JULY 2008 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The Social Impact of Foreign Direct Investment

Introduction

Multinational enterprises (MNEs) have become one of the key drivers of the world economy and their importance continues to grow around the world. The increased influence of OECD-based MNEs in developing countries is particularly striking. Today, developing countries account for almost one-third of the global stock of inward foreign direct investment (FDI), compared to slightly more than one fifth in 1990.

The increased role of FDI in developing and emerging economies has raised expectations about its potential contribution to their development. FDI can bring significant benefits by creating high-quality jobs and introducing modern production and management practices. And many governments have developed policies to further promote inward FDI.

However, the activities of multinational enterprises abroad have also aroused much controversy and social concerns. For example, MNEs have been accused of practicing unfair competition when taking advantage of low wages and labour standards abroad. In some cases, MNEs have also been accused of violating human and labour rights in developing countries where governments fail to enforce such rights effectively. In many OECD countries, civil society has appealed to MNEs to ensure that internationally-recognised labour norms are respected throughout their foreign operations.

This *Policy Brief* presents the main insights from OECD work on the social impact of inward FDI in host countries. It looks at how much MNEs contribute to better working conditions in host countries and what governments, in both home and host countries, can do to promote good work practices by MNEs. ■

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How important is FDI for developing countries?

During the past 15 years, the importance of FDI in the world economy has increased rapidly. The total stock of FDI increased from 8% of world GDP in 1990 to 26% in 2006. Although the bulk of FDI continues to take place between OECD countries, the increase in FDI has been particularly pronounced in developing countries, largely reflecting the integration of large emerging economies, the so-called BRICs (Brazil, Russia, India and China), into the world economy.

The increase of FDI into developing countries has been spectacular. The share of non-OECD countries in the global stock of inward FDI has risen from 22% in 1990 to 32% in 2005 (see Figure 1). China is by far the most important non-OECD country as a recipient of FDI, accounting for about one third of FDI in non-OECD countries in 2005. However, FDI inflows also tend to be sizable in many other emerging countries. Indeed, since the mid-1990s, inward FDI has become the main source of external finance for developing countries and is more than twice as large as official development aid.

Developing countries have also become increasingly active as foreign direct investors themselves. The share of non-OECD countries in the global stock of outward FDI has risen from 10% in 1990 to 17% in 2005. The rise in outward FDI in emerging economies reflects predominantly the increase in FDI between non-OECD countries (South-South FDI). Outward FDI by emerging economies into the OECD remains relatively small, despite recurrent claims in the popular media that developing countries are acquiring strategic assets in OECD countries. ■

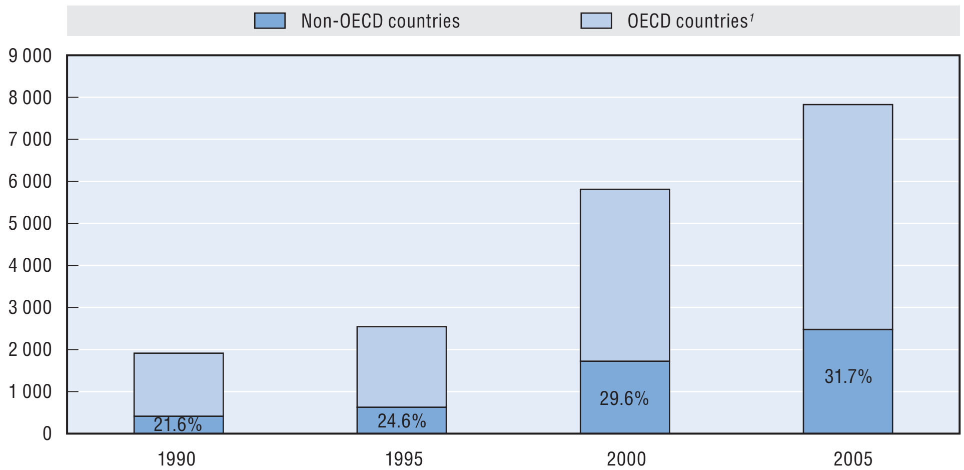
How does FDI affect workers?

MNEs tend to have various advantages compared to purely domestic firms that allow them to compete successfully in foreign markets, despite the additional cost of having to coordinate activities across different countries. They may derive this advantage from their technological know-how, easier access to capital or modern management practices. The potential benefits

FIGURE 1.

