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## Role of multinational companies in developing markets: A special reference to India

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### Introduction

In today's global economy MNCs are playing an important role especially in emerging markets. But what are MNCs? Multinational corporations are those large firms which are incorporated in one country but which own, control or manage production and distribution facilities in several countries. Therefore, these multinational corporations are also known as transnational corporations.

They transact business in a large number of countries and often operate in diversified business activities. Multinational companies (MNCs) play an important role in linking rich and poor economies and in transferring capital, knowledge, ideas and value systems across borders of different countries. Their interaction with institutions, organizations and individuals generates both positive and negative spillovers for various groups of stakeholders in both the home and host countries.

A good understanding of the role of MNCs in emerging economies is vital both for policymakers and for MNCs themselves. Policymakers are today influencing the regulatory regime under which both MNCs and local business partners operate. They are interested in understanding how foreign direct investment (FDI) influences economic development and national welfare. This is critically important for emerging markets as the sole purpose of their policy framework is to achieve increased levels of economic development for their country.

The expectation that FDI will benefit the local economy has motivated many governments to offer attractive incentive packages to entice investors. The rationale is that the social benefits of inward FDI would exceed the private benefits of FDI, and investors would take into account only the latter when deciding over investment locations.

Despite the policy relevance, the impact of MNCs on host economies is not well understood. Some FDI is good, almost certainly some is harmful. It is difficult to assess which FDI falls into which category. Thus, the interest in analyzing the role and impact of MNCs.

### Modes of Foreign Investment by MNCs

There are various modes of foreign investment. The three main modes are:

#### 1. Agreement with Local Firms for Sale of MNCs Products

A multinational firm can enter into an agreement with local firms for exporting the product produced by it in the home country to them for sale in their countries. In this case, a multinational firm allows the foreign firms to sell its product in the foreign markets and control all aspects of sale operations.

#### 2. Setting up of Subsidiaries

The second mode for investment abroad by a multinational firm is to set up a wholly owned subsidiary to operate in the foreign country. In this case a multinational firm has complete control over its business operations ranging from the production of its product or service to its sale to the ultimate use or consumers.

A subsidiary of a multinational corporation in a particular country is set up under the company act of that country. Such subsidiary firm benefits from the managerial skills, financial resources, and international reputation of their parent company. However, it enjoys some independence from the parent company.

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### **3. Branches of Multinational Corporation**

Instead of establishing its subsidiaries, Multinational Corporation can set up their branches in other countries. Being branches they are not legally independent business unit but are linked with their parent company.

### **4. Foreign Collaboration or Joint Ventures:**

Thirdly, the multinational corporations set up joint ventures with foreign firms to either produce its product jointly with local companies of foreign countries for sale of the product in the foreign markets. A multinational firm may set up its business operation in collaboration with foreign local firms to obtain raw materials not available in the home country. More often, to reduce its overall production costs multinational companies set up joint ventures with local foreign firms to manufacture inputs or subcomponents in foreign markets to produce the final product in the home country.

### **5. Role of MNCs in India**

Prior to 1991 Multinational companies did not play much role in the Indian economy. In the pre-reform period the Indian economy was dominated by public enterprises. To prevent concentration of economic power industrial policy 1956 did not allow the private firms to grow in size beyond a point. By definition multinational companies are quite large and operate in several countries.

While multinational companies played a significant role in the promotion of growth and trade in South-East Asian countries they did not play much role in the Indian economy where import-substitution development strategy was followed. Since 1991 with the adoption of industrial policy of liberalization and privatization, the role of private foreign capital has been recognized as important for rapid growth of the Indian economy.

Since source of bulk of foreign capital and investment are MNCs, they have been allowed to operate in the Indian economy subject to some regulations. The role of these corporations has been increasingly recognized in India in the post reform period. The following are the important reasons for this change in policy towards multinational companies in the post-reform period:

### **6. Promotion of Foreign Investment**

In the recent years, external assistance to developing countries has been declining. This is because the donor developed countries have not been willing to part with a larger proportion of their GDP as assistance to developing countries. MNCs can bridge the gap between the requirements of foreign capital for increasing foreign investment in India.

The foreign investment policies pursued since 1991, have allowed MNCs to make investment in India subject to different ceilings fixed for different industries or projects. However, in some industries 100 per cent export-oriented units (EOUs) can be set up. It may be noted, like domestic investment, foreign investment has also a multiplier effect on income and employment in a country.

For example, the effect of Suzuki firm's investment in Maruti Udyog manufacturing cars is not confined to income and employment for the workers and employees of Maruti Udyog but goes beyond that. Many workers are employed in dealer firms who sell Maruti cars.

