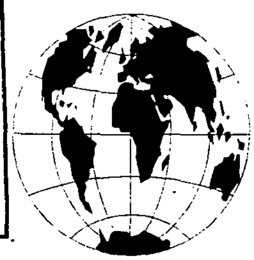
UNCLASSIFIED

LICY STAFF COMMENTARY No. 2



Outward Direct Investment: Implications for Domestic Employment

Julie Fujimura / Robert T. Stranks
Policy Analysts

Economic and Trade Policy (CPE)
Policy Staff

(April 1994)

Policy Staff Commentaries are short papers on issues of interest to the foreign policy community.
The views expressed are not necessarily those of the Government of Canada.
Comments or enquiries on Commentaries should be addressed to the author (s).

Outward Direct Investment: Implications for Domestic Employment

The effects outward direct investment (ODI) has on domestic employment are complex and not well-defined. Work by the OECD, academics and others illustrates the considerable controversy surrounding the issue and the difficulty in determining direct and indirect linkages. The OECD has concluded that, "there is a lack of systematic theoretical and empirical analysis on the inter-linkages of foreign direct investment (FDI) and employment to provide guidance to policy makers, reflecting both methodological shortcomings and data paucity."[1]

This said, the present Commentary attempts to provide an overview of the theoretical, empirical and popular views concerning the subject, and to clarify some policy issues involving the employment effects of ODI. The aggregate employment effects of ODI depend on the relative magnitudes and directions of short-term and long-term effects. Much of the existing analysis points to only a negligible aggregate effect of ODI on domestic jobs, whether positive or negative, while the direction of the aggregate effect can be country-, industry- and even case-specific. ODI can also affect the composition of the labour force, shifting employment to higher wage, white collar jobs from lower wage, blue collar jobs. The public fear of domestic job loss due to ODI will be more prevalent when there is high domestic unemployment, but less so as labour markets tighten. Therefore, policy makers should take into account the cyclical component of unemployment and be sensitive to possible future labour market conditions.

Trends and Motives of ODI

Direct investment, inward or outward, is a dynamic element in the global economy. Direct investment flows increased dramatically in the 1980s, stimulated by regulatory liberalization and firms' international production and marketing strategies. Growth in the stock of FDI was exceptionally strong in the 1985-1990 period, increasing at an average annual rate of 19.4 per cent. This slowed in 1991 to 11.2 per cent.[2] From 1985 to 1991, the world stock of FDI increased from U.S. $733 billion to $1,882 billion.

[1]OECD, *FDI and Employment*, DAFFE/IME(93)25, November 1993, p. 5.

[2]John Rutter, "Recent Trends in International Direct Investment: The Boom Years Fade", U.S. Department of Commerce, August 1993.

An interesting and important feature of FDI is that most occurs within the developed countries. In 1967, the developed countries accounted for 69.4 per cent of the world stock of inward direct investment, and 76.6 per cent in 1991. The perception that most FDI flows from developed to developing countries, attracted by lower wage rates or labour standards, is, in general, incorrect. On a regional basis, the Asian developing countries saw a marked increase in foreign inward investment during the 1980-91 period, from 7.1 per cent to 14.3 per cent of the global total. With respect to outward direct investment, however, the Asian developing countries, as with the developing countries as a whole, are not a significant source.

Foreign direct investment is undertaken for a number of reasons. Five major objectives motivating foreign direct investment have been identified.[3] These are: to facilitate the penetration of foreign markets; to take advantage of the opportunities provided by technological change; to secure a presence in all major centres of production and consumption; to keep costs down; and to increase global flexibility in production and distribution. Firms consider all these motivating factors, as well as the reliability of transportation and communications networks, political stability, social considerations, and other related factors, when deciding whether and where to undertake an investment. Firms pursue their own interests when deciding whether to undertake any investment. Job creation is not generally an explicit objective.

When ODI is motivated by the need to circumvent tariff and non-tariff barriers, the choice for the home country firm is not between exporting the product or investing in the foreign country. To not undertake the ODI would mean foregoing a potentially lucrative market, to which market access, via trade, is impeded. In this situation, there is no real choice between domestic and foreign investment; there is either investment abroad or no investment. Also, ODI in industries in which the home country has lost its comparative advantage constitutes a production strategy that might allow a firm to remain in business, when otherwise it might have closed. Again, the choice may not be between investing abroad and investing domestically, but between investing abroad or not investing at all.

Although it could be argued that it would be more beneficial for the home country to have a firm change production lines to conform with changing comparative advantages, instead of undertaking ODI, this is not always achievable. In reality, competitiveness and profitability of individual firms can depend on intangible assets

[3]Graham Vickery, "Global Industries and National Policies", in the *OECD Observer* 179, December 1992/January 1993.

such as technology, production techniques, managerial skills or other expertise. These assets are not always easily transferable to different types of products, production processes or market conditions and this restricts the number of business options open to firms.

