

## Chapter 5

# Do Multinationals Promote Better Pay and Working Conditions?

*Foreign direct investment (FDI) by OECD-based multinational enterprises (MNEs) in developing and emerging economies has increased dramatically over the past two decades. While generally perceived as beneficial for local development, it has also raised concerns about unfair competition and the protection of workers' rights in host countries. This chapter assesses the effects of FDI on wages and working conditions for workers of foreign affiliates of MNEs and those of their independent supplier firms. The evidence suggests that MNEs tend to provide better pay than their domestic counterparts, especially when they operate in developing and emerging economies, but not necessarily better non-wage working conditions. The effects on wages may also spread to the foreign suppliers of MNEs, but those spillover effects are small.*

## Introduction<sup>1</sup>

Multinational enterprises (MNEs) have become one of the key drivers of the world economy and their importance continues to grow. The total stock of foreign direct investment (FDI) increased from 8% of world GDP in 1990 to 26% of GDP in 2006. Moreover, developing countries have become increasingly important as host and home countries for FDI in recent years. The increasing importance of FDI from the OECD in developing countries has given rise to new opportunities, but also raised social concerns.

In general, policy-makers have tended to emphasize the potential benefits that FDI can bring to local economies through the creation of high-quality jobs and the introduction of modern production and management practices. The positive impact of FDI can be particularly important in the context of developing countries and many governments in these countries have developed specific policies to encourage inward FDI.<sup>2</sup> Such policies can range from the removal of discriminatory barriers against FDI to positive incentives such as providing information services or granting specific fiscal and regulatory advantages to potential foreign investors, including through the creation of designated export-processing zones.

However, the behaviour of OECD-based MNEs in developing countries has also raised public concerns. For example, MNEs have been accused of practicing unfair competition when taking advantage of lower 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 order to encourage responsible behaviour by MNEs in countries where the rule of law is weak, civil society has appealed to the responsibility of MNEs to go beyond prevailing local labour practices to ensure that internationally recognised labour norms are respected in the workplaces of their foreign affiliates and independent contractors. The OECD Guidelines for Multinational Enterprises provide a notable example of a government-backed initiative that provides a benchmark for responsible business conduct for MNEs (OECD, 2000a).

The aim of this chapter is to analyse the role of inward FDI on wages and working conditions, and particularly, FDI from the OECD in developing and large emerging economies.<sup>3</sup> To this end, it seeks to address two main questions. First, how much do MNEs contribute to higher living standards and better working conditions? Using a variety of data sources, including micro-data for three developed countries (Germany, Portugal and the United Kingdom) and two developing countries (Brazil and Indonesia),<sup>4</sup> this question is analysed by evaluating to what extent MNEs pay higher wages and provide better working conditions to workers in their foreign affiliates than are provided by their local counterparts, and to what extent foreign affiliates foster better labour practices in local firms. The second question asks what governments in both home and host countries can do to promote good work practices by MNEs. In particular, what role can FDI promotion by host countries, and the promotion of responsible business conduct by home countries, play

in strengthening the contribution of MNEs to improved wages and working conditions in the host country?<sup>5</sup>

The structure of the chapter is as follows. The first section presents some stylised facts on FDI and MNEs to motivate the empirical analysis. Section 2 presents an analysis of the direct effects of inward FDI by comparing wages and working conditions in the foreign affiliates of MNEs with those offered in comparable domestic firms. Section 3 analyses the indirect (“spillover”) effects of inward FDI on wages and working conditions in local firms. Section 4 discusses what governments can do to promote FDI whilst ensuring that minimum labour standards are respected in countries where governments fail to enforce national and international labour provisions effectively. The final section presents some concluding remarks.

## Main findings

- Developing countries have become increasingly important destinations for FDI by OECD-based MNEs. The share of developing countries in the inward stock of world FDI has risen from 22% in 1990 to 32% in 2005. FDI by OECD-based MNEs has also grown rapidly in countries with low *de jure* or *de facto* labour standards, which raises the question as to whether they exploit weak labour standards.
- In response to public concerns about the respect for minimal environmental and labour standards in their foreign operations, reputation-sensitive MNEs have increasingly adopted codes of conduct, including explicit policies with respect to labour practices to ensure that labour and human rights are respected in their affiliates abroad and throughout the supply chain. There exist, however, considerable differences across high-income OECD countries in terms of the depth and scope of the codes adopted by OECD-based MNEs. European MNEs have the most extensive formal policies relating to labour standards, while North-American MNEs have the least extensive policies.
- Various normative standards have been used to assess the social impact of FDI in the host country. This chapter uses a host-country standard to assess the *actual* impact of FDI on wages and working conditions in the host country. This involves comparing the wages and working conditions of employees in the foreign affiliates of MNEs and their supplier firms to the wages and working conditions that they would have received had they not been employed by a foreign firm or one of its suppliers.
- Econometric analysis for three OECD countries (Germany, Portugal and the United Kingdom) and two emerging economies (Brazil and Indonesia) indicates, consistent with the existing literature, that FDI generally raises wages of employees in *foreign affiliates*. There is no strong evidence that FDI also improves non-wage working conditions. More precisely:
  - ❖ Firm-level estimates of the effect of foreign takeovers on average wages point to fairly large positive effects, although their magnitude varies across countries. The effects range from 5% in the United Kingdom, 8% in Portugal, 11% in Brazil to 19% in Indonesia, while the effect is positive but statistically insignificant in Germany. In general, these results are consistent with previous studies that have shown small and positive foreign wage premia in developed economies and larger foreign wage premia in developing countries.
  - ❖ The effects of foreign takeovers on individual workers that stay in the same firm tend to be positive, but rather small, at least in the short-term. The wage effect ranges from

nil in the United Kingdom, to 1-4% in Brazil, Germany and Portugal. This suggests that the large positive effects of foreign takeovers on average wages that are found in the firm-level analysis result primarily from changes in the composition of the workforce after foreign takeovers, rather than from increased wages of workers who stay in the same firm.

- ❖ Workers who change jobs from domestic to foreign firms tend to experience a considerable increase in wages. This increase ranges from 6% in the United Kingdom to 8% in Germany, 14% in Portugal and 21% in Brazil. This is consistent with the consensus in the empirical literature that foreign wage premia are more important in developing than in developed countries. It may also indicate that the large positive effects of FDI on average wages at the firm-level reflect to some extent better pay conditions for new hires.
- ❖ The effects of foreign takeovers are potentially larger in the long-run. One would expect that the positive effects of FDI that initially accrue to new hires, eventually spread through the entire workforce as large pay disparities between new and old workers within firms are unlikely to be sustainable in the longer term. While it is not feasible to estimate the causal effect of inward FDI in the long-run with the data analysed here, it is possible to place an upper bound on this effect by simply comparing wages in foreign-owned and comparable domestic firms. The upper-bound estimates range from 4% in Germany, around 12% in Portugal and the United Kingdom, to 23% in Brazil and 32% in Indonesia.
- ❖ The results point at important cross-country differences in the wage effects among workers with different skills. In the United Kingdom, the results suggest that foreign takeovers have a small negative impact on the wages of low-skilled workers and no effect for semi- and high-skilled workers. In Germany and Portugal, the impact of foreign takeovers is positive for all three skill groups and differences across skill groups are modest. For Brazil and Indonesia, the impact of foreign takeovers differs importantly across skill groups. In Brazil, foreign takeovers have a positive effect on the wages of unskilled and semi-skilled workers and a negative effect on that of skilled workers. In Indonesia, the impact of foreign takeovers is positive for both skilled and unskilled workers, but almost twice as large for the former.
- ❖ The estimated effects of foreign takeovers on non-wage working conditions tend to be considerably weaker than those for wages. While job stability, working hours and union bargaining power in foreign firms tend to differ from those in comparable domestic firms, this is largely due to the specific characteristics of firms that become foreign-owned. Non-wage working conditions do not necessarily improve in firms following a foreign takeover.
- The empirical analysis presented in this chapter further suggests that FDI – through both greenfield investment and cross-border mergers and acquisitions (M&A) – may have positive spillover effects in terms of wages and non-wage working conditions of employees in *domestic* firms, but these indirect effects tend to be considerably weaker than the direct effects on employees in the foreign affiliates of MNEs.
- ❖ While FDI appears to have a strong effect on average wages in local firms in Indonesia, this largely reflects the direct effect of FDI on labour demand in *foreign* firms, particularly for non-production workers. The wage of non-production workers in domestic firms may also increase as a result of the effect of FDI on the labour demand

of domestic firms, through its impact on productivity in those firms. However, this effect appears to be very small. Previous empirical studies on productivity spillovers from FDI suggest that positive spillovers do not necessarily arise and may even be negative.

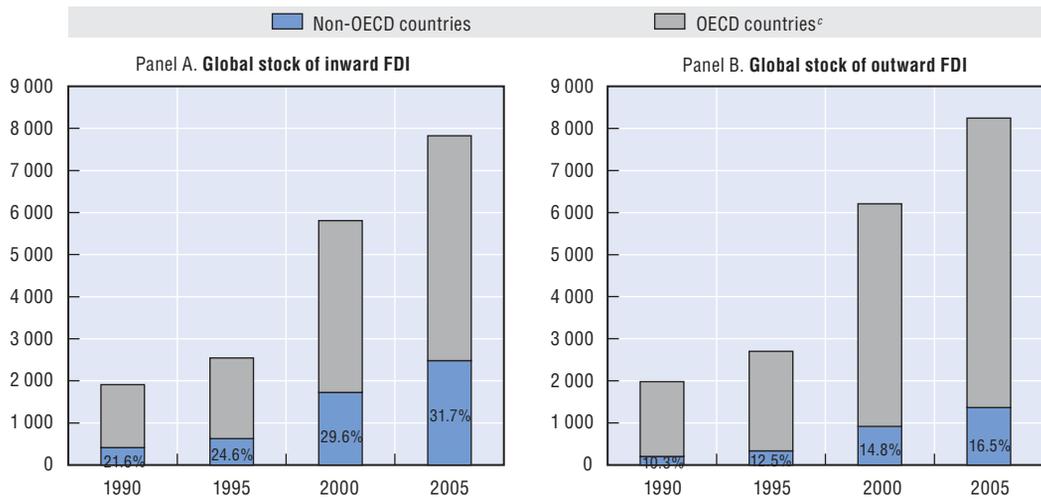
- ❖ Positive productivity-driven wage spillovers are likely to be more important in the presence of strong linkages between local firms and foreign MNEs, such as through the participation of local firms in the supply chain or worker mobility. The analysis of worker mobility confirms that worker movements from foreign to domestic firms allow for the transfer of human capital across firms. However, the analysis does not allow one to assess whether this also results in positive externalities.
- The generally positive effect of FDI on host economies provides a rationale for promoting FDI by removing regulatory obstacles to FDI and taking measures to enhance the overall investment climate. FDI-friendly policies in host countries can be usefully complemented by multilateral initiatives that seek to enhance the social impact 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 to promote responsible business conduct, as do public-private initiatives that combine market incentives with enhanced enforcement and monitoring of labour practices.

