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Impact of foreign direct investments on the economy

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Abstract

The paper evaluates the influence of foreign direct investments on the economy of the Slovak Republic which forms the necessary part of the international capital movement. More often, governments of individual countries consider them to be a tool for increasing competitiveness. Direct foreign investments influence not only the economic, political and social aspects in the host country but in the mother country as well and they play a key role in the economy performance growth.

Keywords: foreign direct investments; sector structure of FDI; regional structure of FDI; FDI effects; structure of the economy;

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1. Introduction

Foreign investments are one of the irreplaceable foreign sources that influence the development of the host economy. They ensure the interconnection of the home economy with the global one, the increase of its competitiveness, financial as well as tangible investments acquisition, e.g. in the form of technologies or company management skills, etc. Financing of investments that significantly affect the overall performance of the economy can be realized from own or foreign sources. The Slovak economy is open to foreign countries also in terms of foreign investments, upon which it is considerably dependent.

2. Literature review and theoretical background

Foreign direct investment is an international investment expressing an intention of a subject, being a resident of one economy (direct investor), to get a permanent share in a company based in different economy (direct investment enterprise). Direct investment enterprise may be:

- a subsidiary with more than 50% of the direct investor's share in the core capital or voting rights;
- A subsidiary with 10-50% of the direct investor's share or a branch with 100% owned by the direct investor.

Foreign direct investments (FDI) shall be defined in many ways. The OSN definition states they are such investments whose basis is formed by a long-term relationship and a lasting interest of a subject based in one country (direct investment) in a subject based in other country. Flows of foreign direct investments influence, without any doubts, individual macroeconomic aggregates and economy structure and they may, to a lesser or greater extent, be reflected in every aspect of socio-economic life of the national economy. FDI indicators provide information on international investment activities in the form of equity investments and associated loans and the revenue accruing from such invested capital.

According to Sestakova (2008), there are two main ways how foreign direct investments influence the national economy. Firstly, foreign investments are a form of a long-term transfer of sources which national economies often miss for their economic development. The primary areas where these resources are used in the host country are subsidiaries of foreign companies, mostly of transnational corporations. Their positive effect is directly reflected in the increased productivity, added value, corporate export, and in the increase of their competitiveness. The second form of the FDI effect on the economy represents indirect effects or spill-over effect as well. For instance, it represents the influence on the national economy through supplier-customer relationships. FDI arise from the relationship: Direct investment = core capital + reinvested profit + other capital.

Core capital includes non-resident contribution into the core (own) capital of a company. Reinvested profit represents the share of a direct investor (in proportion to direct equity participation) on the profit not being distributed in the form of dividends. Other capital involves lending and borrowing, including debt securities and supplier borrowings among direct investors and their affiliated companies and other enterprises in the group.

Foreign direct investments started to come to Slovakia after the beginning of the transformation of our economy to a free market economy; the dominating were privatization investments that helped with the industrial restructuring. The first years of the independent Slovakia existence were characterized by the caution on the side of foreign investments, largely influenced by unstable political and macroeconomic environment. There has been a significant increase in the FDI inflow since 2000, caused mostly by the changes in the political and economic situation. In 2008, FDI were directed mostly into the fields of automobile and chemical industry. Most of the investment projects were realized during the first half of the year, the second half recorded the presence of global financial

crisis. After 2009, the year of FDI fall, there was recorded lower growth of investments in the form of equity, being the most important form of FDI.

When evaluating FDI branch structure in our country, there is a need for comprehensive overview of the positives as well as negatives of their inflow into individual economic activities. On one side, it is possible to generally consider inflow of foreign sources, while lacking capital in the home country, to be a positive accompanied by a number of positive effects on our economy. On the other hand, it is necessary to consider certain risks connected with the investor entry into the strategic sectors of the economy, e.g. energetics or the financial sector which may therefore get weaker in case there is a decline in the banking sector of mother countries. Strong orientation of our economy towards automobile and electro-technic industry increases the vulnerability of our economy in case of cyclical fluctuations with negative impact on the entire supply network. Table no.1 shows the FDI development in Slovakia in the years 2010-2014.

