

# Economics 404W

## lecture 28

Professor Tybout  
April 27, 2006

Announcements: Final writing assignment posted; due May 1 by 5 pm

## Host Country Effects of FDI, outsourcing

### Effects on wages

- To the extent that globalization creates extra demand for labor in the developing countries, it is putting upward pressure on wages there.
- This should be true whether the extra demand comes from FDI or from local firms acting as suppliers to northern markets.
- A positive effects of FDI on wages in general have been documented in some cases—e.g., Ireland.
- It is well established that subsidiaries pay more than their local counterparts. Differentials range from 6 to 26 percent in developed countries, and from 10 to 260 percent in developing countries. (Why?)

## Host Market Effects of FDI, outsourcing

### Sweatshops:

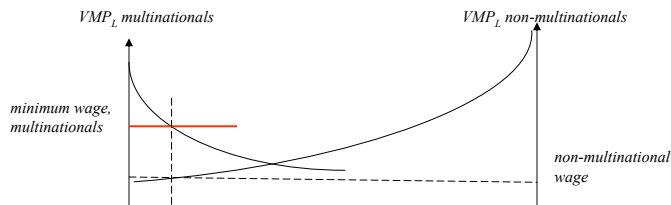
- Although multinationals pay their workers more than their competitors, many people have complained that multinationals exploit their workers in sweatshop conditions, and have demanded that products from these sweatshops be banned from U.S. markets (Brown, Deardorff and Stern, 2004).
- Two major anti-sweatshop organizations have emerged: Fair Labor Association (FLA, 1998) and the Workers Rights Consortium (WRC, 1999).
- FLA is more closely associated with the apparel industry; WRC more closely associated with unions. Both developed codes of conduct and enforcement mechanisms.

## Host Market Effects of FDI, outsourcing

### Sweatshops, continued

- The two groups differ on wage policy:
  - FLA: employers shall pay employees, as a floor, at least the minimum wage required by local law or the prevailing industry, whichever is higher, . . . “
  - WRC: “licensees shall pay employees, as a floor, wages and benefits which comply with all applicable laws and regulations, and which provide for essential needs and establish a dignified living wage for workers and their families . . . .” [A living wage provides the basic needs of an average family unit of employees in the garment manufacturing employment sector of the economy]
- So most subsidiaries satisfy the FLA code, but many do not satisfy the WRC code. If it were to be enforced, what would happen?

## Host Market Effects of FDI, outsourcing



### Anti-sweatshop minimum wages

- If the multinational does not leave, a minimum wage for multinationals only can lead to heightened inequality and job queuing.
- How are multinational profits affected by the minimum wage?
- Among workers, who benefits, and who is hurt?

## Host Market Effects of FDI, outsourcing

### Child labor

- Why ban child labor? if you believe that certain minimal standards of human behavior are fundamental, and that children cannot make decisions in their own interest.
- A global ban on child labor would not simply re-direct FDI (as would “living wage” regulations).
- One problem: distinguishing exploitative child labor from children helping out on family farms in non-exploitative ways.
- Another problem: how to enforce such a ban. The International Labor Organization (ILO) has no enforcement powers. The WTO doesn't want to get involved.

## Host Market Effects of FDI, outsourcing

### Child labor, continued

- Does globalization encourage child labor? Not obviously:
  - Vietnamese experiences went the other way—increased income among rural households led to more schooling and less child labor among rural children.
  - Edmunds and Pacvnik (2005) “find a negative but statistically insignificant association between openness and child labor conditional on cross-country income . . .”

## Host Market Effects of FDI, outsourcing

### International technology diffusion

- A large fraction of the R&D and innovation in the world comes from multinationals.
- Multinationals generally try to protect their technological advantage rather than let it diffuse. But some of the expertise embodied in the multinational is likely to spill over to domestic firms:
  - As employees turn over.
  - Through shared domestic suppliers.
  - Through demonstration effects
  - Through competitive pressures (?)