## 1. The social dimension of foreign direct investment

Multinational enterprises (MNEs) have become one of the key drivers of the world economy and their importance continues to grow. The total stock of foreign direct investment (FDI) increased from 8% of world GDP in 1990 to 26% of GDP in 2006 (UNCTAD, 2007). UNCTAD (2007) estimates that the foreign affiliates of MNEs accounted for about 33% of world exports, 10% of world GDP and 3% of world employment in 2006. These figures, however, underestimate the role of MNEs in the world economy as they do not take account of the activities of the domestic affiliates of MNEs or the activities of their sub-contractors.<sup>6</sup> Moreover, the importance of developing countries for inward and outward FDI has grown in recent years (see Figure 5.1). Although the bulk of FDI continues to take place between developed countries, the share of developing countries in the inward stock of world FDI has risen from 22% in 1990 to 32% in 2005. Their share in the outward stock of world FDI has risen from 10% in 1990 to 17% in 2005.<sup>7</sup>

Policy-makers have tended to emphasize the potential benefits that FDI can bring to the host economy. These benefits may be direct or indirect. The former refer to benefits that accrue to employees in foreign-owned firms, whereas the latter refer to benefits that accrue to workers in domestic firms. The source of these benefits is the productivity advantage of MNEs based on, for example, technological know-how or modern management practices that allows them to compete effectively in foreign markets and to offset the cost of coordinating activities across different countries. Crucially, the productivity advantage has the characteristics of a public good so that it can be transferred between affiliates in different countries at zero or no costs. This transfer may give rise to direct benefits in the form of higher productivity in foreign-owned firms, but may also lead to indirect benefits by increasing the productivity of domestic firms when the productivity advantage spills over from foreign affiliates to domestic firms. Productivity spillovers represent positive externalities to the host country and explain why policy-makers have

Figure 5.1. **Trends in foreign direct investment, <sup>a, b</sup> 1990-2005**  
Billions US dollars at constant prices (2000)



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- a) Foreign direct investment (FDI) is defined by UNCTAD as an investment involving a long-term relationship and reflecting a lasting interest in, and control by, a resident entity in one economy (foreign direct investor or parent enterprise) of an enterprise resident in a different economy (FDI enterprise or affiliate enterprise or foreign affiliate). Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates. FDI may result from greenfield investment or cross-border mergers and acquisitions. For statistical purposes, FDI is typically defined as an incorporated or unincorporated enterprise in which the direct investor, resident in another economy, owns 10% or more of the ordinary shares of voting power (or the equivalent). However, this criterion is not strictly observed by all countries reporting. For more information see, [www.unctad.org](http://www.unctad.org).
- b) In principle, the global stocks of inward and outward FDI should be equal. In practice, however, sizable discrepancies exist due to gaps in coverage and the use of different reporting systems across countries. See Patterson et al. (2004) for more details.
- c) Corresponds to the 30 OECD member countries.

Source: UNCTAD, FDI Statistics.

sometimes treated foreign investment more favourably than investment by domestic firms that do not necessarily have a productivity advantage that may give rise to externalities. Increased productivity in domestic or foreign-owned firms may lead to higher incomes, better working conditions and more employment.<sup>8</sup>

The rising importance of FDI by OECD-based MNEs in developing countries has also raised concerns about its potential social impact in the host countries. The nature of these concerns depends on the normative standard that is used to judge how MNEs treat their workers abroad:

- **Home-country standards.** The behaviour of MNEs is sometimes evaluated by comparing working conditions abroad with those prevailing in the home country. In particular, MNEs that exploit international differences in labour costs by relocating production activities to affiliates abroad or foreign sub-contractors have sometimes been accused of practising “unfair competition”. Their behaviour is judged unfair because it is argued that workers who are engaged in supply-chain activities abroad do not get their “just” reward and workers in the home country have to withstand competition based on “unfairly” low wages. This logic has motivated demands for restrictions on offshoring and the adoption of protectionist policies in many OECD countries. However, reducing access to foreign markets is likely to impede the development process in low-wage countries and may even aggravate poverty and worsen working conditions in these

countries. While home-country standards may have a place in the debate on the social impact of *outward investment in the home country*, their use is inappropriate and potentially counterproductive in the debate on the social impact of *inward investment in the host country*.

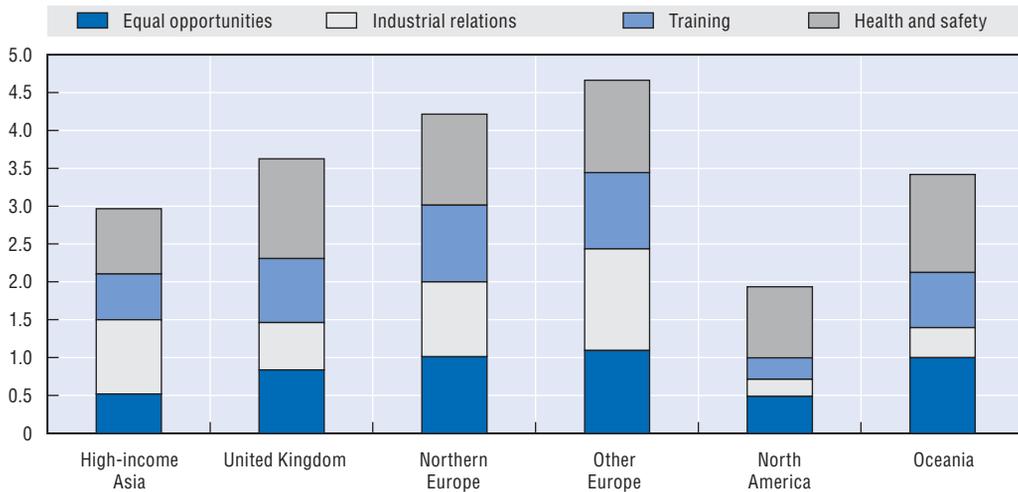
- **Universal standards.** Working conditions in the affiliates and sub-contractors of MNEs may further be assessed against universal standards that are unrelated to the stage of social and economic development in the home or host countries of MNEs. Universal standards may be particularly appropriate in the context of labour and human rights such as those enshrined in international labour provisions (e.g. the set of ILO conventions that are held to represent “core” labour standards). As many developing countries fail to enforce these effectively, human-rights activists have demanded that accountability mechanisms be put in place to ensure that labour and human rights are respected within the foreign affiliates and independent suppliers of MNEs. While there is widespread support for guaranteeing these rights, it should be borne in mind that imposing excessive standards on MNEs may have unintended consequences by shifting problems of poor working conditions to other sectors of the economy or by inducing MNEs to reduce or even withdraw their operations from these countries.<sup>9</sup>

Thus, while home-country standards are not appropriate to judge the social impact of FDI in the host country, assessing the behaviour of MNEs against a universal standard may be useful, especially as concerns core labour standards.

In response to social concerns about the respect for minimal labour standards in the foreign operations of MNEs, reputation-sensitive MNEs have increasingly adopted explicit corporate social responsibility (CSR) policies (also called “codes of conduct”) in order to ensure that labour and human rights are respected in their affiliates abroad and throughout the supply chain. Figure 5.2 reports evidence on the importance of formal policies of this nature among MNEs across different home regions using the EIRIS firm-level database.<sup>10</sup> The following company policies are considered: i) policies with respect to equal opportunities and diversity issues in the domain of gender and ethnicity; ii) systems for managing employee relations through the recognition of trade unions for collective bargaining purposes or alternative consultative arrangements; iii) systems to support employee training and development; and iv) systems relating to health and safety. For the present purposes, only MNEs with at least one affiliate operating in a country deemed by EIRIS to be high-risk in terms of human-rights violations were selected (see Annex 5.A.1 for more details). These data indicate that:

- The level of development of formal policies in MNEs with respect to labour practices differs considerably across home regions. European companies have the most developed formal policies with respect to all four working conditions noted above. Within Europe, companies from Continental Europe stand out for their elaborate corporate systems in the area of industrial relations.<sup>11</sup> North-American companies, on average, have the least developed formal policies with respect to any of the working conditions.<sup>12</sup> Companies from high-income Asia, as well as Australia and New Zealand, take an intermediate position in terms of overall labour policies, although the weight given to specific practices differs across them. In high-income Asia, formal labour policies emphasise industrial relations, whereas in Australia and New Zealand labour policies relate mostly to equal opportunities and health and safety.<sup>13</sup>

Figure 5.2. **MNE policies on working conditions**  
Average scores by home region<sup>a, b, c</sup> (0 to 8 from low to high evidence)<sup>d</sup>



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- The universe covered by the EIRIS database consists of 2 629 listed companies (FTSE All World Developed and All-Share constituents as well as publicly announced constituents of the MSCI World). The analysis here is restricted to companies with operations in countries deemed by EIRIS to be high risk in terms of human rights violations (“list A and B countries”). This reduces the sample to 1361 companies.
- High-income Asia: Hong Kong (China), Japan and Singapore; Northern Europe: Denmark, Finland, Iceland, Ireland, Norway and Sweden; Other Europe: Austria, Belgium, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain and Switzerland; North America: Canada and the United States; Oceania: Australia and New Zealand.
- The data for the United Kingdom include small, medium and large companies whereas for the other areas the EIRIS data only cover medium-sized and large companies.
- Each of the four working conditions is scored according to the extent of policies, systems and reporting: 0: No or little evidence; 1: Some evidence; 2: Clear to very clear evidence.

Source: OECD calculations based on EIRIS database. For further details on the way firms are scored, see Annex Table 5.A1.1.

- It is not straightforward to explain the regional variation in formal policies relating to labour practices as these are likely to result from a complex combination of cultural, legal and political factors. However, a few possible determinants are worth mentioning. First, differences in regulatory systems matter. For example, European countries tend to have much more extensive regulations with respect to job security, trade unions and collective bargaining than Anglo-Saxon countries (Botero *et al.*, 2004; OECD, 2004).<sup>14</sup> Second, legal systems play an important role in explaining the willingness of companies to disclose information on issues that are not mandated by law. The litigious nature of US society may be particularly important in explaining the traditional reluctance of US companies to voluntarily disclose information about their work practices, which may account for the relatively low scores among North-American MNEs for extensive policies on labour practices. Third, the more prominent role of trade unions in many European countries than in North America may be expected to increase the influence of employees in the formulation of formal policies on labour practices.<sup>15</sup>

The analysis of the EIRIS-data gives an idea of the extent to which MNEs have adopted formal policies with respect to labour practices at a centralised level, but does not say much about how such policies are implemented in host countries or their effectiveness in improving the wages and working conditions offered by their foreign affiliates (see Box 5.3 for a discussion of the effectiveness of private codes of conduct in the supply

chain). It would be interesting, therefore, to assess the behaviour of MNEs abroad in terms of their compliance with international and national labour standards. However, this is not straightforward in practice due to the lack of systematic information on compliance levels. While anecdotal evidence suggests that in some of the foreign operations of MNEs labour practices can be poor, suggestive evidence from the World Bank Enterprise Survey indicates that compliance levels among MNEs tend to be higher on average than among their domestic counterparts.<sup>16</sup>

Rather than comparing working conditions in the foreign affiliates and sub-contractors of MNEs to legal norms, this chapter analyses the social impact of FDI in the host country by comparing wages and working conditions in the foreign affiliates and sub-contractors of MNEs to the labour practices in comparable domestic firms. The difference may be interpreted as the potential contribution of MNEs to improving wages and working conditions in the host country as employment conditions in comparable domestic firms provide a plausible approximation (“counterfactual”) of the conditions that would have been offered to individuals had they not been able to work for MNEs (directly or indirectly). By adopting a benchmark based on host-country standards (i.e. labour practices in comparable domestic firms), this chapter assesses both the potential positive impact on wages and working conditions, as well as social concerns that MNEs use their bargaining power to force workers to accept sub-standard employment conditions or to negotiate exemptions from labour provisions from governments.<sup>17</sup>

## 2. The direct effects of FDI on wages and working conditions in the foreign affiliates of MNEs

This section analyses the direct effect of inward FDI by looking at the extent to which pay and labour practices in the foreign affiliates of MNEs deviate from those prevailing in host-country firms. To this end, it compares working conditions in foreign affiliates with those in domestic firms and analyses how employment conditions change when local firms are acquired by foreign firms or when workers move from domestic to foreign firms. The section starts off with a brief discussion of why it may be in the interest of MNEs to offer better pay and working conditions than comparable domestic firms. It then proceeds by presenting some descriptive statistics on employment conditions in MNEs across host regions. The final part of this section presents the results of an econometric analysis of the impact of FDI on wages and working conditions in three developed countries (Germany, Portugal and the United Kingdom) and two developing countries (Brazil and Indonesia).

