FOREIGN DIRECT INVESTMENT AND ENTERPRISE DEVELOPMENT

Magdalena Byczkowska[1],
Galya Gercheva[2]

Abstract

Direct foreign investment is one of the most important part of cash flow specially for emerging economies. It is essential for economic development and comparative improvement of these countries. Direct foreign investment is connected with technology and management transfer. It also improves organization development. Investment influences industrial and employment structure and improves corporation's potential. Such investment made by international corporations aims to take over the control on the company activity. This is the focus of this paper.

Keywords: foreign direct investment, development, enterprise, industrial & employment structure

Introduction

In the initial period of transformation of the Polish economy many state-owned companies was in a similar, generally bad situation. In collision with forming a market economy within a very short time became apparent errors in the management and the huge inefficiencies throughout the past period. State-owned enterprises were poorly managed, with outdated machinery and technology, producing low-quality products, often so far subsidized, and had no chance of survival in a new environment without major restructuring. In this situation, foreign investment was essential. Hopes for the survival and development was linked primarily with foreign capital.

[1] PhD, University of Applied Sciences in Gorzów Wielkopolski, Poland.
[2] Prof. Dr. Sc, Rector of Varna Free University, Bulgaria.

The company, which has managed to find a foreign investor had a chance to survive and develop[3].

Despite numerous controversies related to the influx of foreign investment to Polish economy, one of the strategic objectives of the transformation process has become a recovering from a distance to the most advanced EU countries and increasing the competitiveness of Polish enterprises in view of the entry into the European Union. The distance between Poland and EU countries manifested, inter alia, the existence of the equity gap as well as technological gaps. A very important role in reducing these vulnerabilities was granted to foreign investment.

Foreign direct investment, in addition to the transfer of financial capital, brings transfer of knowledge and physical capital (tangible) in the form of machinery and equipment. They are considered to be one of the more effective and rapid channels for transfer of technology, know-how and managerial skills.

Basic concepts of foreign direct investment (FDI)

Contemporary world economy is characterized by emerging internationalization of the company. This process is accompanied by the growing importance of economic links between countries and their regional groupings. Although import and export is still the dominant form of foreign involvement of companies, this is only the beginning of the seventies of the XX century that contributed to the economic activities of foreign investment, which become increasingly important.

On the basic criterion of the purpose of investment, one can simply accept that foreign entities can make investment in Poland in three categories:

– Direct investment - in case of which the target is going to keep and profit from ordinary activities;
– Acquisition of real estate, what is extracted due to the nature of which can be implemented also for other purposes.[4]

An example of real recognition of foreign direct investment is their identification with vertical or horizontal extension of the business beyond the boundaries of the native country. However, this approach is very limited and often equated with transnational corporation. In financial terms the FDI are defined as:

[3] W. Polak, *Rola inwestycji zagranicznych w rozwoju polskich przedsiębiorstw* w: Przedsiębiorstwo na przełomie wieków, UMK, Toruń 2001, p. 169.

[4] 3 Ch. Kindleberger, *American Business Abroad, Six Lectures on direct investment*, Nev Heaven 1969, s. 1.

- form of the international movement of capital, that is emerging in response to the interest rate differential between the native country the host country, in which the higher the interest rate is a factor in attracting foreign capital;
- External source of financing the economy - in the balance of payments and showing the flow of foreign capital invested during the year, in a given country,
- Source of funding for transnational corporations,
- Investment capital.

Foreign direct investment is an attractive form of external funding, not only because they provide capital, but also because they do not increase the foreign debt. In addition, this form of financing implies the outflow of foreign exchange in the form of profit and dividends only when as the results are profitable. In case of foreign loans they must be repaid even investments were unprofitable. In addition, financing through foreign direct investment means the risk is shared between the investor and the country investments, while in case of foreign loan all risks shall be borne by the borrower.[5] The above definitions show FDI as a macroeconomic phenomenon. There are also specific terms of FDI in terms of microeconomics (company level). In this case, the FDI is capital investments, undertaken with a view to obtaining a direct impact on business, in which it invests, or as a provision of the new company, in which the investor already has a significant share.[6]

It is also worth of mentioning the impact of control and ownership. In this approach, the FDI are taken in order to create and increase operating overseas operators, which are controlled by a foreign investor. The degree of this control varies and depends on whether the company is 100% owned by the investor, or in parts (joint venture with a minority or a majority participation). For example, reflecting the above may be the treatment of FDI as an effect of the activities of the international organizations, that in order to attain the benefits under the aegis of the common ownership and control shall be established in other countries. This amounts to de facto control by the parent company on the use of manufacturing factors located abroad.

Another definition of the essence of foreign direct investment, which can be cited, is proposed by the IMF, the OECD and the EU.