Table 1 Foreign direct investment in Slovakia in 2010 - 2014

Indicator/year	2010	2011	2012	2013	2014
FDI in bill. €	3.765	4.017	4.178	4.207	4.323
GDP in bill. €	65.91	68.974	71.096	72.13	74.65
FDI/GDP v %	5.712	5.824	5.876	5.832	5.791

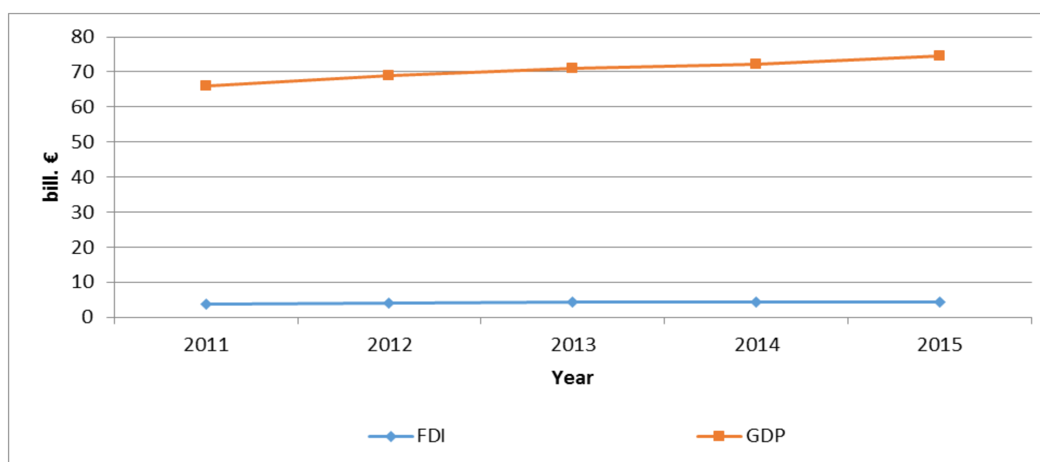

Figure 1. GDP development and FDI inflow in 2011-2015

As seen in the table, there was an FDI increase in Slovakia during the tracking period with the highest increase in 2011, by 6.7% compared to the previous year. In 2012, the total amount of FDI was of 4.178 billion EUR, 3.7 billion was invested into the business sector mostly in the form of equity and reinvested profit and the remaining 0.478 billion EUR was put into the banking sector. Slovakia can be characterized by a relatively high share of FDI inflow into manufacturing (over 30%), the FDI share into the tertiary sector in our country is after Romania of the second lowest value of the countries of Central and Eastern Europe. The highest FDI share in Slovakia is in the electricity, gas, steam, and cold air supply. The development of FDI share in GDP is almost uniform; the lowest FDI share in GDP during the tracking period was recorded in 2010 at the level of 5.712%, on the contrary, the highest FDI share in GDP was recorded in 2012 at the level of 5.876%. It declined in the following years. Based on the data in Table 1, we can conclude that the change in the level of foreign direct investments influences also the value of gross domestic product. This may be related to the increasing costs of individual components of gross domestic product, mostly government expenditure on investment incentives.

3. Discussion

The issue of foreign direct investments is often a discussion topic at various levels. Impact of foreign direct investments on a host country becomes the subject of professional economic or political debates. There is a general consensus in the professional literature on the positive effect of FDI on the home economy. Conclusions of empirical studies prove that the FDI effects are not explicit. Some effects are even hardly to be quantified. Many authors, e.g. Kucera et al. (2010) state that investment incentives do not contribute to the reduction of regional disparities and they warn that if an investor takes advantage of the provided incentives, this may be a sign of so-called incentive tourism, i.e. the investors may shift their activities into other region after they run out all the investment incentives.

We therefore consider that more rational way of increasing the attractiveness of less developed regions as well as whole Slovakia for investors is to preferentially focus on other factors supporting the FDI inflow than on the provision of investment incentives for selected foreign investors. In particular, there shall be the overall improvement of business environment and infrastructure, improvement of innovative and education system, reduction in tax burden, preferably in connection with the business contribution to job creation and the growth of innovative performance. The great positive of such approach is the fact that the home business sector would not be discriminated. Provision of fiscal incentives (such as tax allowances in the form of tax holidays or tax concessions, etc.) and financial incentives (in the form of contributions to job creation, subsidies, etc.) for foreign investors is controversial, not in terms of their relevance to the decision of foreign investors on the selection of the country they place their investments in, but in terms of economic efficiency of incentives for the host country. Investment incentives also mean a decline in public revenue (fiscal incentives), resp. increase in their expenditure (financial incentives), while their benefits (of economic character, for regional development or in terms of desired structural changes in the economy) and thus backflow are often very hard to quantify. Concurrently there is a serious matter that such allowance of foreign investors is at the same time a handicap of home investors who may be forced to reduce their investments or to lay off their employees.