### 2.1. Why would MNEs provide better pay and working conditions than comparable domestic firms?

In a competitive labour market, MNEs would generally be expected to provide comparable pay and working conditions to those offered by their local counterparts. In such a context, MNEs may pay higher wages only to the extent that they employ a more skilled workforce or must compensate workers for undesirable differences in the characteristics of jobs such as lower job security. The presence of certain market failures, however, could provide MNEs with an incentive to offer better pay and working conditions also to individuals with similar characteristics doing a similar job (see Box 5.1 for more details).

### Box 5.1. Why would MNEs provide better pay and working conditions than comparable domestic firms?

In a competitive labour market, one would expect MNEs to offer comparable pay and working conditions to individuals with comparable characteristics doing comparable job. In such a context, average pay differences between MNEs and comparable domestic firms may still arise for two reasons:

- *Workforce composition.* Average pay differentials may reflect differences in workforce composition between multinational and domestic firms. This could be because they tend to hire different types of workers. However, it may also be that multinational and domestic firms have different human-resource practices related to, for example, the importance of training, on-the-job learning and career development. In this case, workers with similar characteristics when they are hired develop differently in multinational and domestic firms, thereby giving rise to pay differentials.
- *Compensating differentials.* Wages compensate for differences in working conditions that are valued positively or negatively by workers. For example, it is sometimes suggested that jobs are less secure in MNEs because they are footloose or have more elastic labour demand. This could provide a rationale for multinational firms to offer higher wages than their local competitors to compensate for lower job security. Conversely, workers may be willing to accept working for lower pay in multinational firms if the latter attach greater importance to training and career development.

In addition, *market failures* may give rise to differences in pay and working conditions between multinational and domestic firms for individuals with comparable characteristics doing comparable jobs for essentially three reasons:

- *Efficiency wages.* MNEs may wish to pay higher wages than their local competitors in the hope that this will reduce worker turnover and thereby minimise the risk of their productivity advantage spilling over to competing firms. MNEs may also be willing to pay higher wages than their local competitors due to higher monitoring costs related to informational problems or to compensate for their lower managerial responsiveness to industrial-relations demands due to cultural differences.
- *Search frictions.* Search frictions reduce the degree to which arbitrage takes place across firms due to differences in labour productivity for identical workers. As a result, MNEs may derive monopsony power from their ownership advantage allowing them to pay their workers less than their marginal value product, but more than their local competitors. The cost-saving that can be achieved by a MNE thanks to its monopsony power is likely to fall with the availability of comparable jobs outside the MNE, which may be closely related to the level of economic development.\*
- *Institutional factors.* Trade unions may induce differences in pay between multinational and domestic firms as a result of differences in the availability of rents and worker bargaining power. On the one hand, MNEs may be in a stronger bargaining position relative to trade unions than their domestic competitors, because they may have the option of substituting domestic for foreign workers by relocating production activities abroad. On the other hand, the availability of rents may be larger in MNEs thanks to their higher productivity and greater market power. Labour legislation may also induce differences when multinational and domestic plants differ in the degree of compliance. MNEs from developed countries that operate in developing countries may be more compliance-driven than local firms, because of reputational concerns and consumer pressure in their home markets (e.g. differences in national consumer preferences may induce vertical product differentiation).

\* Decreuse and Maarek (2007) refer in this context to a *technology-rent effect*, which allows MNEs to derive monopsony power from their technological advance, and a *competition-wage effect*, that results from the competition between firms for labour services.

The extent to which MNEs offer better pay and working conditions than their local counterparts may vary across the countries from which MNEs originate and the countries in which they operate, as well as between different groups of the workforce:

- The incentive to offer better working conditions is likely to be greater for MNEs from developed countries that operate in developing countries as the technological advance of their foreign affiliates relative to local firms is likely to be greatest and the availability of comparable alternative job opportunities lowest. Moreover, MNEs from developed countries that operate in developing countries may be more compliance-driven than other MNEs because of reputational concerns and consumer pressure in their home markets.<sup>18</sup>
- The incentives of MNEs to offer better working conditions are generally expected to be stronger for more skilled workers for at least two reasons. First, because of the relative scarcity of skilled workers, vacancies for such workers tend to be more difficult to fill. This should be particularly important in developing countries. Second, turnover of skilled workers is more likely to lead to the dispersion of firm-specific knowledge, thereby undermining the productivity advantage of MNEs. One way to lower turnover among skilled workers is to offer them a pay premium.<sup>19</sup>
- To the extent that it takes time to acquire firm-specific knowledge, the incentive to offer better pay and working conditions should also increase with job tenure, particularly among skilled workers.

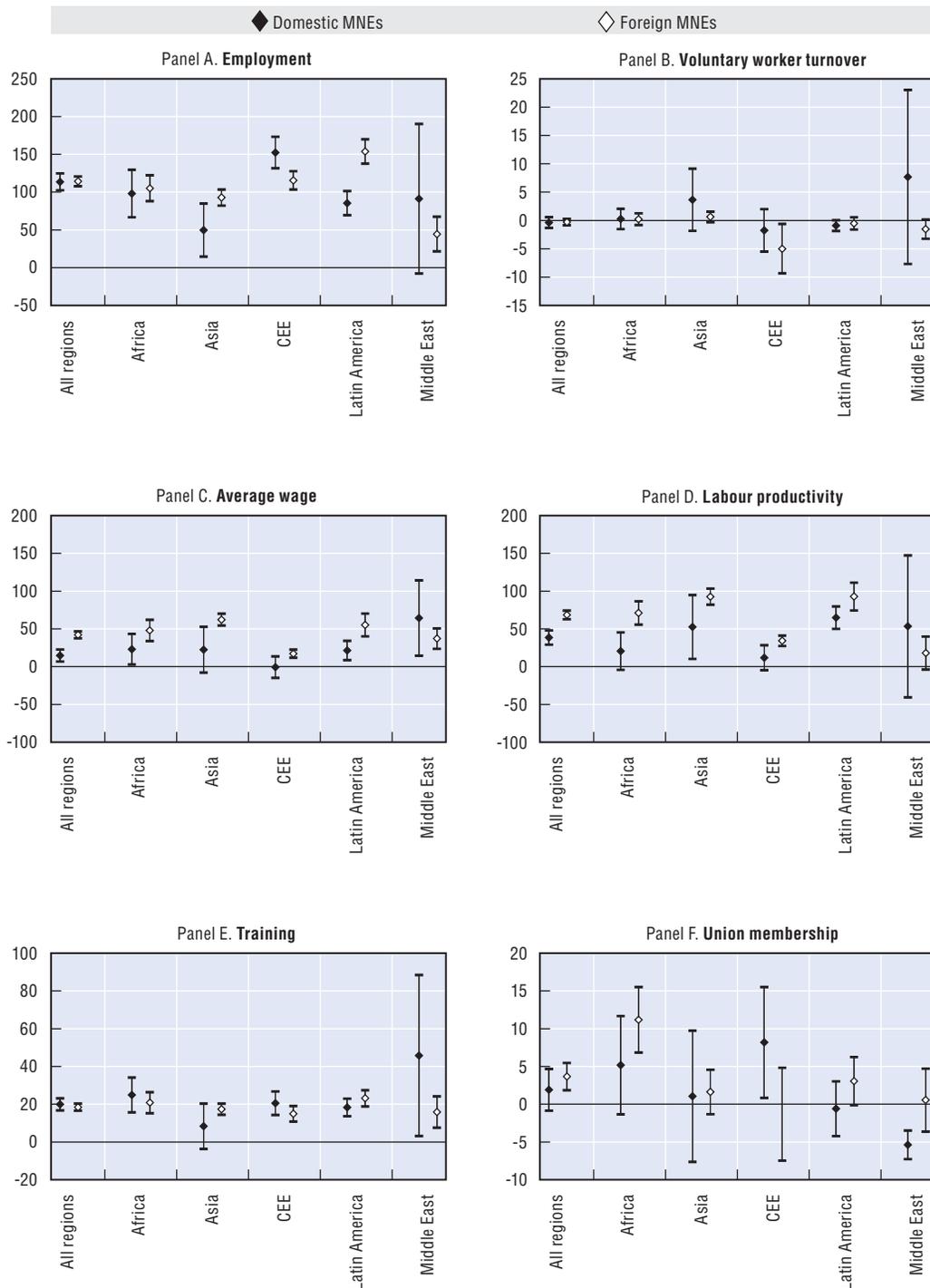
## 2.2. Descriptive evidence

Figure 5.3 compares MNEs, domestic and foreign, with domestic firms, in terms of employment, voluntary worker turnover, average wages, labour productivity, union membership and training. The figure allows one to make the following observations:

- Simple comparisons of MNEs and local firms suggest that the former tend to employ more workers and provide better jobs than local firms in the countries where they invest. In particular, the average MNE employs more than twice as many workers as the average local firm. To the extent that voluntary worker turnover may be considered as an indirect measure of the overall quality of working conditions (Brown and Medoff, 1988), the descriptive statistics also suggest that MNEs provide similar, if not better, jobs than domestic firms. In particular, the quality of jobs in foreign MNEs appears to be better than in local firms in central and eastern Europe and the Middle-East.
- Jobs in MNEs tend to pay higher wages: average wages are more than 40% higher in foreign MNEs and 15% higher in domestic MNEs than in local firms. These differences tend to be considerably larger in developing-country regions such as low-income Asia and Latin America than in Europe.<sup>20</sup> This largely reflects the larger technological and productivity gaps between foreign MNEs and local firms in low and middle income developing countries.<sup>21</sup>
- MNEs also appear to provide better working conditions beyond paying higher wages. Both domestic and foreign MNEs are more likely to provide training opportunities to their workforce than local firms and their workforces are more highly unionised. Both the emphasis on training and the higher unionisation rate could also help explain why wages tend to be higher in MNEs.
- Foreign MNEs tend to provide more and better jobs than domestic MNEs, especially in developing countries, as shown by the positive differences in terms of employment,

Figure 5.3. **A comparison of employment conditions and productivity between MNEs and local firms<sup>a</sup>**

Average percentage differences by host region and 95% confidence intervals<sup>b</sup>



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CEE: central and eastern Europe.

a) Asia includes low-income Asia only.

b) The diamonds reflect the average percentage differences between MNEs and domestic firms within countries by host region. The vertical segments reflect the 95% confidence interval. If the vertical segment crosses the zero-axis, the differences between MNEs and domestic firms are not statistically significant.

Source: OECD estimates based on World Bank Enterprise Survey. See Annex Table 5.A1.4 for details on variable definitions.

average wages, and labour productivity. This may reflect the possibility that foreign MNEs that operate in developing countries, tend to originate from developed countries and are closer to the global technology frontier than local MNEs. Apart from suggesting that the nationality of the owner matters, this finding also provides a rationale for focusing on foreign-owned firms in developing countries in the remainder of this chapter.