Moreover, many intermediate goods are supplied by Indian suppliers to Maruti Udyog and for this many workers are

employed by them to manufacture various parts and components used in Maruti cars. Thus their incomes also go up by investment by a Japanese multinational in Maruti Udyog Limited in India.

### **7. Non-Debt Creating Capital inflows**

In pre-reform period in India when foreign direct investment by MNCs was discouraged, we relied heavily on external commercial borrowing (ECB) which was of debt-creating capital inflows. This raised the burden of external debt and debt service payments reached the alarming figure of 35 per cent of our current account receipts.

This created doubts about our ability to fulfill our debt obligations and there was a flight of capital from India and this resulted in balance of payments crisis in 1991. As direct foreign investment by multinational corporations represents non-debt creating capital inflows we can avoid the liability of debt-servicing payments.

Moreover, the advantage of investment by MNCs lies in the fact that servicing of non-debt capital begins only when the MNC firm reaches the stage of making profits to repatriate. Thus, MNCs can play an important role in reducing stress strains and on India's balance of payments (BOP).

### **8. Technology Transfer**

Another important role of multinational corporations is that they transfer sophisticated technology to developing countries which are essential for raising productivity of working class and enable us to start new productive ventures requiring high technology.

Whenever, multinational firms set up their subsidiary production units or joint-venture units, they not only import new equipment and machinery embodying new technology but also skills and technical know-how to use the new equipment and machinery.

As a result, the Indian workers and engineers come to know of new superior technology and the way to use it. In India, the corporate sector spends a very small fraction of its resources on Research and Development (R&D). It is the big MNCs which can spend resources on the development of new technologies which in turn benefits the developing countries by transferring the new technology developed by them. Therefore, MNCs can play an important role in the technological up-gradation of the Indian economy.

### **9. Promotion of Exports**

With extensive links all over the world and producing products efficiently and therefore with lower costs multinationals can play a significant role in promoting exports of a country in which they invest. For example, the rapid expansion in China's exports in recent years is due to the large investment made by multinationals in various fields of Chinese industry.

In recent years, Japanese automobile company Suzuki made a large investment in Maruti Udyog with a joint collaboration with Government of India. Maruti cars are not only being sold in the Indian domestic market but are exported in a large number to the foreign countries. Samsung, LG, Honda have all contributed to better technologies coming into India.

### **10. Investment in Infrastructure**

With a large command over financial resources and their superior ability to raise resources both globally and inside India it is seen that multinational corporations also invest in infrastructure such as power projects, modernization of

airports and posts, telecommunication.

The investment in infrastructure gives a boost to industrial growth and helps in creating income and employment in the India economy. The external economies generated by investment in infrastructure by MNCs would in turn crowd in investment by the indigenous private sector and will therefore stimulate higher economic growth.

In view of above, even Common Minimum Programme of the present UPA government provides that foreign direct investment (FDI) will be encouraged and actively sought, especially in areas of (a) infrastructure, (b) high technology and (c) exports, and (d) where domestic assets and employment are created on a significant scale.

### 11. A Critique of Multinational Corporations

In recent years foreign direct investment through multinational corporations has vastly increased in India and other developing countries. In the increasingly liberalized economic environment multinational corporations which are in search for global profits are induced to make investment in developing countries.

As explained above, foreign direct investment by multinational firms bring many benefits to the recipient countries but there are many potential dangers and disadvantages from the viewpoint of economic growth and employment generation.

Therefore, role of multinational corporations in India and other developing countries has its negative side as well. Some of the criticisms levelled against multinational corporations are as follows:-

### 12. Capturing Markets

The biggest risk of having MNCs in developing countries is that the MNCs with their large resource and competitive strength tend to eliminate competition from domestically produced goods and thus capture the market.

This is especially done by lowering prices to such an extent that the local firms with limited resources are not able to sustain the heavy losses and succumb to it. When these firms are eliminated then the MNCs slowly raise their prices again and thus succeed in capturing markets.

### 13. Use of Capital-intensive Techniques

It has been seen that increasing capital intensity in modern manufacturing sector is responsible for slow growth of employment opportunities in India's industrial sector. These capital-intensive techniques may be imported by large domestic firms but presently they are being increasingly used by multinational corporations which bring their technology when they invest in India.

Emphasizing this factor, Thirwall rightly writes, "In this case the technology may be inappropriate not because there is not a spectrum of technology or inappropriate selection is made but because the technology available is circumscribed by the global profit maximizing motives of multinational companies investing in the less-developed country concerned

### 14. Encouragement to Inessential Consumption

The investment by multinational companies leads to overall increase in investment in India but it is alleged that they encourage conspicuous consumption in the economy. These companies cater to the wants of the already well-to-do people. For example, in India very expensive cars (such as Honda City, Hyundai Accent, Mercedes, Audi, BMW etc.) the air conditioners, costly laptops, washing machines,

expensive fridges, 29" and Plasma TVs are being produced/sold by multinational companies.