According to the International Monetary Fund, foreign direct investment capital investments are undertaken with a view to obtain an influence on the

[5] S.P. Krugman, *Growing World Trade: Causes and Consequences*, Brookings Papers on Economic Activity, nr 1., 1995, s. 311.

[6]

activity of the enterprise in another country, including the impact on business management[7].

In turn, according to the Organisation for Economic Cooperation and Development (OECD): direct investor is an individual entrepreneur, public or private company, the government, the group of private or public companies that have direct investment in another country, in which a single foreign investor controls 10 or more percent of the ordinary shares (unprivileged) or (general meeting of shareholders) in the corporate business; or has an effective impact on the decisions of the company, where direct investment include the flow of capital in subsidiaries/subsidiaries (subsidiary), branches (branch) and associated companies (associate), where:

– subsidiary/affiliate/is defined as having legal personality, in which a foreign investor controls, directly or indirectly (through another subsidiary) for more than half of the votes in the company,
– the associated company is a company in which the investor a direct and/or its affiliates do not control more than 50% of the vote or have a decisive influence on the management of the company,
– a branch is a company not having a separate legal personality (unincorporated). This company can be permanent establishment (leading company continued operations on the foreign market), office (representative office), company or joint venture. This category includes also participated in another property company in the form of: equipment or fixed assets, intangible assets (patents, copyrights), held by a foreign investor, or equipment to be used for a period longer than 1 year.

The flow of capital in the form of direct investments means, in case of dependend company (subsidiary):

– direct investor's share in reinvested profits,
– the direct investor's share in the purchase of shares, loans (debts),
– plus net worth given by the short-term investor loans[8].

Finally, according to European Union direct investment refers to as: any kind of investments made by private individuals, commercial enterprises, industrial or financial, that can be used to create or sustain permanent and direct relationship between the provider of funds and the head of the enterprise or undertaking, for which the funds are intended to perform economic activities.[9]

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8 A. Stępniak, *Integracja regionalna i transfer kapitału. Inwestycje bezpośrednie w aspekcie klimatu inwestycyjnego w Unii Europejskiej*, Wydawnictwo Uniwersytetu Gdańskiego , Gdańsk 1996, s.77- 78.

9 I. Ostrowska, *Bezpośrednie inwestycje zagraniczne w EWG*, Wrocław 1988, s.15.

It should be mentioned that foreign direct investment are not only of a financial nature flows, they can also take the form of transfer of fixed assets, technology, can rely on the transfer of the license, the patent and the new techniques of management and organization. Theories of direct investment (table 1) are trying to explain the reasons for, and the conditions under which are taken in terms of what themes FDI NET firms undertaking the decisions to extend the activities abroad. Analyze why the transfer of the capital follows in the direction of the country.[10]

It should be also noted that it is very difficult to give a correct and accurate definition of foreign direct investment. Some of the authors dealing with these issues by taking direct investments investment prints, while others talk about those investments as the activity of multinational enterprises. Most, however, by definition, contains two elements in common:

– Each investment directly affects at least two countries (international nature of foreign direct investment),
– the issue of ownership and control, allowing you to distinguish the direct investment from portfolio investment.

Despite many inconsistencies and difficulties of interpretation to present the definition of foreign direct investment, it seems to be necessary. For the purposes of this article, adopted the definition of foreign direct investment, that will treat them as investments made by operators of the country concerned (individual entrepreneurs, private or state-owned companies, governments, groups, private or public companies) in order to obtain a sustainable impact on the activity of the enterprise in another country or create from scratch a new company abroad.

Foreign direct investment and enterprise development

One of the basic elements of the impact of foreign investment on the development of Polish enterprises is the transfer of technology, with the development of enterprises can be defined as the process of qualitative and quantitative changes or change without distinguishing between its characteristics[11]. A very large part of the research and development done for industry and innovation is carried out by transnational corporations. The

[10] E. Wojnicka, *Bezpośrednie Inwestycje Zagraniczne w Polsce 1976 – 1996* (nr 4/1997), IBnGR Gdańsk, 1997, s. 8.

[11] A. Kaczmarek, *Park naukowo- technologiczny jako narzędzie wspierania rozwoju małych i średnich przedsiębiorstw* [in:] A. Bielawska (ed.) *Uwarunkowania rynkowe rozwoju mikro- i małych przedsiębiorstw. Mikrofirma 2009*, WNUS Szczecin 2009, s. 334.

capital of the international transfer of new technology includes the export of goods, the sale of licenses and migrations of scientists and qualified technical personnel, among them the most important and most common way remain FDI.[12]

Some important phenomena for the development of enterprise (also region), associated with the transfer of technology, should include:

- skill transfer (migration of the scientific and technical personnel, training of staff),
- to stimulate the development and implementation of new technologies (for example, by working with research and development laboratories subsidiaries of foreign companies with the laboratories host countries, creating strategic alliances)
- technology transfer in the form of imported capital goods subsidiary of transnational enterprises production,
- diffusion of technology to other areas of the economy, for example. as a result of the effect of learning and demonstration effects, uświadamiającego local businesses capacity with regard to the application of new technologies and production processes (technological externalities).