The results in Figure 5.3, however, should be interpreted carefully. These descriptive data are subject to a number of shortcomings that give rise to three potential biases in comparing multinational and local firms: aggregation, composition and selection bias:

- *Aggregation bias.* As the unit of observation is the firm, rather than the individual, the analysis tends to give relatively more weight to small firms. To the extent that working conditions tend to be better in larger firms, which are more likely to be foreign-owned, this will tend to bias the results in favour of MNEs.
- *Composition bias.* The analysis relates to *average* worker outcomes as opposed to *individual* worker outcomes. As a result, it is not clear whether the observed differences in average employment conditions reflect differences in the composition of the workforce or whether employment conditions differ across workers with comparable characteristics in local and multinational firms. To the extent that MNEs employ more skilled workers, this would bias the results in their favour.
- *Selection bias.* Selection bias may result from either firm or worker selection. Firm selection arises when foreign-owned firms are systematically different from domestic firms, as a result of unobservable firm characteristics unrelated to ownership status. In order to address this problem, it has become common practice among researchers to focus on changes in ownership status as a result of cross-border mergers and acquisitions (M&A). Doing so allows one to control for unobservable characteristics that are the same before and after takeovers. This reduces the selection problem that arises when foreign acquiring firms “cherry-pick” local targets with good employment conditions (*e.g.* because firms with good employment conditions tend to be more productive). Selection bias may also result from worker selection, *i.e.* the possibility that cross-border M&A is associated with changes in the composition of the workforce as a result of the restructuring process that typically follows such operations. Both firm and worker selection may lead to an overestimation of the *causal* effect of FDI on pay and working conditions.

All three biases are likely to contribute to an overestimation of the causal effect of FDI on pay and working conditions.<sup>22</sup> The econometric analysis of the effects of foreign ownership on wages and working conditions in the next sub-section will take account of each of these biases.

### 2.3. New micro-level evidence for selected countries

This sub-section presents new micro-level evidence on the impact of inward FDI on both wages and non-wage working conditions using data for three developed (Germany, Portugal and the United Kingdom) and two emerging economies (Brazil and Indonesia). First, results will be presented on the impact of foreign ownership on average wages at the firm-level. The firm-level analysis is consistent with most of the empirical literature and supports its main findings that foreign-owned firms provide better jobs than local firms. The bulk of the analysis here, however, makes use of linked employer-employee data in keeping with recent advances in the literature. The use of linked employer-employee data

allows one to control for both firm and worker effects; to study the role of foreign ownership for different types of workers; and to consider its role for non-wage outcomes such as working hours, job stability, and union bargaining power.

Two sets of results are presented. The first set identifies the impact of foreign ownership on wages and non-wage working conditions by concentrating on *changes* in ownership status. This allows one to control for time-invariant fixed effects, but also implies that the analysis is necessarily constrained to the short-term, due to the relatively short period spanned by the panel data sets analysed. In the present case, the analysis takes account of the effects of changes in ownership status up to three years after the event. In the firm-level analysis, changes in ownership status necessarily result from cross-border mergers and acquisitions (M&A). At worker level, changes in ownership status can result from either cross-border M&A or workers who change jobs between domestic and foreign-owned firms. *To the extent that the positive effects of foreign ownership take time to materialise, these results provide a lower bound on the effect of inward FDI on wages and non-wage working conditions.* More details on the methodology can be found in Box 5.2.

As the first set of results only relates to the short-term, it is complemented in some cases with comparisons in *levels* between foreign and domestic firms similar to those in Figure 5.3. The main difference with Figure 5.3 is that the present comparisons control for a range of observable characteristics. The results are likely to give a more positive impression of the impact of FDI in host countries than those based on changes in ownership status. In part, this may reflect selection bias resulting from unobservable fixed-effects unrelated to ownership status. However, there may also be genuine reasons for this effect to be stronger as the estimations are more likely to capture the long-term effects of FDI. And unlike the results based on takeovers, the level comparisons include both foreign-owned firms that were previously domestic-owned but have been acquired by a foreign owner and those that are established through greenfield investment. *These results may thus be interpreted as giving an upper bound on the long-term effects of inward FDI on wages and working conditions.*

### **Firm-level evidence**

There is a large empirical literature on multinational wage premia.<sup>23</sup> Until recently, there was a consensus that foreign firms tend to provide better pay to workers than their domestic counterparts. In an early study for Mexico, the United States and Venezuela, Aitken *et al.* (1996) showed that average wages in foreign-owned plants tend to be about 30% higher than in domestic plants. Moreover, these wage differences persist once one controls for size, geographic location, skill mix and capital intensity in Mexico and Venezuela, but not in the United States. This suggests that foreign-owned firms pay higher wages than their local competitors in developing countries. However, this does not necessarily mean that FDI raises working conditions when a domestic firm is being taken over by a foreign firm. Alternatively, foreign firms may cherry-pick the best domestic firms on the basis of characteristics that are not controlled for in the regression analysis, but are associated with higher average wages. One such variable is the quality of the labour force. In order to address this possibility, subsequent studies have analysed to what extent foreign wage premia persist after controlling for worker quality as well as unobservable time-invariant fixed effects.<sup>24</sup>

Most recent studies focus on cross-border takeovers to analyse the causal effect of a change in ownership status on worker outcomes by making use of firm-level panel data.

### Box 5.2. Econometric methodology

In order to analyse the causal impact of FDI on working conditions, four different changes in ownership status (“treatments”) will be considered: foreign takeovers of domestic firms; domestic takeovers of foreign firms; workers who change jobs from domestic to foreign employers; and finally, workers who change jobs from foreign to domestic employers. Each treatment will be evaluated in the year during which the change in ownership status occurs ( $t = 0$ ), one to two years after the change in ownership status ( $t = 1$ ), and two to three years after the change in ownership status at ( $t = 2$ ). The analysis of cross-border takeovers (T) involves comparing workers who stay in a firm that does not change ownership status with workers who stay in a firm that changes ownership status.

$$T_i^T = \begin{cases} 0 & \text{if } F_{jt=-1} = F_{jt \geq 0} \\ 1 & \text{if } F_{jt=-1} \neq F_{jt \geq 0} \end{cases} \quad [1 - \text{Case A}]$$

where  $T$  refers to treatment status of worker  $i$ ,  $F$  to ownership status of firm  $j$ , and  $t$  to time relative to the year in which the treatment is “allocated”. The analysis of worker movements (M) involves comparing workers who stay in a firm that does not change ownership status with workers who switch to another firm with different ownership status.

$$T_i^M = \begin{cases} 0 & \text{if } F_{jt=-1} = F_{jt \geq 0} \\ 1 & \text{if } F_{jt=-1} \neq F_{k \neq j, t \geq 0} \end{cases} \quad [1 - \text{Case B}]$$

In order to evaluate the causal effect of FDI on working conditions, the method of propensity-score matching (PSM) in combination with difference-in-differences (DiD) is used. PSM involves replicating a natural experiment by constructing treated and control groups *ex post* using the observable characteristics of individuals before treatment.<sup>a</sup> The mean difference in outcomes between the treated and untreated gives the average treatment effect on the treated. Formally, this can be written as follows:

$$\hat{\alpha}_{ATT} = E(y^1 | T = 1) - E(y^0 | T = 0) \quad [2]$$

where superscripts 0 and 1 refer to untreated and treated firms, respectively,  $T$  is a dummy for treatment status and  $y$  is the outcome of interest (wages or working conditions in this case).

Matching is implemented using the propensity that an individual changes ownership status. The propensity score is estimated with a Probit model which specifies the probability of changing ownership status as a function of industry, region and skill dummies, log employment, log average wage, log individual wage, a gender dummy, age, age squared and tenure. All these variables are measured at the year before takeover at  $t = -1$ .<sup>b</sup> The propensity score is estimated separately by year, broad economic sector and skill group. Treated individuals are matched to their untreated counterparts using one-to-one nearest-neighbour matching which attributes a weight of one to the nearest untreated neighbour of each treated observation and zero to others. The quality of the matches is assessed using a variety of balancing tests.

Propensity-score matching is complemented with the difference-in-differences estimator following Heckman *et al.* (1997). The DiD-estimator allows one to control to some extent for selection on unobserved characteristics by transforming the evaluation problem to one of estimating the difference in the trend before and after treatment instead of the difference in levels. The actual regressions are estimated with fixed effects which represents a generalisation of DiD. The sample is restricted to individuals that are present each year of relative time period  $t = -1$  to  $t = 2$ .<sup>c</sup>

Box 5.2. **Econometric methodology** (cont.)

Using the matched sample of treated and controls the following model is estimated:

$$y_{it} = \alpha_i + \sum_{t=0}^2 \gamma_t T_i D_t + \sum_{t=0}^2 \delta_t D_t + \varepsilon_{it} \quad [3]$$

where  $\alpha_i$  refers to a fixed effect for individual  $i$ ,  $\gamma_t$  refers to the treatment effect at relative time  $t$ ,  $T_i$  is a treatment dummy,  $\delta_t$  refers to the effect of relative time,  $D_t$  is a relative time dummy and  $\varepsilon_{it}$  represents a white noise term.

- There are a number of reasons for using PSM rather than standard OLS. First, OLS is inappropriate if individuals in the treated and untreated groups differ in their observable characteristics (non-overlapping common support, differences in the distribution of observables within the common support). Second, in the present case the treatment, i.e. a change in ownership status, may be expected to affect the control variables in the regression. As a result, it is no longer clear which variables one should include as controls. When using matching, one only controls for pre-treatment characteristics. Third, the comparison of standard regression results across countries may be problematic due to the non-randomness of the various samples. By constructing explicit control groups, differences in the sample design are no longer relevant. Finally, the datasets used tend to be very large. Using relatively small samples of matched data makes it more manageable in terms of computing power.
- For the firm-level analysis, only log employment, log average wage, and a full set of industry and region dummies are included.
- The data are organised into stacked cohorts. See Hijzen et al. (2008b) for more details. In order to avoid conflating treatment and composition effects related to the appearance pattern of individuals, each cohort is balanced.

The main advantage of focusing on cross-border takeovers is that it allows one to control for firm-selection, i.e. the possibility that wage levels in foreign-owned plants differ from those in domestic plants because foreign investors select their targets on the basis of unobservable time-invariant characteristics that affect pay but do not represent an effect of ownership status. However, correcting for selection bias in this manner also means that the analysis no longer captures the role of greenfield investment, the effects of which may be different.<sup>25</sup> The focus on cross-border M&A may, nevertheless, be justified on the basis that this form of FDI accounts for the bulk of FDI (UNCTAD, 2007).<sup>26</sup> Girma and Görg (2007) find for the United Kingdom that foreign takeovers of domestic firms tend to increase wages, but also that their effect depends on the industry of target firms and the nationality of acquirers. For Indonesia, Lipsey and Sjöholm (2006) find that even after controlling for firm-fixed effects, foreign takeovers raise production-worker wages by 17% and non-production-worker wages by 33%. More generally, these studies show that controlling for fixed effects reduces the estimated foreign wage premium without, however, challenging the conventional wisdom that foreign-owned firms pay higher wages than domestic firms.