According to Vlachynsky (2013), investment incentives represent an expensive tool with unclear outcomes. Their volume of nearly 1.4 billion EUR (2002 - 2012) constitutes tax relief from corporate income tax (the highest share), further subsidies for tangible and intangible assets, contributions for newly created jobs (average cost per job created amounts to EUR 30,000), grants for retraining, and finally the transfer of property at a price lower than the market price. Since 2011, the investment aid has been preferentially provided in the form of tax relief. As Vlachynský suggests, current policy on investment incentives could be replaced by lower corporate tax rate or by progressive decline in contributions for low-income employees. In terms of active fiscal policy, Okali (2013) suggests general tax relief provision for corporations, which would be strictly bound to new staff hiring, while satisfying the conditions for obtaining additional demand for the production of additional staff (i.e. foreign exports of increased production, resp. its placement on the domestic market while reducing imports) This instrument would be applicable for all businesses and would be more targeted than a flat-rate decline of corporate tax rate. Similarly, other economists (e.g. Sikula et al, 2009; Kucera et al., 2010) agree that the rules for investment incentives provision should be the same for domestic as well as for the foreign enterprises. Vlachynský states that beside other negative effects (competition damage, headhunting of highly-skilled staff, deformation of investment structure, chaining of incentives), investment incentives also deform the structure of the economy. As an example, he refers to the allocation of high volume of resources into automobile industry, what caused, in Slovakia, cutback in the development of other industries; the concentration on export of products of the automobile and electrical industries are moreover increasing the instability of the production of the Slovak economy.

In case a multinational company is entering an industry in which domestic entrepreneurs have already been operating, this often leads either to crowding out or taking over by the multinational company. Domestic companies cannot do business as efficiently and be competitive to transnational companies. Moreover, domestic businessmen are not attractive to multinational companies, not even

as suppliers, because they do not fulfill the global standards regarding supply quality. There is no official Slovak statistics showing the percentage ratio of subcontracting from domestic suppliers on the total subcontracting for transnational companies. For example, Srholec (2004) state that the share of subdeliveries from domestic entrepreneurs on the total supplies within FDI realized on a greenfield is in most cases of a low level. Foreign investors tend to draw their own suppliers into a host country. Such case is typical for example in the automobile industry of Central and Eastern European countries.

Several economists, e.g. Cohort (2005), Agosin a Machado (2005), Titarenko (2006), point out to the poorly implemented policies on attracting foreign investments. When attracting foreign investors, government should evaluate total effect of such investments on the economy. Creation of thousands of new vacancies by a new foreign investor may be accompanied by the cessation of higher number of jobs due to competitiveness inability and the following closure of several businesses in an industry. Inability of domestic enterprises to compete with multinational companies in a given sector and the failure to meet high quality standards of subdeliveries required by foreign businesses is connected with technologies. Technology transfer is one of the presented FDI advantages. It can be either direct or indirect. The direct one takes place between a mother company and its subsidiary, the indirect one between the transnational company and the domestic enterprises. In case there is no indirect technology transfer, we talk about the extrusion of domestic businesses by foreign direct investments. In order to ensure technology transfer, there is, of course, a need for adequate technology absorption capacity in a country. In most cases, however, an indirect technology transfer does not occur. Görg and Greenway (2002) point out that the indirect technology transfer is not systematically evidenced in the global economy, not even on long-time series, so the assertions in favor of indirect technology transfer are overrated. Multinational companies protect their know-how and they fight back against the spread of technologies. Therefore, this fact can be considered as one of the reasons for domestic investment extrusion by foreign direct investments.

4. Conclusion

Foreign direct investments (FDI) and their considerable impact on export growth, labor productivity, technology and innovative development, and thus the process of structural changes in the economy will be an important factor in the performance growth of Slovak economy and its further development. To attract higher volume of FDI into Slovakia, to direct these investments more into such industries whose development contributes to desirable structural changes in the economy, and to continuously increase the favorable direct or indirect impacts of FDI on the economy, it is necessary to still create more attractive conditions for investment activities in the whole Slovakia, but to some extent also in its regions lagging behind. Such conditions include a wide spectrum of interrelated areas where improvements, in many cases, are not only necessary from the perspective of foreign investors but also from the perspective of the future direction of the economy. These are improving the functioning of education system and the national innovation system, support of science, research and development, further development of domestic business sector, improvement of labor market conditions, reducing the tax and contribution burden, further development of infrastructure, mostly in the regions lagging behind, and the overall improving of the business environment quality.

Slovak economy policy should focus on promoting FDI inflow into the sectors which have the highest potential for the creation of direct and indirect effects on the economy. Priority pursuit of the objective of creating the largest number of jobs can be classified as short-sighted. It would be beneficial both in terms of the FDI effects, as well as the stability of the domestic economy during adverse cyclical fluctuations to direct FDI in a balanced manner, within the realms of possibility, into more sectors, preferably into sectors with the high added value. However, it must be borne in mind that the key factor in assessing the investment attractiveness of a country is the overall development of the business environment. Such development must be seen in the context of countries of a particular region. Negative trends in the development of the business environment (in comparison

with other states of the region concerned) may be an obstacle to the allocation of investments and direct investment incentives are unlikely to achieve the desired effect.

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