FOREIGN DIRECT INVESTMENT IN NON-OECD COUNTRIES HAS RISEN RAPIDLY

Inward FDI stocks in billions of US dollars at constant prices (2000), 1990-2005



1. Corresponds to the 30 OECD member countries.

Source: *OECD Employment Outlook 2008*, Paris.

of inward FDI depend on the extent to which local firms and workers can benefit from these assets.

One way that FDI can be beneficial for host economies is by creating high-quality jobs that are associated with higher pay and better working conditions. While there is no reason, in general, to expect MNEs to offer better jobs than their local counterparts, under certain circumstances, MNEs may find it in their interest to share their productivity advantage with their employees. For example, MNEs may wish to rely more heavily on pay incentives to ensure quality and productivity, given the higher cost of monitoring production activities from abroad. MNEs may also offer above-market wages in an effort to reduce worker turnover and minimise the risk of their productivity advantage spilling over to competing firms.

FDI by OECD-based MNEs may also affect the quality of jobs available in domestic firms when there are knowledge spillovers from foreign to domestic firms. For example, domestic firms may learn from foreign firms by collaborating with them in the supply chain. Knowledge transfers may also result from worker mobility, when domestic firms recruit workers with experience in foreign firms. Finally, increased product-market competition as a result of FDI may strengthen incentives among domestic firms to improve their efficiency. However, FDI does not necessarily have positive effects on the performance of local firms. Under certain circumstances, it may lead to the crowding out of local firms, reducing their ability to operate at an economically efficient scale. ■

Are working conditions in MNEs better than in local firms?

According to the conventional wisdom, foreign MNEs offer better pay than their local counterparts and foreign-domestic pay differences are particularly important in the context of developing countries. The difference in pay offered by domestic firms and MNEs may reflect the greater technology gap between foreign MNEs and local firms in less developed countries. This view is based on a substantial body of research using information on cross-border takeovers to identify the effect of foreign ownership on average wages within firms.

Recent OECD work, however, suggests a rather more complex picture. Figure 2 presents new OECD evidence on the effects of foreign takeovers on average wages for two emerging economies (Brazil and Indonesia) and three OECD countries (Germany, Portugal and the United Kingdom). It shows that foreign takeovers raise average wages within firms in the short-term, particularly in emerging economies. Wages are estimated to grow between 10% and 20% following foreign takeovers in Brazil and Indonesia, and between 0% and 10% in the three OECD countries.

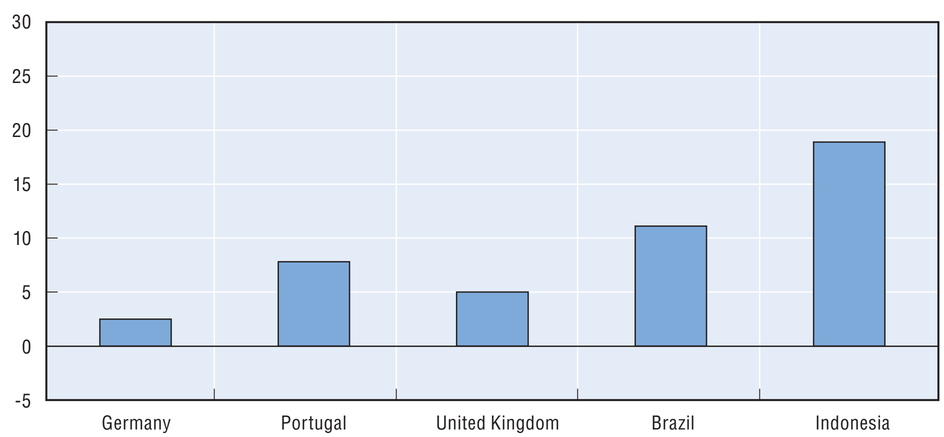
However, as these figures show the effect on average wages, it is impossible to tell how the change is distributed across the workforce and, particularly, whether the increase in average wages reflects wage gains for incumbent workers or instead changes in the skill composition of the workforce. To the extent that foreign takeovers lead to skill upgrading, the evidence overestimates the positive effects of takeovers on *individual* wages.