## Host Market Effects of FDI, outsourcing

### International technology diffusion: the evidence

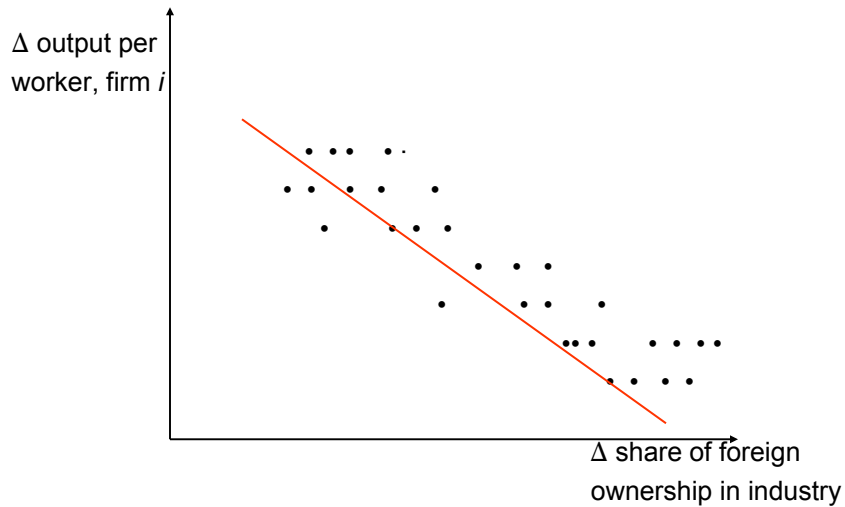
- Upstream suppliers may learn from subsidiaries, and their domestically-owned clients benefit.
  - Especially when subsidiaries are part of global supply chain, parent company has incentives to maintain quality, punctuality (Moran, 2001). Examples:
    - Mexican auto parts producers organized coordination meetings, technical training and managerial training for their local suppliers
    - Japanese auto assembly firms in Thailand organized “cooperation clubs” to assist with quality control, cost reduction, product improvement
    - Semi-conductor producers in Malaysia have also provided tech. assistance.

## Host Market Effects of FDI, outsourcing

### International technology diffusion: the evidence

- There are instances where labor turnover has led to learning spillovers.
- It's difficult to say how pervasive these phenomena are, however. Econometric studies generally don't pick up strong systematic effects.
- In the short run, they sometimes find negative association between FDI and domestic firms' performance.

## Evidence on International technology diffusion



## FDI policies in host countries

- Many countries want to attract FDI, and pursue policies to do so. Some policies are sensible in their own right:
  - Stable, sustainable macro policies translate into relatively steady growth, with few crises. When they do, the country is relatively attractive.
  - An effective legal system and protection of property rights are also important from the multinational's perspective.
  - Informational, marketing efforts to educate potential investors.

## FDI policies in host countries

- Some countries go beyond these policies:
  - Trade barriers to encourage domestic production.
  - Tax breaks
  - Exclusive rights to the domestic market
  - Complementary services, including infrastructure

## FDI policies in host countries

- Countries have also tried to ensure that spillovers take place, once the subsidiary is there:
  - Local content requirements ensure upstream suppliers are part of the action.
  - Local R&D requirements are an effort to prevent multinationals from simply outsourcing the low skill, labor intensive stages of production rather than bringing sophisticated processes to the host country.
  - Local hiring requirements for managerial and skilled personnel, to develop an indigenous stock of expertise.

## FDI policies in host countries

- Have these policies attracted investment?
  - Regression analyses have shown that many of the policies described above do induce FDI.
  - But when captive markets are created for multinationals, the effect can actually be to reduce the value of GDP at world prices. Case studies suggest that this has happened in a significant minority of cases.
  - When FDI reduces national income, it's not because the multinationals are losing money. It's because there are large discrepancies between domestic and world prices.

## FDI policies in host countries

- Are the payoffs worth it?
  - The subsidiaries do often bring newer technologies in, and they typically pay above-market wages to their employees.
  - But as already noted, the magnitude of the spillover effects is debatable, and sweetheart deals are often not welfare-improving for the country as a whole.
  - Moran (2001) argues that the reason regression studies detect little positive spillovers is that they don't weed out FDI due to protection and/or subject to domestic content requirements.

## FDI policies in host countries

- Are the payoffs worth it (continued)?
  - When domestic content requirements or joint ownership/minority ownership requirements are in place,
    - Affiliates tend to be oriented toward the domestic market, and thus smaller. They are not typically part of a global supply chain.
    - Scale economies matter, so more protection from import competition is required. (In autos, estimated 50 percent protection needed.)
    - There are bigger lags in the diffusion of new technologies (joint ventures are estimated 3-5 years further behind wholly-owned subsidiaries).
    - Bias toward screwdriver operations, with little scope for technology spillovers.

## Causes of Underdevelopment: recap

- **Characteristics of the labor force**
  - Just too many people, or
  - inability to attain skills and education because of collateral trap, or
  - cycle of low education, high birth rates as optimal choice.

## Causes of Underdevelopment: recap

- **Insufficient incentives to invest**
  - misguided government controls choke the financial system
  - government taxes capital formation excessively
  - cycle of subsistence and high dependency rates prevents savings
  - to be profitable, K projects must be done in right environment:
  - need critical mass of other investment projects (coordination failure)
  - need infrastructure
  - need enforceable property rights

## Causes of Underdevelopment: recap

- **Problems of Interaction with the world economy**
  - not reaping benefits of foreign capital inflows, including FDI
  - not reaping the benefits of trade:
    - comparative advantage
    - x-efficiency
    - technology transfer
    - monopoly behavior
  - trade has driven country away from goods with learning potential
  - adverse external shocks: T/T, protectionism in ROW

## Causes of Underdevelopment: recap

- **Inadequate resource endowment**
  - Saharan Africa and parts of Asia (e.g., Bangladesh) are good locations for diseases, not so good for staple crops
  - Climate and topography are destiny