Firm-level studies of the kind discussed above have motivated to an important extent the perception that foreign-owned firms pay higher wages than local firms and that foreign wage premia are more pronounced in developing countries than in developed countries. Table 5.1 presents new firm-level evidence using recent data for Germany, Portugal, the United Kingdom, Brazil, and Indonesia. The analysis focuses on both the wage and the employment effects of cross-border M&A. The following findings emerge:

- The raw differences in average wages and employment between foreign-owned and local firms are large in all of the five countries. Foreign-owned firms pay considerably more on average than local firms, with pay differences varying from 26% in Germany to 37% in the United Kingdom, 59% in Portugal, 77% in Indonesia, and 133% in Brazil. Foreign-owned firms also employ many more workers than domestic firms on average,

Table 5.1. **The effects of cross-border takeovers on average wages and employment**

Firm-level evidence

	Panel A. Average wage					Panel B. Employment				
	Germany	Portugal	United Kingdom	Brazil	Indonesia	Germany	Portugal	United Kingdom	Brazil	Indonesia
<b>Level comparisons<sup>d</sup></b>										
– without controls	0.255***	0.588***	0.366***	1.332***	0.771***	1.632***	0.827***	0.890***	2.004***	1.244***
– with controls	0.106***	0.357***	0.297***	1.054***	0.319***	1.155***	0.776***	0.872***	1.875***	1.070***
<b>Foreign takeovers of domestic firms<sup>b</sup></b>										
Average effect	0.025	0.078***	0.050**	0.111**	0.189***	-0.060	0.238***	-0.047*	0.140	0.220***
Effect at										
t = 0	n.a.	0.046*	0.038	0.100*	0.175***	n.a.	0.238***	-0.043	0.097	0.213***
t = 1	n.a.	0.106***	0.059**	0.077	0.206**	n.a.	0.235***	-0.065**	0.156	0.245***
t = 2	n.a.	0.081***	0.053*	0.157**	0.221**	n.a.	0.241***	-0.034	0.167	0.247***
<b>Domestic takeovers of foreign firms<sup>b</sup></b>										
Average effect	-0.004	-0.009	-0.061	n.a.	-0.110*	-0.042	0.005*	-0.013	n.a.	-0.011
Effect at										
t = 0	n.a.	0.000	-0.049	n.a.	-0.119*	n.a.	0.015***	0.014	n.a.	-0.012
t = 1	n.a.	-0.015	-0.063	n.a.	-0.097	n.a.	0.018***	-0.015	n.a.	-0.037
t = 2	n.a.	-0.012	-0.072	n.a.	-0.058	n.a.	-0.017***	-0.037	n.a.	0.035

StatLink  <http://dx.doi.org/10.1787/348872748836>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

n.a.: Not available.

a) Estimations with OLS. Coefficients reflect percentage differences. Controls include log employment, industry and region dummies for the average wage comparisons, and industry and region dummies for the employment comparisons.

b) Estimations with difference-in-difference propensity-score matching. Coefficients reflect percentage differences in the average wage and employment between firms that change ownership status relative to their counterfactual value had they not changed ownership status.

Source: Martins (2008) for Brazil and Portugal; Upward (2008) for Germany and the United Kingdom, OECD calculations for Indonesia based on the National Manufacturing Survey. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

with employment differences ranging from 83% in Portugal to 200% in Brazil. However, this does not necessarily mean that foreign-owned firms provide more and better jobs than *comparable* domestic firms.

- Controlling for observable firm characteristics reduces considerably average pay and employment differences between foreign-owned and domestic firms, but they still remain sizable. Foreign-domestic average pay differences range from 11% in Germany to 30% in the United Kingdom, 32% in Indonesia, 36% in Portugal and 105% in Brazil. Foreign-domestic employment differences vary from 78% in Portugal to 87% in the United Kingdom, 107% in Indonesia, 116% in Germany and 188% in Brazil. As mentioned above, these estimates may be interpreted as providing an upper bound on the potential long-term effects of inward FDI. Nevertheless, a considerable part of these differences is likely to be due to selection bias. One can address this issue by looking at changes in wages and employment of domestic firms undergoing a foreign takeover.
- Foreign takeovers of domestic firms tend to raise average wages relative to those that would have occurred in the absence of takeovers, although their impact varies considerably across countries. The effects range from 5% in the United Kingdom to 8% in Portugal, 11% in Brazil, and 19% in Indonesia, while the effect is positive but statistically insignificant in Germany. In general, these results are consistent with previous studies that have shown small and positive foreign wage premia in developed economies and potentially larger foreign wage premia in developing countries.

- The effects of foreign takeovers on average wages tend to become more positive over time. For Brazil, the foreign wage premium increases from 10% directly after the takeover to 16% after two years; for Indonesia, it increases from 18% directly after the takeover to 22% after two years; for Portugal, from 5% to 8% and the wage premium increases from 4% to 5% in the United Kingdom. The gradual increase in the positive effect may reflect the time it takes to transfer technology from parent to affiliate and for employees to accumulate human capital. However, it may also reflect the impact of foreign takeovers on the composition of the workforce.
- Foreign takeovers also tend to raise employment in some of the countries analysed, but not in all. Whereas foreign takeovers appear to reduce employment by about 5% in the United Kingdom, presumably reflecting the process of restructuring that is associated with takeovers, they raise employment by 22% in Indonesia and 24% in Portugal. No significant effects are found for Brazil and Germany.
- Domestic takeovers of foreign firms generally have no or a small negative effect on average wages and employment. This suggests that the effects of foreign takeovers of domestic firms and domestic takeovers of foreign firms are qualitatively different. This asymmetry supports the hypothesis that foreign takeovers are accompanied by the transfer of modern production and management practices from the parent to the foreign affiliate.

### *Evidence from linked employer-employee data*

The results from the firm-level analysis presented so far are in line with the conventional wisdom based on previous studies that FDI has the potential to increase significantly the number and quality of jobs, particularly in developing countries. However, the results from the firm-level analysis may be biased because they do not control for worker selection, i.e. the possibility that ownership changes are associated with changes in the composition of the workforce. To the extent that unskilled workers tend to leave after takeovers and skilled workers join, this would bias the estimated foreign wage premium upwards. Using linked employer-employee data, one can control for changes in the composition of the workforce due to cross-border M&A by focusing on the wage effects for individual workers who stay in the same firm (so-called “stayers”). Linked employer-employee data also allow one to look at the role of ownership for workers who change jobs between domestic and foreign firms. This is interesting because it allows one to analyse differences in pay conditions between foreign and domestic firms for *new* workers. As productivity differences may have more important implications for workers at the moment of hiring than for stayers (Beaudry and DiNardo, 1991), one may expect the role of ownership to be more important for this category of workers. In addition, the analysis of worker movements takes account of both foreign-owned firms that were previously domestic but have been acquired by a foreign owner and those that are established through greenfield investment.

An increasing number of recent studies have made use of linked employer-employee data to analyse the role of foreign ownership for individual wages.<sup>27</sup> The majority of these studies concentrate on cross-border takeovers in line with the firm-level literature. The results challenge the conventional wisdom by suggesting that foreign takeovers in developed countries have, at best, a small positive effect on individual wages and that their effect could even be negative. For example, Martins (2006) shows for Portugal that the foreign wage premium disappears after controlling for worker selection and may even

reduce individual wages by 3% for workers in foreign firms relative to their counterparts in domestic firms. Heyman et al. (2007) present similar findings for Sweden, which also indicate that foreign takeovers may reduce individual wages relative to their counterparts in domestic firms. By contrast, Andrews et al. (2007a) for Germany, Malchow-Moller et al. (2007) for Denmark and Balsvik (2006) for Norway find small positive effects (1-3%). It is not clear what drives differences in estimated wage premia across these studies. They may reflect differences in country characteristics or the nature of FDI, as well as differences in the econometric methodology. Moreover, it is an open question what the effect of controlling for firm and worker selection would be for the estimation of foreign wage premia in developing countries, where such premia are believed to be much larger.

Table 5.2 presents new evidence of the effects of cross-border M&A on individual wages using linked employer-employee data for Brazil, Germany, Portugal and the United Kingdom. The following findings emerge:

- Simple comparisons across workers in foreign-owned and domestic firms reveal significant differences in individual wages ranging from 9% in Germany to 19% in the United Kingdom, 26% in Portugal, and almost 70% in Brazil. Although sizable, these raw differentials are significantly smaller than the average wage differences found in the firm-level analysis (Table 5.1). This difference reflects the role of aggregation bias in inflating the firm-level estimates. Because the unit of observation has shifted from the firm to the worker this removes the bias due to the positive correlations between foreign ownership, firm size and average pay.
- As in the firm-level analysis, controlling for observable worker and firm characteristics considerably reduces individual pay differences between workers in foreign-owned and

Table 5.2. **The effects of cross-border takeovers on individual wages**

Evidence from linked employer-employee data

	Germany	Portugal	United Kingdom	Brazil
<b>Level comparisons between domestic and foreign-owned firms<sup>a</sup></b>				
– without controls	0.092***	0.265***	0.194***	0.691***
– with controls	0.040***	0.121***	0.117***	0.233***
<b>The effects of foreign takeovers of domestic firms on wages<sup>b</sup></b>				
Average effect	0.028***	0.037***	–0.004	0.012***
Effect at				
t = 0	n.a.	0.015***	0.004	0.044***
t = 1	n.a.	0.051***	–0.003	–0.013***
t = 2	n.a.	0.045***	–0.012	0.004**
<b>The effects of domestic takeovers of foreign firms on wages<sup>b</sup></b>				
Average effect	0.005*	–0.037***	0.022	n.a.
Effect at				
t = 0	n.a.	–0.076***	–0.005	n.a.
t = 1	n.a.	–0.045***	0.030	n.a.
t = 2	n.a.	0.011	0.039*	n.a.

StatLink  <http://dx.doi.org/10.1787/348883604045>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

n.a.: Not available.

a) Estimations with OLS. Coefficients reflect percentage differences. Controls include log employment, tenure, age, age squared and skill, gender, industry and region dummies.

b) Estimations with difference-in-difference propensity-score matching. Coefficients reflect the average percentage differences between the wage of workers staying in a firm that changes ownership status relative to their counterfactual wage had their firm not changed ownership status.

Source: Martins (2008) for Brazil and Portugal, Upward (2008) for Germany and the United Kingdom. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

domestic firms, but they remain fairly large. Foreign-domestic differences in individual pay vary from 4% in Germany to 12% in Portugal and the United Kingdom, and 23% in Brazil. These values place an upper bound on the long-term effect of inward FDI on individual wages. However, these estimates are likely to be upward biased due to the role of firm and worker selection. One can address selection bias by focusing on the short-term effects of changes in ownership status due to cross-border M&A.

- Foreign takeovers of domestic firms tend to have a small positive or no average effect on the individual wages of workers who stay in the same firm relative to similar workers who stay in domestic firms that are not taken over. The results suggest no effect for the United Kingdom and a small positive effect for Brazil, Germany and Portugal in the range of 1% to 4%. 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 that makes it hard to sustain differences in pay for identical workers across firms.<sup>28</sup>
- There is only limited evidence that the wage effects of foreign takeovers for stayers tend to become more positive over time. For Portugal, the foreign wage premium increases from 2% directly after the takeover to 5% after two years, while in Brazil and the United Kingdom there is no apparent time pattern. It may be that the time-span of three years is too short to capture any learning effects associated with the transfer of technology from parent to affiliate.
- The effects of domestic takeovers of foreign firms on individual wages tend to be negative or insignificant. However, any negative effects are likely to be temporary. These effects may be thought of as pure takeover effects.

There may be, at least, two reasons why the wage effects of takeovers for stayers are considerably smaller than those found in firm-level analyses, including the results presented in Table 5.1. First, foreign takeovers may be associated with technological upgrading and increases in skill-intensity. If this is the case, firm-level studies provide an overly positive picture of their wage effects, because a skill upgrading of the workforce is confounded with a pure pay premium. Alternatively, the firm-level analysis may capture a tendency for the ownership advantage of MNEs to be shared more extensively with new hires, and not with stayers, as the market for the former tends to be more competitive. This may also explain why the effects of greenfield investment, where the entire workforce consists of new hires by definition, appear to be more positive than those of cross-border M&A, which rely, at least initially, largely on the existing workforce of target firms.