Employment Effects of ODI

Outward direct investment has a number of effects that may influence both the aggregate level of employment and the composition of the work force. ODI has employment effects that arise from the actual investment, and economic activities stimulated by that investment. These can take the form of short-term and long-term effects. The distinction between short-term and long-term effects could be particularly important for policy makers, as they might be offsetting. For example, potential negative short-term effects, brought about by not building a plant domestically, could be offset by a strengthening of the firm's global competitive position, and the creation of intra-firm trade flows from parent to subsidiary. Some forms of ODI can even directly support exports from the home country, such as investment in sales and servicing organizations, particularly of highly differentiated products. ODI can also generate a stream of return from the host to the home country in the form of dividends, fees, royalties, etc..

Because of the complexity of these effects, it has been very difficult to estimate the amount of job loss (or gain) resulting from ODI. The possibility of job preservation, i.e., jobs saved owing to the parent company maintaining its competitiveness and increasing intra-firm exports, coupled with the fact that there would otherwise have been natural changes in the employment structure as the economy evolved, makes it more difficult to determine the net effects of ODI. It is not feasible to compare accurately a given economy with ODI, to that same economy without ODI, because no such control situation exists.

There are two separate views on the economic effects of ODI, based on different sets of assumptions. The key difference in the two sets of assumptions is the degree to which ODI complements or substitutes for domestic economic activities. The first view, that ODI is a substitute for domestic employment, results in the fear of delocalization. This refers to the concern that potential domestic investment will flow off-shore, thus reducing potential domestic employment; or that production will be transferred abroad accompanied by the closure of a domestic production facility, thus reducing current employment. The second view is that ODI is a complement to domestic activities. With this view, ODI is seen as strengthening a firm's overall competitive position, increasing exports to the new foreign affiliate, and increasing parent company sales, employment and competitiveness. This is positive for the domestic labour market.

When ODI flows to developing countries, there is often a concern that the investment is undertaken as a result of "unfair" labour conditions resulting in unjustly low labour costs against which the home country cannot compete. However, labour, or access to low cost labour, is but one of a number of factors influencing a firm's decision to undertake foreign direct investment in any particular location. A recent report on U.S. manufacturing investment abroad concluded that only 30 per cent of U.S. investment projects abroad went to low wage countries.[4]

In reality, ODI does not seem to first seek out lower wage environments. The most important aspect for a multinational corporation in the early stages of venturing into a foreign market seems to be familiarity with the market, i.e., the similarity to its own home market and culture.[5] This is reinforced by the observation that most investment is confined within OECD countries, and (somewhat) by the trend towards regionalization. However, there is a popular belief that, as investment and trade become more integrated, wage rates in the industrialized world will fall to those of the lowest common denominator of countries. This need not be the case. Real wages reflect productivity, which is influenced by a variety of factors such as skill levels, education, working capital, health, etc.. Wage differentials can be preserved even within the same industry in different countries if, for example, production techniques differ such that they are labour intensive in one country and capital intensive in another.

There is, moreover, a misconception that every job created abroad by ODI is a job taken away from the home economy. This stems from a similar belief that every dollar invested in a foreign country takes one dollar away from the home country. An easy, but incorrect, calculation is that investment undertaken off-shore would have created an equal number of jobs domestically. This calculation does not take into account relative investment climates, and ignores other decisive factors, such as proximity to markets, or resource inputs. In the face of depleted domestic resource

[4]Ernst and Young, *Global Investment by United States Manufacturing, A Review of 1992 Results.* p. 7. For a more complete survey of the investment and labour standards issue, see R. Stranks, "The New Jerusalem: Globalization, Trade Liberalization and Some Implications for Canadian Labour Policy", Department of Foreign Affairs and International Trade Policy Staff Paper No. 94/2 (February 1994).

[5]C. Taylor and G. Fosler, "The Necessity of Being Global", *Across the Board*, February 1994, p. 42.

stocks, access to a commercially exploitable resource base can often be the decisive motivating factor behind ODI (e.g., investment in the mining sector). There is also evidence that ODI improves the profitability of the parent company as it grows, allowing it to stay in business longer, remain competitive, pay home country workers better wages, etc.[6]

Nonetheless, some wage adjustments linked to the effects that ODI can have on the skill mix of the domestic labour force can, and probably will, occur. Unpublished work by Gunderson and Verma (1993) and Globerman (1993) as well as work by the OECD suggests that the labour market restructuring that occurs as a result of ODI is from low wage, blue collar jobs to higher wage, white collar jobs.[7] This is assumed to result partially from a change in the structure of exports to affiliates, which will require capital exports. Also, more managerial staff at the home office will be needed as the parent company expands. This shift in the composition of the labour force can be beneficial for domestic productivity and competitiveness.