Such goods are quite inappropriate for a poor country like India. Besides, their consumption has a demonstration effect on the consumption of others. This tends to raise the propensity to consume and adversely affects the increase in savings of the country.

### 15. Import of Obsolete Technology

Another criticism of MNCs is based on the ground that they import obsolete machines and technology. As mentioned above, some of the imported technologies are inappropriate to the conditions of Indian economy. It is alleged that India has been made a dumping ground for obsolete technology. Moreover, the multinational corporations do not undertake Research and Development (R&D) in India to promote local technologies suited to the Indian factor-endowment conditions. Instead, they concentrate R&D activity at their headquarters.

### 16. Setting up Environment-Polluting Industries

It has been found that investment by multinational corporations in developing countries such as India is usually made for capturing domestic markets rather than for export promotion. Moreover, in order to evade strict environment control measures in their home countries they set up polluting industrial units in India.

A classic example of this is a highly polluting chemical plant set up in Bhopal resulting in gas tragedy when thousands of people were either killed or made handicapped due to severe ailments. "With the tightening of environmental measures in such countries, there is a tendency among the MNCs to locate the polluting industries in the poor countries, where environmental legislation is non-existent or is not properly implemented, as exemplified in the Bhopal gas tragedy".

### 17. Volatility in Exchange Rate

Another major consequence of liberalised foreign investment by multinational corporations is its impact on the foreign exchange rate of the host country. Foreign capital inflows affect the foreign exchange rate of the Indian rupee.

A large capital inflow through foreign investment brings about increase in the supply of foreign exchange say of US dollars. With demand for foreign exchange being given, increase in supply of foreign exchange will lead to the appreciation of exchange rate of rupee.

This appreciation of the Indian rupee will discourage exports and encourage imports causing deficit in balance of trade. For example, in India in the fiscal years 2004-05 and 2005-06, there were large capital inflows by FII (giant financial multinationals) in the Indian economy to take advantage of higher interest rates here and also booming of the Indian capital market.

On the other hand, when interest rates rise in the parent countries of these multinationals or rates of return from capital markets go up or when there is loss of confidence in the host country about its capacity to make payments of its debt as happened in case of South-East Asia in the late nineties there is large outflow of capital by multinational companies resulting in the crisis and huge depreciation of their exchange rate. Thus, capital inflows and outflows by multinationals have been responsible for large volatility of exchange rate.

Then there is the question of repatriation of profits by the multinationals. Though a part of profit is reinvested by the

multinational companies in the host country, a large amount of profits are remitted to their own parent countries.

This has a potential disadvantage for the developing countries, especially when they are facing foreign exchange problem. Commenting on this Thirwall writes “FDI has the potential disadvantage even when compared with loan finance, that there may be outflow of profits that lasts much longer.

### **18. Transfer Pricing and Evasion of Local Taxes**

Multinational corporations are usually vertically integrated. The production of a commodity by multinational firm comprises various phases in its production the components used in the production of a final commodity may be produced in its parent country or in its affiliates in other countries.

Transfer pricing refers to the prices a vertically integrated multinational firm charges for its components or parts used for the production of the final commodity, say in India. These prices of components or parts are not real prices as determined by demand for and supply of them.

They are arbitrarily fixed by the companies so that they have to pay less taxes in India. They artificially inflate the transfer prices for intermediate products (i.e., components) produced in their parent country or their overseas affiliates so as to show lower profits earned in India. As a result, they succeed in evading corporate income tax.

### **19. Conclusion**

We have seen above foreign investment by multinational companies have both advantages and disadvantages. In other words they have both positive and negative spillovers. Therefore, they need regulation and should be permitted in selected sectors and also subject to a cap on their investment in particular fields. If objective of economic growth with stability and social justice is to be achieved, there should not be complete open door policy for them.

It is true that multinational corporations take risks in making investment in India, they bring capital and foreign exchange which are non-debt creating, they generally promote technology and can help in raising exports. But they must be regulated so that they serve these goals.

They should be allowed to invest in infrastructure, high-technology areas, and in industries whose products they can export and if they help in generating net employment opportunities. Colman and Nixon have correctly argued:

“Transnational corporations cannot be directly blamed for lack of development (or the direction development is taking) within less developed countries. Their prime objective is global profit maximization and their actions are aimed at achieving that objective, not developing the host less developed country. If the technology and products that they introduce are inappropriate, if their actions exacerbate regional and social inequalities, if they weaken the balance of payments position, in the last resort it is up to the government of less developed country to pursue policies which will eliminate the causes of these problems.”

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