One way to shed light on these issues is to analyse wage changes for workers moving between domestic and foreign firms. Relatively few studies exploit worker mobility to analyse the role of foreign ownership. Two exceptions are Andrews *et al.* (2007a) and Balsvik (2006), who show that workers moving from a domestic to a foreign firm experience a 6% increase in wages in Germany and 8% in Norway. Table 5.3 presents new evidence of the effects of worker movements between foreign and domestic firms on individual wages using data for Brazil, Germany, Portugal and the United Kingdom.<sup>29</sup> The following findings emerge:

- The results indicate large wage gains for workers who move from domestic to foreign firms and no effects or small wage losses for workers who move from foreign to domestic firms. This indicates that foreign-owned firms offer higher pay than comparable domestic firms for similar workers. Moreover, the foreign wage premia accruing to workers who move from domestic to foreign firms are considerably larger

Table 5.3. **The effects of worker mobility between domestic and foreign firms on individual wages**Evidence from linked employer-employee data<sup>a</sup>

		Germany	Portugal	United Kingdom	Brazil
<b>From domestic to foreign firms</b>					
Average effect		0.080*	0.136***	0.061**	0.213***
Effect at	t = 0	n.a.	0.115***	0.034	0.160***
	t = 1	n.a.	0.138***	0.062**	0.228***
	t = 2	n.a.	0.154***	0.087***	0.252***
<b>From foreign to domestic firms</b>					
Average effect		-0.024	-0.037***	0.013	-0.016*
Effect at	t = 0	n.a.	-0.050***	-0.000	0.013
	t = 1	n.a.	-0.040***	0.030	0.040***
	t = 2	n.a.	-0.020***	0.010	-0.101***

StatLink  <http://dx.doi.org/10.1787/350021010736>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

n.a.: Not available.

a) Estimations are conducted with difference-in-difference propensity-score matching. Coefficients reflect the average percentage differences between the wage of workers who move to a firm with different ownership status relative to their counterfactual outcomes had they not changed jobs.

Source: Martins (2008) for Brazil and Portugal, Upward (2008) for Germany and the United Kingdom. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

than those found in the context of takeovers. This may suggest that the large differences between the firm-level results in Table 5.1 and the worker-level results in Table 5.2 are likely to reflect, in part, the role of new hires in firms that change ownership status. This also makes sense intuitively as it is not obvious why new foreign owners would award large instantaneous wage increases to the incumbent workforce of acquired firms.

- Foreign wage premia associated with job movers, differ considerably across countries. They range from 6% in the United Kingdom to 8% in Germany, 14% in Portugal and 21% in Brazil. This is consistent with the consensus in the empirical literature that foreign wage premia are larger in developing than in developed countries. Presumably, this reflects the more important productivity advantage of foreign MNEs over comparable local firms in less developed countries.

Thus, both the firm-level and the worker-level results suggest that FDI may have a substantial positive effect on wages in foreign-owned firms in the host country. While one should be careful about generalising results based on only a few countries, the present results are consistent with the consensus in the literature that the positive wage effects are likely to be more pronounced in developing and emerging economies. The worker-level results based on takeovers and job movers, further suggest that the positive impact of FDI resides primarily in the provision of better job opportunities to new employees, rather than in the provision of better pay to workers who stay in firms that happen to change ownership, at least, in the short-term. This may reflect more competitive conditions in the market for new hires that allow new employees to share more widely in 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.

### Distinguishing between workers with different skills

The analysis so far has concentrated on the average effect of foreign takeovers on wages. However, the effects of foreign takeovers may not be evenly distributed across workers with different skills. The analysis of foreign takeovers is therefore repeated whilst distinguishing between different skill groups. In a first instance, the impact of foreign takeovers on the wages of production and non-production workers will be analysed at the firm-level using data for Brazil and Indonesia. In a second step, a more detailed analysis will be conducted at the level of the individual worker for the countries for which linked employer-employee data are available by distinguishing between workers with low, medium and high levels of skills.

The firm-level results for Brazil and Indonesia are reported in Table 5.4:

- The results provide some evidence that foreign wage premia may be more important for skilled than for unskilled workers in emerging economies. In Indonesia, estimated foreign wage premia differ considerably across skilled and unskilled workers, being 30% for the former and 17% for the latter.<sup>30</sup> In Brazil, a positive effect of 11% is found for skilled workers and no significant effect for unskilled workers. However, when looking at the estimated coefficients, there is no clear difference between skilled and unskilled workers in Brazil.
- While the positive wage gains for skilled workers appear to strengthen over time in both Brazil and Indonesia, the wage gains for unskilled workers in Indonesia may only be temporary.

**Table 5.4. The effects of foreign takeovers of domestic firms on average wages by skill group**

Firm-level evidence for Brazil and Indonesia<sup>a</sup>

	Unskilled workers		Skilled workers	
	Brazil	Indonesia	Brazil	Indonesia
Average effect	0.088	0.166***	0.110*	0.295***
Effect at				
t = 0	0.011	0.167***	0.112	0.262***
t = 1	0.113	0.142	0.093	0.333***
t = 2	0.142	0.099	0.125*	0.456***

StatLink  <http://dx.doi.org/10.1787/350048152405>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

a) Estimations with difference-in-difference propensity-score matching. Coefficients reflect percentage differences between domestic firms that are taken over by a foreign firm relative to their counterfactual value had they not been taken over.

Source: Martins (2008) for Brazil. OECD calculations for Indonesia based on the National Manufacturing Survey. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

Table 5.5 reports the effects of foreign takeovers of domestic firms on the wages of low-skilled, semi-skilled and high-skilled workers. The results imply important differences across countries with respect to the role of skill in both qualitative and quantitative terms:

- In the United Kingdom, the results suggest a small negative impact on the wages of low-skilled workers and no effect for semi- and high-skilled workers. By contrast, in Germany and Portugal, the impact of foreign takeovers on wages is positive for all three skill groups and differences across skill groups are modest. If anything, foreign takeovers tend to benefit most workers with medium skills.

- For Brazil, the results indicate large differences across skill groups with a positive effect for unskilled workers, a smaller but still positive effect for semi-skilled workers and a negative effect for skilled workers.<sup>31</sup> The findings for Brazil differ from the prevailing view in the literature that the effects of foreign ownership tend to be more important for skilled workers.

Table 5.5. **The effects of foreign takeovers of domestic firms on wages by skill group**

Evidence from linked employer-employee data<sup>a</sup>

		Germany <sup>b</sup>	Portugal	United Kingdom	Brazil
<b>Unskilled workers</b>					
Average effect		0.018***	0.019***	-0.025**	0.054***
Effect at	t = 0	n.a.	-0.005	-0.007	0.046***
	t = 1	n.a.	0.031***	-0.031***	0.053***
	t = 2	n.a.	0.033***	-0.036***	0.067***
<b>Semi-skilled workers</b>					
Average effect		0.027***	0.053***	0.006	0.008***
Effect at	t = 0	n.a.	0.028***	0.009	0.048***
	t = 1	n.a.	0.085***	0.010	-0.019***
	t = 2	n.a.	0.049***	-0.000	-0.007**
<b>Skilled workers</b>					
Average effect		0.014***	0.041***	0.001	-0.046***
Effect at	t = 0	n.a.	0.022***	-0.006	0.027***
	t = 1	n.a.	0.050***	0.015	-0.108***
	t = 2	n.a.	0.049***	-0.005	-0.061***

StatLink  <http://dx.doi.org/10.1787/350058145315>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

n.a.: Not available.

a) Estimations with difference-in-difference propensity-score matching. Coefficients reflect the average percentage differences between the wage of workers whose firm is taken over by a foreign firm relative to their counterfactual wage had their firm not been taken over.

b) As information on skill levels is missing for some workers, the results are not comparable to those reported in Table 5.2.

Source: Martins (2008) for Brazil and Portugal, Upward (2008) for Germany and the United Kingdom. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

### Relatively little is known about the impact of FDI on non-wage working conditions

So far, the analysis has concentrated on differences in pay between multinational and domestic firms. In the remainder of this section, attention shifts from average-wage effects to a number of alternative dimensions of working conditions which can be measured with the available data.

The empirical literature suggests that MNEs have a relatively low tendency to export labour practices to their foreign affiliates, tending instead to adapt to local practices (e.g. Almond and Ferner, 2006). Bloom *et al.* (2008) use survey data on management and work-life balance practices for over 700 medium-sized firms in the United States, the United Kingdom, Germany and France to analyse to what extent US multinationals export certain practices to their affiliates in Europe. The evidence indicates that US MNEs export management practices but not work-life balance practices. Freeman *et al.* (2007) compare labour practices in domestic and foreign affiliates of a single US firm in different countries. They find that considerable heterogeneity remains across countries, after controlling for

worker, job and product characteristics. This suggests that US firms adapt their labour practices to host country conditions.

The management literature suggests a number of reasons why US MNEs might have a low propensity to export labour practices. First, labour practices tend to be embedded in national rules and social norms. For example, the extensive regulation of the labour market in many European countries and the strong role of trade unions may make it difficult or unattractive for US MNEs to export labour practices to Europe (Bloom *et al.*, 2008). Second, the low propensity of US MNEs to export working practices may also reflect strategic considerations. For example, empirical evidence indicates that local affiliates with a domestic market orientation tend to have a significantly greater degree of discretion about the way human resources are managed than firms that are more export-oriented (Harzing, 2000; Fento-O’Creevy *et al.*, 2008).<sup>32</sup> Finally, the low propensity of US MNEs to export labour practices may reflect the specific management style of US MNEs and not be representative for MNEs originating from other countries.

There appears to be no systematic evidence on the propensity of MNEs to export labour practices to developing countries. This is unfortunate, as it not obvious to what extent the results for developed countries carry over to developing countries. On the one hand, enforcement of labour provisions and trade unions tend to be weaker in developing countries, thereby reducing the role of institutional constraints for the foreign affiliates of MNEs to implement the same labour practices they use in OECD countries. On the other hand, labour practices that are socially acceptable in developing countries may not be acceptable to the consumers and investors in developed countries, creating incentives for MNEs from developed countries to export their human-resource practices abroad.

Table 5.6 presents the estimated impacts of foreign takeovers of domestic firms on a number of working conditions other than average pay: working hours (weekly working hours for full-time workers), worker turnover (the rate of job separation), union bargaining power (the wage premium associated with collective agreements) and low pay (the probability of receiving a wage equal or lower than the minimum wage). Key findings include:

- *Hours of work.* Raw comparisons between foreign and domestic firms (not reported) suggest that working hours are longer in foreign firms in Brazil, Portugal and the United Kingdom.<sup>33</sup> However, this is largely due to the specific characteristics of firms that are acquired by foreign owners. Foreign takeovers, if anything, have a slight negative impact on working hours. The results are generally not statistically significant and even in Brazil, where they are statistically significant, they are economically negligible (*i.e.* a foreign takeover is estimated to reduce working hours by 0.2%, corresponding to five minutes per week). A reduction in working hours as a result of foreign takeovers may result when i) foreign takeovers increase hourly earnings and this induces employees to substitute working time for leisure; or ii) when foreign firms are more likely to comply with statutory limits on working hours. In either case, the reduction in working hours is most likely to be perceived positively by workers.<sup>34</sup>
- *Worker turnover.* There is some evidence that foreign takeovers increase worker turnover in Portugal, while no effect is found in either Brazil or Germany. Increased worker turnover may just reflect the process of restructuring that accompanies such takeovers in the short-term. However, it is also possible that foreign-owned firms have higher worker turnover than domestic firms in the longer-term. Level comparisons between

Table 5.6. **The effects of foreign takeovers of domestic firms on working conditions<sup>a</sup>**

		Germany	Portugal	United Kingdom	Brazil
<b>Log weekly hours</b>					
Average effect		-0.291 <sup>c</sup>	-0.002	-0.001	-0.002***
Effect at	t = 0	n.a.	-0.003	0.001	-0.001***
	t = 1	n.a.	-0.009***	0.002	-0.005***
	t = 2	n.a.	0.007**	-0.006	0.000
<b>Worker turnover</b>					
Average effect		-0.034	0.055**	n.a.	0.052
Effect at	t = 0	n.a.	0.020	n.a.	0.029
	t = 1	n.a.	0.078**	n.a.	0.057
	t = 2	n.a.	0.066**	n.a.	0.070*
<b>Low pay<sup>b</sup></b>					
Average effect		n.a.	0.006***	-0.002	0.001***
Effect at	t = 0	n.a.	-0.000	-0.006	0.001
	t = 1	n.a.	0.011***	0.001	0.002***
	t = 2	n.a.	0.007**	-0.000	0.001
<b>Union wage premium</b>					
Average effect		-0.056	n.a.	-0.039**	n.a.
Effect at	t = 0	n.a.	n.a.	-0.008	n.a.
	t = 1	n.a.	n.a.	-0.053***	n.a.
	t = 2	n.a.	n.a.	-0.055***	n.a.