This restructuring, however, could be quite painful for some labour groups, who may be highly organized and have political clout. For example, highly paid but lower skilled manufacturing jobs that are labour intensive may disappear or experience wage reductions, and workers in these industries might resist the change. Since it is possible for the aggregate effects and skill mix effects of ODI to work in opposite directions (i.e., positive skill mix effects increasing average wages but negative aggregate effects decreasing employment), the social weighting one gives to "good" jobs versus aggregate employment is an important policy concern. If higher unemployment with a higher average wage for those working is deemed more desirable, this would have different implications than if the reverse were true.

The employment effects are complicated further because different types of ODI can effect employment in different ways. ODI can take the form of greenfield investments, cross-border mergers or acquisitions. A foreign acquisition may result in less exports of capital equipment and intermediate products to the newly acquired firm than a greenfield investment. But, mergers and acquisitions may help maintain the overall competitiveness of the parent firm and reduce negative labour market

[6]Taylor and Fosler, *op. cit.*. S. McGuire, *FDI and Employment*. OECD, *Foreign Direct Investment, Trade and Employment in the United States*, DAFFE/IME(94)9.

[7]M. Gunderson and S. Verma, *Labour Market Implications of Outward Direct Foreign Investment*, unpublished, pp. 16-7. S. Globerman, *The Public and Private Interests in Outward Direct Investment*, unpublished, pp. 33-4. OECD, *FDI and Employment*, p.10.

implications for the home economy. This is the role of job preservation, as opposed to job creation.

ODI also affects different industries differently. Financial and non-financial industries are an example of where differences in effects would be expected. Within manufacturing, there would also be a wide range of employment effects of ODI, due to differing industrial and even firm-specific structures. For example, ODI which occurs in sectors characterized by relatively non-tradeable goods, such as the newspaper industry, would not substitute for domestic investment and employment the same way ODI in tradeable goods might. Moreover, employment effects have also been shown to be country specific. Since the effects of ODI on home country employment are very industry specific and also vary greatly intra-industrially among countries, generalizations are cautioned against as potentially misleading. Policy should not be based on overly-generalized conclusions or studies of effects in other countries.

Policy Implications

There is a lack of empirical evidence indicating whether ODI complements or substitutes for trade, domestic production and domestic employment. Much of the available analysis, in any case, concludes that there are only small aggregate effects of ODI on domestic employment.[8] Therefore, strong policy guidelines based on the acceptance of specific sets of assumptions about the ability of ODI to create jobs (or to terminate jobs) may be imprudent.

The net employment effects of ODI depend upon how individual investors behave, as well as upon how much ODI contributes to economic growth in the foreign country and the trading relationship between countries. This issue received wide attention with respect to U.S. investment in Mexico as a result of the NAFTA negotiations. The assumptions were that increased U.S. investment in Mexico would result in increased exports of U.S. capital equipment and intermediate products. Moreover, increased U.S. and foreign investment in Mexico would stimulate Mexican economic growth and import demand, thus increasing U.S. exports to Mexico. U.S.

[8]For example, a recent OECD study concerning the employment effects of foreign investment in the U.S. found that there was little or no adverse effect of ODI on employment. S. McGuire, *Foreign Direct Investment, Trade and Employment in the United States,* p. 7.

investment in Mexico could also improve access to high-quality resources that could be used as inputs into the U.S. investor's production process.[9]

Public opinion of ODI is influenced by a country's macroeconomic situation and political factors. For example, following the entry into force of the Canada-U.S. FTA, the media began an "employment watch" which focussed on ODI and "resulting" plant closures and job losses in Canada. Since it is more difficult to recognize employment created or preserved by ODI, public concerns can be influenced by a highly visible, presumed negative result of policy. Also, a country's level of unemployment can influence the visibility of ODI polices. Public concern over ODI in countries at or near full employment is likely to be lower than in countries with higher unemployment rates. In countries with high rates of unemployment, there is a fear that ODI will reduce the level of potential employment and employment growth. Structural adjustment, such as can occur with the changing skill mix of the labour force due to ODI, will be more difficult to weather, politically and economically, the further away the economy is from full employment. Due to the current high rate of unemployment in Canada, and concern about its structural component, the public may have fears about policies which facilitate ODI.