Figure 3 presents new OECD evidence on the effects of foreign ownership by focusing directly on individual workers. Foreign takeovers of domestic firms have a small positive effect on the wages of existing workers in Brazil, Germany and Portugal in the short-term, ranging from 1% to 4% and no effect in the UK. The absence of a positive effect in the United Kingdom may reflect the relative flexibility of the UK labour market compared to the other countries, which makes it hard to sustain differences in pay for identical workers across firms. While the short-term impact of takeovers on incumbent workers is modest, the role of foreign ownership is more substantial for new hires. This is indicated by the relatively large wage gains of workers who move from domestic to foreign firms. They range from 6% in the United Kingdom to 8% in Germany, 14% in Portugal and 21% in Brazil.

In sum, the new evidence confirms that FDI may have a substantial positive effect on wages in foreign-owned firms in the host country, even when the focus is on the short-term impact of cross-border mergers and acquisitions. And consistent with the conventional wisdom, the positive wage effects are more pronounced in emerging economies. Furthermore, the positive impact of FDI resides primarily in better job opportunities for new employees, rather than better pay for workers who stay in firms that happen to change ownership. This may reflect more competitive conditions in the market for new hires that allow new employees to more widely share the productivity advantages of MNEs. In the longer term, however, one would expect the positive effects to spread across the entire workforce, as large pay disparities between new and old workers within firms are unlikely to be sustainable.

The question whether MNEs also promote improvements in other aspects of workers' employment conditions, such as training, working hours and job stability, is more complex and the existing evidence is scarce. Studies

FIGURE 2.
FOREIGN TAKEOVERS RAISE AVERAGE WAGES
The short-term effects of foreign takeovers on average wages[1]
Evidence from firm-level data (% differences)



1. Average effects over the first three years after the takeover.
Source: *OECD Employment Outlook 2008*, Paris.

that have looked into this issue suggest that MNEs have a low propensity to export non-wage working conditions abroad. New analysis by the OECD suggests that, in contrast to wages, non wage working conditions do not necessarily improve following a foreign takeover. Even when they do, it is not clear whether these effects derive from a centralised policy to maintain high labour standards or merely reflect the optimal responses by MNEs to local conditions. ■

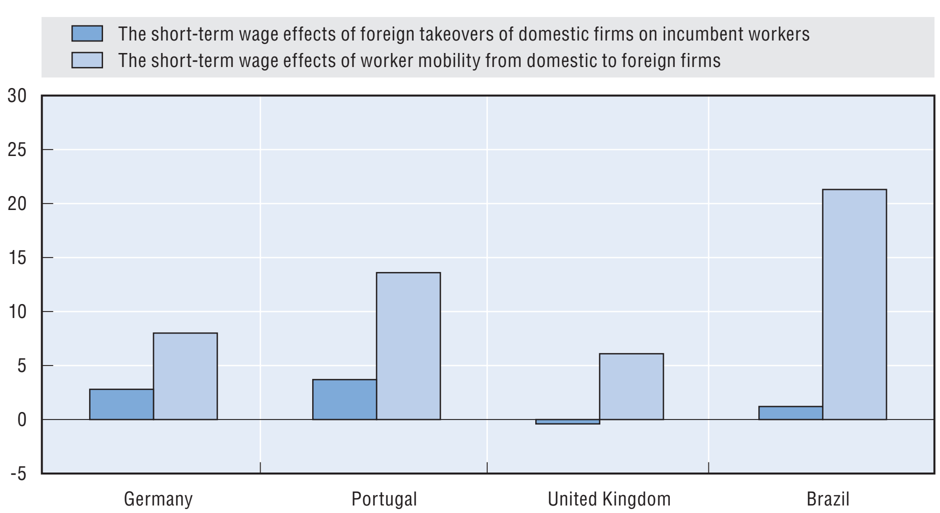
How does FDI affect the wider economy?

In addition to having direct effects on workers employed by MNEs, FDI may also have indirect effects on workers' employment conditions in domestic firms when there are knowledge spillovers associated with FDI. The effect on workers in domestic firms, however, is considerably weaker than the direct effect on employees of foreign affiliates of MNEs.

It is true that FDI typically has a strong effect on average wages in local firms, but this largely reflects the competition among foreign and domestic firms for local workers. In principle, FDI could also affect wages in local firms through its impact on the productivity in those firms. Positive productivity-driven wage spillovers are likely to be more important when there are strong links between local firms and foreign MNEs, such as through the participation of local firms in the supply chain or through worker mobility. New OECD evidence indicates that average wages are a little higher in local firms which participate in these supply chains or recruit managers with prior experience in MNEs, than in local firms with no apparent link to MNEs.