StatLink  <http://dx.doi.org/10.1787/350077056677>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

n.a.: Not available.

a) Estimations with difference-in-difference propensity-score matching. Coefficients reflect the average percentage differences between the working condition of workers whose firm is taken over by a foreign firm relative to their counterfactual working condition had their firm not been taken over.

b) The UK sample is restricted to 1999-2005 due to the introduction of the minimum wage in 1998 in the United Kingdom.

c) Estimates are based on standard working hours at the firm-level.

Source: Martins (2008) for Brazil and Portugal, Upward (2008) for Germany and the United Kingdom. See Annex Tables 5.A1.2 and 5.A1.3 for details on data sources and variable definitions.

domestic and foreign firms suggest that foreign-owned firms experience higher worker turnover also in the longer term (not reported). This is consistent with Andrews *et al.* (2007b) who show for Germany that jobs are less secure in foreign than in domestic firms. A possible explanation for this may be that MNEs have more elastic labour demand as they more easily substitute local workers for workers in other locations in response to changes in relative wages (Fabbri *et al.*, 2003; Barba-Navaretti *et al.*, 2003; OECD, 2007a).

- **Low pay.** Individuals in foreign-owned firms are less likely to earn the minimum wage (or less) than those in domestic firms (not reported).<sup>35</sup> Nonetheless, foreign takeovers appear to increase the probability of low pay in Brazil and Portugal relative to comparable workers in firms that are not taken over, but there is no such effect in the United Kingdom. Note that in Brazil and Portugal, this does not necessarily mean that workers are worse off in absolute terms, but that workers at the bottom-end of the wage distribution do not experience as much wage growth as they would have, had their firm not had been taken over by a foreign firm.
- **Union wage premium.** The analysis for the United Kingdom and Germany assesses to what extent foreign takeovers affect the union wage premium for workers that were covered

by a collective agreement before the takeover relative to workers whose firm is taken over by a foreign firm but were not covered by a collective agreement.<sup>36</sup> The analysis suggests no effect for Germany and a negative effect for the United Kingdom.<sup>37</sup> The latter suggests that foreign takeovers reduce union bargaining power in the United Kingdom. This may result from the fear on the part of unions that excessive wage demands are more likely to result in the relocation of production to other countries.

The question whether MNEs promote better working conditions other than average wages is complex and the analysis above only presents a preliminary attempt to address this issue. Bearing this caveat in mind, one can draw the following tentative conclusions. First, the evidence that foreign takeovers affect working conditions other than average wages is considerably weaker than that for raising average wages. Second, and also in contrast to average wages, the impact of foreign takeovers on other working conditions is not unambiguously positive. Third, while foreign takeovers may have some impact on non-wage working conditions, it is not clear whether these effects derive from a centralised policy to export certain labour practices or reflect the responses by MNEs to local conditions. Overall, there is little evidence to suggest that MNEs export working conditions abroad.

### *Summing up*

The evidence presented in this section for three developed and two emerging economies suggests that inward FDI tends to have a positive effect on the wages of employees in foreign-owned plants, particularly in emerging economies, but little effect on working conditions other than average wages. The positive wage effects of FDI correspond well to the consensus in the empirical literature that is based on evidence for a large number of developed and developing countries. As these findings relate only to the effects of FDI within MNEs (taking no account of externalities) the positive evidence in itself does not provide a rationale for policies that favour FDI over other forms of investment. However, it suggests removing discriminatory barriers against FDI in the countries for which positive average wage effects are found.

Despite these positive results, it cannot be excluded that a minority of foreign firms offer wage and working conditions below that of their local counterparts or that fall short of national or international social norms. As a result, consumers and policy-makers in many OECD countries may still have grounds to be concerned about the labour practices of the foreign affiliates of some OECD-based MNEs. Accordingly, governments may wish to explore the role of various government instruments to promote good labour practices in the foreign operations of MNEs.<sup>38</sup>

### **3. The indirect effects of FDI on wages and working conditions in domestic firms**

This section focuses on the indirect effects of FDI on wages and working conditions in domestic firms. To this end, it starts with a brief discussion of why wages and working conditions may spillover from foreign-owned to domestic firms. It then proceeds with an analysis of average wage spillovers from FDI to domestic firms in local labour markets in the context of Indonesia. It concludes with an analysis of the specific role of supply-chain linkages and worker mobility in facilitating wage spillovers in Brazil, Germany, Portugal and the United Kingdom.<sup>39</sup>

### 3.1. Why might pay and working conditions spill over from foreign to domestic firms?

Labour practices may spill over from foreign-owned to domestic firms through productivity spillovers and labour market effects:

- *Productivity spillovers.* FDI may be associated with knowledge spillovers to local plants that raise their productivity. The literature has emphasized four channels through which such spillovers may take place.<sup>40</sup> First, domestic plants may be able to improve productivity by imitating production or management practices in foreign firms. Second, workers who change from jobs in foreign-owned to domestic plants may introduce knowledge of modern production and management practices to their new employers (Fosfuri et al., 2001; Glass and Saggi, 2002). Third, spillovers may occur from foreign firms to domestic suppliers in the supply chain: i) when sub-contracting induces specialisation among domestic input suppliers (Rivera-Batiz and Rivera-Batiz, 1990); ii) when foreign firms provide technical assistance to domestic suppliers; or iii) when foreign firms impose productivity-enhancing labour standards on their domestic suppliers. Finally, FDI may increase productivity in domestic firms when more intense product-market competition reduces X-inefficiencies in local firms.
- *Labour-market effects.* FDI may change the equilibrium market wage through its impact on labour demand and supply. Entry of foreign firms is likely to raise labour demand, thereby bidding up local wages. To the extent that foreign firms tend to pay higher wages (see Section 2), FDI may also reduce the supply of labour available to domestic firms by lowering the willingness of individuals to work for such firms. This would also tend to raise wages in domestic firms.<sup>41</sup>

### 3.2. FDI and wage spillovers

Using firm-level data for Mexico and Venezuela, Aitken et al. (1996) find no evidence of positive wage spillovers from FDI to domestic firms, even though foreign-owned plants pay substantially higher wages. The absence of positive wage spillovers may indicate that foreign-owned and domestic plants operate in different labour markets and/or that productivity spillovers may be absent or even negative. Labour markets may be segmented between foreign and domestic firms because foreign-owned firms tend to provide better working conditions, in order to limit worker turnover or because of institutional differences such as compliance with labour laws or bargaining strength vis-à-vis trade unions. Positive productivity spillovers may fail to materialise because of the lack of technological absorptive capacity of domestic firms or because of the crowding-out effect of foreign entry on local competitors.<sup>42</sup> Driffield and Girma (2003) directly control for productivity in their estimations and concentrate on the wage effects of FDI through its impact on labour demand and supply. Using data for the UK electronics industry, they find that FDI has a large positive effect on wages in domestic firms through its impact on labour demand and a small positive effect through its impact on labour supply. Moreover, wage spillovers appear to be more important for skilled than unskilled workers, which may reflect the relative scarcity of skilled labour. Finally, using a cross-section of linked employer-employee data for Indonesia, Lipsey and Sjöholm (2004b) find that FDI is positively associated with average wage levels in domestic firms, particularly those of non-production workers.

**FDI has a significant positive effect on the wages of skilled workers in domestic firms**

New evidence on wage spillovers is reported for Indonesia in Table 5.7. The wage effects of inward FDI on domestic manufacturing plants in the same region and industry are analysed using data for the period 1997-2005. The empirical model allows for productivity, labour-demand and labour-supply effects. The labour-demand effect may either reflect the direct effect of FDI on labour demand in foreign firms or its indirect effect on labour demand in domestic firms, when FDI is associated with productivity spillovers. One can isolate the foreign labour-demand effect by augmenting the basic empirical model with a measure of productivity in domestic firms (labour productivity in this case). The difference in the coefficients on the foreign presence index, between the estimations that control for productivity and those that do not, gives an indication of the role of productivity spillovers from FDI for domestic labour demand. The labour-supply effect of FDI is captured by including the average wage offered by foreign firms in the same region and industry as a regressor. To account for the possibility that the effects of FDI on wages in domestic firms differ across skill groups, the empirical model is also estimated separately for production and non-production workers. (More details on the derivation of the empirical model can be found in Annex 5.A3) The following findings emerge:

- The results suggest that inward FDI has a positive effect on the average wage of non-production workers in domestic firms in the same industry and region in Indonesia, but no impact on the average wage of production workers. This reflects to a large extent the direct effect of foreign entry on the local demand for non-production workers.<sup>43</sup> A 10% increase in the foreign-presence index raises non-production worker wages in domestic firms by about 2%. While this may be good for non-production workers, employment in domestic firms may suffer at the expense of foreign-firm employment.

**Table 5.7. Foreign direct investment and wage spillovers to domestic firms<sup>a</sup>**  
Firm-level evidence for Indonesia<sup>b</sup>

	All		Production workers		Non-production workers	
Log capital	0.022***	0.033***	0.020**	0.032***	0.008	0.020*
Log labour productivity	0.183***		0.189***		0.161***	
Foreign presence index <sup>c</sup>	0.057	0.103	0.041	0.086	0.212**	0.234**
Log average wages in domestic firms <sup>c</sup>	0.210***	0.242***	0.246***	0.282***	0.199***	0.209***
Log average wages in foreign firms <sup>c</sup>	0.004	0.000	-0.006	-0.009	0.008	0.006
Log employment, nonproduction workers			0.043***	0.034**		
Log employment, production workers					0.243***	0.202***
Constant	4.586***	5.891***	4.199***	5.213***	4.232***	5.653***
R-squared	0.41	0.36	0.38	0.33	0.19	0.17
Observations (1number of firms)	26 903 (14 404)					

StatLink  <http://dx.doi.org/10.1787/350107054604>

\*, \*\*, \*\*\*: statistically significant at the 10%, 5%, 1% level, respectively, confidence interval based on robust standard errors.

a) All regressions are estimated with fixed effects and include a full set of time dummies and industry- and region-specific trends.

b) The sample covers the manufacturing sector for the period 1997-2005.

c) Employment and average wages refer to all workers, production workers and non-production workers, respectively.

Source: OECD calculations for Indonesia based on National Manufacturing Survey. See Annex Tables 5.A1.2and 5.A1.3 for details on data sources and variable definitions.

- The wage of non-production workers in domestic firms may also increase as a result of the indirect effect of FDI on the labour demand of domestic firms through its impact on productivity in those firms. However, this effect appears to be very small.
- There is no evidence of a labour-supply effect of FDI.<sup>44</sup>

### 3.3. Spillovers through backward linkages and worker mobility

The analysis for Indonesia suggests that the effects of inward FDI on wages in domestic firms through its impact on productivity are very small on average. Previous empirical studies on productivity and wage spillovers provide mixed results and suggest that the average effect of FDI can even be negative. The lack of robust evidence in support of positive productivity-driven wage spillovers may reflect the crowding-out effect of domestic firms as a result of the competition from foreign firms in output and input markets, including the local labour market for skilled workers. While the evidence in support of positive productivity-driven wage spillovers may be limited on average, their importance is likely to differ across local firms according to their engagement with foreign MNEs. In particular, productivity-driven wage spillovers are likely to be more important for local firms that supply foreign MNEs or that hire workers with prior experience in foreign firms. The remainder of this section will explore the impact of FDI on wages in domestic firms through productivity spillovers by explicitly focusing on the role of backward linkages and worker mobility between domestic and foreign firms.