Policies that either facilitate or discourage ODI, whether based on the assumption of it being a substitute or complement for domestic employment, should take into account the cyclical nature of economic growth and employment. Pro-cyclical policies should be avoided. In countries with tight labour markets, it could be argued that ODI, acting as a substitute for domestic economic activity in the short term, may ease labour market conditions and inflationary pressures. Alternatively, if ODI is considered complementary to domestic economic activity, it could be seen as contributing to overly tight labour market conditions. Thus, whether ODI is considered to be beneficial for the domestic economy is dependent upon assumptions about its complementarity or substitutability, current labour market conditions and the structure of unemployment.

---

[9]Various empirical studies have attempted to quantify the employment effects of the NAFTA (e.g., United States International Trade Commission, *The Likely Impact on the United States of a Free Trade Agreement with Mexico*, USITC Publications 2353 (February 1991) and D. Brown, A. Deardorf, et. al., *An Assessment of Extending NAFTA to Other Major Trading Countries in South America*, 1994). These studies generally conclude that the agreement will have positive, but small, employment effects. Empirical studies have not been able to identify how the NAFTA will alter ODI specifically, or to estimate the indirect employment effects of such changes.

Annex:
Canadian ODI: Recent Trends[10]

Empirical evidence seems to indicate that Canadian firms are becoming more involved in ODI. Canada is no longer just a recipient of investment inflows, but is increasingly a source of international investment capital. Whether this is viewed as a signal of strength and maturity in Canadian firms' international position or as a sign of weakness of the domestic economy, depends on the assumptions made about the motives and results of ODI. As noted above, most evidence seems to indicate that ODI is indicative of growing firms that must expand beyond the domestic market to gain market share.

Canadian ODI reached $99 billion at the end of 1992, doubling since the mid 1980s. Approximately 95 per cent of the $45 billion increase of ODI from 1986 to 1992 was financed with net outflows of Canadian capital. Over 75 per cent of the Canadian funds went to create or add capital in subsidiaries abroad, with the balance used to acquire foreign businesses. Over this period, ODI has also recorded faster growth than FDI in Canada, which has brought Canadian direct investment assets into better balance with liabilities. Most ODI was accounted for by Canadian-controlled firms at year-end 1991. Although just under 20 per cent was accounted for by enterprises controlled by non-residents, this share has been declining.

Canadian ODI is predominantly in OECD countries, with the U.S. accounting for 58 per cent of the total at year-end 1991. The U.S. share, however, has been declining in favour of European countries, which held 21 per cent of the total at year-end 1991. Consistent with global direct investment patterns, the developing countries overall are not a major destination for Canadian ODI.

Canadian-owned firms tend to invest horizontally in industries in which they are already involved. The largest share of Canadian ODI, 25 per cent at year-end 1991, was concentrated in the financial and insurance industries, while the metallic minerals and products industry followed at 13 per cent. Horizontal investment patterns and the predominance of the U.S. and Europe as destinations of Canadian ODI would tend to reinforce the view that access to low wage labour is not the prime motivating factor encouraging Canadian firms to invest abroad. Instead, horizontal investment

[10]Much of the information presented in this annex is based on F. Chow, "Recent Trends in Canadian Direct Investment Abroad -- The Rise of Canadian Multinationals", *Canadian Economic Observer*, Statistics Canada Catalogue No. 11-010, December 1993.

strategies may be the result of the maturity of Canadian firms or the small Canadian market.[11]

Although Canadian firms' propensity to invest abroad seems to be increasing and the growth of Canadian ODI has been rising significantly, the number of Canadian firms involved in ODI decreased in the period 1985 to 1991.[12] As a result, the average size of investment abroad almost doubled from $34.8 million in 1988 to $67.7 million in 1991. By 1991, seventeen enterprises with investments of over $1 billion comprised approximately half of total Canadian ODI. Canadian firms, however, seem to be having problems making these large investments pay off and foreign investment has often proved unprofitable not only for many small Canadian direct investors who have dropped out of the picture since the mid 1980s, but also for some large multinationals.[13]

Since Canadian ODI is growing at a faster rate than FDI and is an integral part of international integration and competitiveness for Canadian firms, policies that affect ODI will likely have increasing visibility and importance. High unemployment, slow growth, expansion of free trade and liberalization of investment rules will also lead to concerns about delocalization and unfair labour competition practices. Policy makers will need to be sensitive to the issue that the employment effects of ODI are far from clear and that strong policies may meet with opposition from groups with diverse interests.

[11]This is consistent with the experience in the U.S., where a need was found for firms to go global in order to continue to expand, even in the largest market in the world.

[12]A rough indicator of the propensity to invest abroad is provided by relating Canadian ODI to the long-term capitalization of the Canadian direct investors. F. Chow *op. cit.*, p. 4.6.

[13]F. Chow, *op. cit.*, p. 4.12.