, industrial relations, and quality of the labour force also. When it comes to the effect of MNEs on the trade, the available literature is not generalisable about the impact (extent or direction) of MNEs on trade. However, the empirical studies strongly supports that MNEs, over the years, have changed the structure of composition of world trade.

Check Your Progress 5

1) What roles does a multinational company play for the development of an economy?

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2) What are the likely effects of multinational activities?

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16.4 LET US SUM UP

Today, many countries allow FDI with varying degrees of restrictions in different activities. There has been an upward trend in foreign direct investments (FDI) inflows since the early nineties. FDI has been soaring particularly in the recent years. Growing foreign direct investment (FDI), as a form of multinational activity, has been possible due to globalisation moves undertaken by national economies, increasing integration of world markets, and last but not the least, liberalisation and opening up of new areas for investment. With the increased role of private sector, and shift in attraction and focus towards barrier-less globalised production, it has now become imperative for firms to gain competitive advantage from of the location of investment.

Integration at a global level will continue to propel the growth of different forms of multinational activities. Statistics suggest that, national economies that have globalised and liberalised their economies have benefited out of FDI. Thus, with privatisation and globalisation moves across the globe, multinational activities will play a bigger role in the national economies. Foreign and domestically owned enterprises will coexist irrespective of the status of the countries whether it is developed or developing. International factors of production as well as the markets, along with the advancements in communication, transport, and technology, are gradually getting integrated at a faster pace after the spurt of economic liberalisation of 1990's. Thus in times to come, it is going to boost the multinational activities further. Of late there has been efforts across the globe to move towards multilateral kind of arrangements not only in trade but also in investment. This multilateral approach to investment is going to give further fillip to multinational activities through greater flow of FDI. This, in turn, has got the potential to further reinforce the liberalisation moves taken by various countries.

16.5 KEY WORDS

Foreign Direct Investment: An investment involving a long-term relationship and reflecting a lasting interest and control of a resident entity of one economy in an enterprise resident in an economy other than that of the foreign direct investor.

Globalisation: Trend towards greater integration of markets around the world.

Multinationals: Multinational firms are those who own, control, and manage production processes and generate value-adding activities in more than one country.

Transnational: Multinational companies where owner managers belong to more than one country.

Wholly Owned Subsidiaries: A form of entry into the foreign market, where an existing firm is fully acquired to have full control over its operations.

International Mergers & Acquisitions: A form of FDI, where a foreign firm acquires or merges with an existing local firm, which entails change of control in the acquired or the merged firm.

Home Country: The country where the parent firm is registered or located

Host Country: The country where the multinational firms own, control, or manage various value adding activities.

16.6 SOME USEFUL BOOKS AND REFERENCES

Cullen, John B. (1999). *Multinational Management: A Strategic Approach,* South-Western College Publishing, USA.

Dunning, John H. (1996). *Multinational Enterprises and the Global Economy,* Addison Wesley, England.

World Investment Reports, Various issues.

16.7 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) See section 16.1, 2nd paragraph

2) See section 16.1, 2nd and 4th paragraph

3) See section 16.1, 2nd paragraph

Check Your Progress 2

1) See Sub-section 16.2.1

2) See Sub-section 16.2.1

3) a) False b) True

Check Your Progress 3

1) See Sub-section 16.2.2, 3rd paragraph

2) See Sub-section 16.2.2

3) See Sub-section 16.2.2, 4th paragraph

Check Your Progress 4

1) See Sub-section 16.2.3, 2nd paragraph

2) See Sub-section 16.2.3, 3rd paragraph

3) See Sub-section 16.2.3, 4th paragraph

Check Your Progress 5

1) See section 16.3

2) See section 16.3