In addition to technological externalities that are based on direct dependencies between economic operators, there are also the effects of emerging as a result of carrying out the dependencies through the market mechanism. These effects occur when the development of certain industries, for example. producing consumer goods, is transmitted to other areas with increasing purchasing power and consumer savings (horizontal externalities), and when the expansion of one industry affects the profitability of other industries (vertical externalities).

A more detailed specification of situations in which FDI can make cash benefits is as follows:

- investments in the industry and cheapening the product; increase in profits;
- the expansion of the industry that can generate profits in a sector that produces factors of production;
- the expansion of the industry that can lead to an increase in profits in the industry, whose product is complementary;
- the expansion of the industry that can lead to an increase in profits in the industry, whose product is a substitute;

[12] E. Czerwieniec, *Zagraniczne inwestycje bezpośrednie w gospodarce krajów wysoko rozwiniętych*, Zeszyty Naukowe- Seria II. Prace Doktorskie i Habilitacyjne z. 105. Akademia Ekonomiczna w Poznaniu, Poznań 1990, s.41-44.

– industry development that causes an increase in profits in the industry of a good consumed by people whose incomes increase as a result of industrial development.

With the influx of foreign capital the benefits may concern the management and organization, as well. These benefits may be direct, i.e. productivity growth factors, lower prices, higher earnings and tax revenues, as well as indirect, as a result of companies that learn operating on the market (for example, improving the management system by contacts with suppliers and customers, taking patterns in this regard as a result of the mobility of executives). In addition to these positive effects however, there are risks associated with inhibition of the development of the national senior managerial staff in situation, where the top managers are represented by foreigners.[13]

Transnational corporations also have an impact on the production structure in the host country. The average size of foreign subsidiaries, measured in terms of employment and sales, is much larger than domestic companies. This is a consequence of the performance of economies of scale.

Foreign companies can also have a qualitative impact on the employment of the company. This impact may be, however, in two directions. In the first case, the use of new techniques and methods of manufacture can contribute to raising the qualifications, while the second one shows that foreign investor, interested in finding the most favourable ways to increase profitability and rapid adaptation to local conditions, may choose to use simple techniques that do not require highly qualified work. Generally, however, the level of qualifications of the employees in the foreign subsidiaries is higher than in the case of domestic ones. In addition to the application of more advanced manufacturing techniques this is a consequence of the education system of workers in the company as well as an active policy in attracting highly qualified staff with local companies. In case of transnational companies there is a tendency to employ proportionally a greater number of highly skilled workers than in case of domestic ones.[14]

In addition, in many host countries it has also been observed that the goods manufactured and sold by transnational enterprises are characterized by greater participation of added value than those of local companies.

Beneficial changes in the structure of employment need not, however, apply to all industry sectors. It is highly likely that investors will contribute to an increase in the share of skilled labour in some sectors and to the

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[13] E. Czerwieniec, *Zagraniczne...*, op. cit. s. 49.

[14] S. Luc, *Zagraniczne inwestycje bezpośrednie a przekształcenia strukturalne w przemyśle polskim*. Monografie i Opracowania. Zeszyt 475. SGH, Warszawa 2000, s. 26-29.

decline in the others. It depends on the type and age of the investment, the economic environment and market structure of the host country.

Companies with the participation of foreign capital can also facilitate the process of adaptation of Polish enterprises to changes occurring in the global economy. According to J. H. Dunning, transnational corporations[15]:

– generally fall in case of the most dynamically developing sectors,
– are interested in the most dynamically developing economies
– generally have higher productivity and profit margins.

At the end of the entry of foreign corporations they can affect change in the degree of concentration of production. In this field there are two contradictory hypotheses. According to the first one, corporations are likely to increase competition and reduce the degree of concentration of production, while in case of the second: thanks to the possession of an unique ownership, advantages can create barriers for potential competitors or by its aggressive policy displace already operating competitors and consequently increase the degree of concentration.[16]

Disclosure in business effects, listed above, depends to a large extent on the scale and structure of foreign direct investment and the progress in system transformation. To meet the second condition one shall decide how the current economic environment will be extended towards the promotion of market behavior.

Conclusions

Foreign direct investment is a very important form of capital flow, especially for countries in transition. They are one of the most important factors for the development of Polish enterprises, relating to: transfer of technology, new management methods and general progress. In addition, FDI affect the industrial structure and employment structure, strengthening the position of the company.

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[15] J. H. Dunning, *Multinational enterprises...*, op. cit. s. 428.
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