Do the potential benefits of FDI for workers also help to improve the performance of the labour market as a whole? This question is more difficult to address. First, it depends on whether FDI increases labour market inequality or labour market segmentation. The previous literature suggests

FIGURE 3.
FOREIGN OWNERSHIP MATTERS PARTICULARLY FOR NEW HIRES
Evidence based on worker-level data (% differences)[1]



1. Average effects over the first three years after the takeover.

Source: OECD *Employment Outlook 2008*, Paris.

that inward FDI may contribute to higher earnings inequality, particularly in developing countries, by raising the relative earnings of skilled workers. However, there is little evidence to suggest that FDI leads to an expansion of the informal sector or non-compliance with labour standards. The effects of FDI on the performance of the labour market as a whole also depend on its effects on overall efficiency. The positive wage effects of inward FDI may be a *prima facie* indication of its impact on productivity resulting from the transfer of modern production and management practices. The bottom-line may be that the overall effects of inward FDI on the host country are positive, but that the benefits are not evenly spread over the host-country population. ■

How can governments ensure that FDI boosts development?

The positive effects of inward FDI for workers in host economies suggest that FDI-friendly policies could be a useful component of an integrated policy framework for development. When designing policies to promote FDI, policy-makers should take into account that these may not only affect the volume of inward FDI, but also its composition and, as a result, its corresponding benefits. The *OECD Policy Framework for Investment* provides a useful starting point. For a start, removing specific regulatory obstacles to inward FDI could be important. Under certain circumstances, it may also be appropriate to provide specific incentives to potential foreign investors. However, such targeted policies should not become a substitute for policies aimed at improving the business environment more generally. By contrast, lowering core labour standards in an effort to provide a more competitive environment for potential investors is likely to be counter-productive. It does not appear to be effective in attracting FDI and is likely to discourage investment from responsible MNEs, for whom it is important to ensure that minimum labour standards are respected throughout their operations.

FDI-friendly policies in host countries can be usefully complemented by multilateral initiatives that seek to enhance the social benefits of inward FDI by promoting responsible business conduct amongst MNEs. The *OECD Guidelines for Multinational Enterprises* provide a good example of a government-backed initiative that aims to promote responsible business conduct. The Guidelines are most widely known for their system of National Contact Points (NCPs) through which disputes between relevant stakeholders with respect to the implementation of the guidelines can be addressed. Since its revision in 2000, more than 160 cases have been raised at the NCPs. Most of these have dealt with employment, labour and industrial-relations issues. The increasing share of these cases related to labour issues in non-OECD countries suggests that the OECD Guidelines are playing a growing role in the improvement of labour conditions worldwide.

There is also an important role for public initiatives that are specifically designed to raise labour practices in the supply chain. For example, by generating greater transparency in labour practices, improved public monitoring can strengthen the incentives for responsible business conduct among supplier firms. To enhance the attractiveness of their products to responsible buyers, technical assistance and credit facilities may be required to help supplier firms overcome obstacles to improved labour practices in the production process. *The Better Work Program*, a joint initiative launched by the International Finance Corporation (a member of the World Bank Group) and the International Labour Organisation in 2006, is a promising initiative that attempts to raise working conditions in the workplaces of supply-chain factories through the enhanced public monitoring of labour practices and the provision of technical assistance and credit facilities to program participants. ■

For further information

For more information about this *Policy Brief* and OECD work on the social impact of FDI in host countries, please contact: Alexander Hijzen, tel.: +33 1 45 24 92 61; or e-mail: alexander.hijzen@oecd.org, or visit ***www.oecd.org/els/employment***.

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For further reading

OECD (2003), **OECD Guidelines for Multinational Enterprises**, Revision 2000, Paris: OECD. ISBN: 978-92-64-03397-9, 67 pages, available at ***http://publications.oecd.org/acrobatebook/2100201E.PDF.***

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OECD (2008a), **"Do Multinationals Promote Better Pay and Working Conditions?"** *OECD Employment Outlook,* Paris. ISBN: 978-92-64-04632-0, € 80, 370 pages.

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