A number of recent papers have attempted to analyse how productivity and wage spillovers may occur by looking at specific ways through which domestic firms engage with foreign firms. For example, Görg and Strobl (2005) examine empirically the contribution of worker mobility to productivity spillovers using a panel of Ghanaian manufacturing firms. They find that domestic firms with an owner who has previously been employed in a foreign firm in the same industry, are more productive than other domestic firms. Balsvik (2006) also analyses productivity spillovers through worker mobility by concentrating on the share of workers with recent experience in MNEs as the main explanatory variable. Using linked employer-employee data for Norway, she finds that workers with prior experience in MNEs tend to contribute 20-25% more to productivity than workers without such experience. Moreover, the contribution to firm productivity exceeds the private return to mobility, which suggests that worker mobility entails genuine productivity externalities. Poole (2006) analyses the role of worker mobility for wage spillovers using linked employer-employee data for Brazil. She finds evidence in support of positive wage spillovers and that their magnitude depends on the skill levels of workers previously employed by MNEs and incumbent workers in the domestic firm.

Backward linkages provide an alternative channel through which spillovers may occur from FDI to local firms. A number of studies have shown using input-output tables that backward linkages from foreign plants to local suppliers are associated with positive productivity spillovers (see Javorcik, 2004 for Lithuania; Blalock and Gertler, 2008 for Indonesia). Intuitively, this reflects the fact that foreign firms often have a strong interest in helping local supplier firms to improve the quality of inputs or to ensure that sub-contractors respect minimum labour standards (Moran, 2007; Sabel *et al.*, 2000). There is little systematic analysis that specifically looks at the effects of backward linkages from MNEs on wages and working conditions in supplier firms. Harrison and Scorse (2006) provide indirect evidence that reputation-sensitive MNEs helped raising the wages of unskilled workers in Indonesian textiles factories without, however, inducing a reduction

in unskilled employment in those factories. This may indicate that MNEs not only helped raise wages but also productivity.<sup>45</sup> A number of case studies analyse the impact of CSR policies (i.e. private codes of conduct) adopted by MNEs on working conditions in upstream suppliers (Frenkel and Scott, 2002; Locke *et al.*, 2007a and b; Lake, 2007). In general, the effectiveness of such codes appears to be limited. The main reasons are likely to be the difficulty of raising labour standards in a highly competitive environment and the failure of MNEs to actively engage with supplier firms to help improving working practices and productivity. Box 5.3 discusses the impact of private codes of conduct and monitoring in the supply chain in more detail.

Using data from the World Bank Enterprise Survey, Figure 5.4 compares employment conditions and productivity in domestic firms that engage with foreign firms in the supply chain or that have managers with previous experience in foreign firms, on the one hand, with domestic firms that have no apparent relationship with foreign firms, on the other. For comparison, the average difference between foreign and unrelated domestic firms is also included in the figure. These data indicate that:

- Domestic firms that engage with foreign firms in the supply chain or that hire managers with prior experience in foreign firms tend to be larger, more productive and pay higher wages than local firms that have no apparent relationship with foreign firms (but are considerably smaller and less productive than foreign firms).
- Domestic firms that engage with foreign firms are also more likely to provide training courses to their employees.
- There is no apparent difference in terms of union membership or voluntary worker turnover between such firms and other domestic firms.

While the simple comparisons reported in Figure 5.4 suggest that backward linkages and worker mobility could potentially be important channels of wage spillovers between foreign and domestic firms, this does not necessarily follow as the simple correlations do not say anything about the causal effect of engaging with foreign firms on working conditions in domestic firms. Indeed, it seems plausible that foreign firms select more productive firms as their suppliers and that workers with experience in foreign firms find it more attractive to work in more productive firms. Due to the cross-sectional nature of the World Bank Enterprise Survey, it is not possible to address these selection issues.

### ***Human capital accumulated in foreign firms can be effectively transferred through worker mobility***

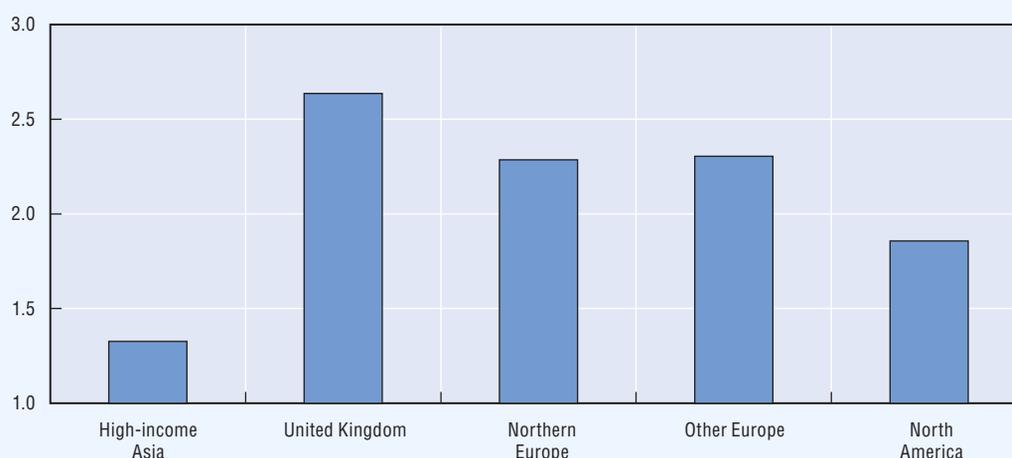
In order to get a deeper understanding of the role of worker mobility for wage spillovers, it is worth turning back to the results presented in Table 5.3 on worker movements. The analysis on worker movements may be considered a first step towards analysing wage spillovers through worker mobility as it provides insights in the extent to which human capital that is accumulated in foreign firms can be transferred to domestic firms. By comparing the magnitude of wage gains associated with worker movements from domestic to foreign firms with the wage losses associated with movements from foreign to domestic firms, one may get an idea of the extent to which worker mobility may be a potentially important channel for wage spillovers. To the extent that wage gains are not completely offset by corresponding wage losses, workers may be able to carry with them some of the knowledge that they have accumulated in foreign firms. The results indicate that wage gains are considerably larger than wage losses in each of the four countries

### Box 5.3. The impact of corporate social responsibility (CSR) on working conditions in the supply chain

In response to social concerns about poor labour practices in the supply chain, reputation-sensitive MNEs have increasingly adopted private codes of conduct that specify minimal labour standards for supplier factories and implemented increasingly sophisticated monitoring arrangements to ensure supplier compliance. Using the EIRIS firm-level database, the figure in the box gives an indication of the importance of formal policies adopted by MNEs with respect to labour standards in the global supply chain. The figure shows that, except for MNEs from high-income Asia, there is substantial evidence for such policies. The significant presence of such systems among North-American MNEs is particularly noteworthy given their traditional reluctance to disclose any information not mandated by law. This may reflect the impact of anti-sweatshop campaigns on the corporate conduct of US-based MNEs. However, these figures do not reveal to what extent these policies indeed help raise working conditions in foreign supplier factories or whether supply-chain policies are mere window-dressing intended to alleviate consumer concerns about unethical working practices.

#### MNE policies on working conditions in the supply chain

Average scores by home region<sup>a, b</sup> (0-3 from low to high evidence)<sup>c</sup>



StatLink  <http://dx.doi.org/10.1787/348804024477>

- a) EIRIS only assesses companies in sectors with high exposure to supply-chain issues: retailers, apparel manufacture, toy manufacture, sports goods manufacture, food producers and processors and tobacco. The sample consists of 266 listed companies. The analysis here is restricted to companies with operations in countries deemed by EIRIS to be high risk in terms of human rights violations ("list A and B countries"). This reduces the sample to 121 companies.
- b) High-income Asia: Hong Kong (China), Japan and Singapore; Northern Europe: Denmark, Finland, Iceland, Ireland, Norway and Sweden; Other Europe: Austria, Belgium, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain and Switzerland; North America: Canada and the United States; Oceania: Australia and New Zealand.
- c) What is the extent of policies, systems and reporting overall on global supply-chain standards? The values are coded as: 0: Little or no evidence; 1: Some evidence; 2: Clear evidence; and 3: Very clear evidence.

Source: OECD calculations based on EIRIS database. For further details on the indicators and the definitions, see Annex Table 5.A1.1.

An interesting case study was conducted on the effectiveness of CSR in raising working conditions in the supply chain for Nike (see Locke *et al.*, 2007a and 2007b). Nike is an ideal subject for such a study as i) it is one of the largest sportswear companies in the world; ii) it is strongly dependent on outsourcing production to low-cost suppliers abroad;<sup>4</sup> and iii) it became one of the focal points of the anti-sweatshop movement that criticised certain MNEs for the poor working conditions in some of their supplier factories.

### Box 5.3. The impact of corporate social responsibility (CSR) on working conditions in the supply chain (cont.)

Nike initially refused to take responsibility for working conditions in independent supplier firms but reversed its position in 1992 when it first formulated a code of conduct that required suppliers to respect minimum labour standards. From 1992 onwards, it developed an increasingly sophisticated corporate responsibility and compliance program. By 2004, it employed 80 CSR and compliance managers. Footwear factories were inspected on a daily basis and apparel and equipment factories weekly. In addition, Nike employed about 1000 production managers who work in close collaboration with its suppliers around the world. The efforts by Nike to raise working conditions in their supplier firms are also acknowledged by EIRIS who attributes it the highest score for evidence of policies on labour standards in the supply chain. Despite Nike's substantial efforts, the impact of its corporate responsibility and compliance program seems to have been rather limited. Nike reports that working conditions in almost 80% of its suppliers have failed to improve (and may have even worsened).

Using data from Nike on compliance with its codes of conduct Locke *et al.* (2007a) show that average compliance may not be too poor. However, there is substantial heterogeneity in compliance levels across suppliers, even within single countries. This heterogeneity can be explained, in part, through the relationship between Nike and its suppliers. While the interaction between Nike and its suppliers on non-compliance matters – measured by the number of visits by production specialists – turns out to be an important determinant of compliance, inspections by compliance staff appear to have little or no effect. Although surprising at first sight, this finding corresponds well to the experience of Adidas, as documented by Frenkel and Scott (2002). They conclude that compliance programs based on long-term partnerships are more likely to bear fruit than those based on the policing of working conditions. The latter have a tendency to raise labour costs among suppliers, whereas the former are more likely to induce deep organisational change that allows for improvements in both productivity and working conditions.

In a complementary study, Locke and Romis (2007) compare two of Nike's independent suppliers of T-shirts. Both are subject to the same economic conditions and labour regulations, deal with the same regional office of Nike, and perform similarly in Nike Factory audits. Despite these similarities, the authors observe striking differences in actual working conditions. Workers in Plant A are paid higher wages, report greater work satisfaction, and have a greater voice in the production process. Moreover, in Plant A overtime is limited and always voluntary and in Plant B overtime tends to be structural and imposed on workers. These differences reflect profound differences in the way the plants are managed. Plant A operates an efficiency-wage strategy in which workers are seen as an important factor to bolster productivity and output quality, whereas Plant B operates a competitive market model in which workers are seen as a variable cost that is to be minimised. Interestingly, despite paying higher wages, productivity is higher and unit labour cost lower in Plant A.

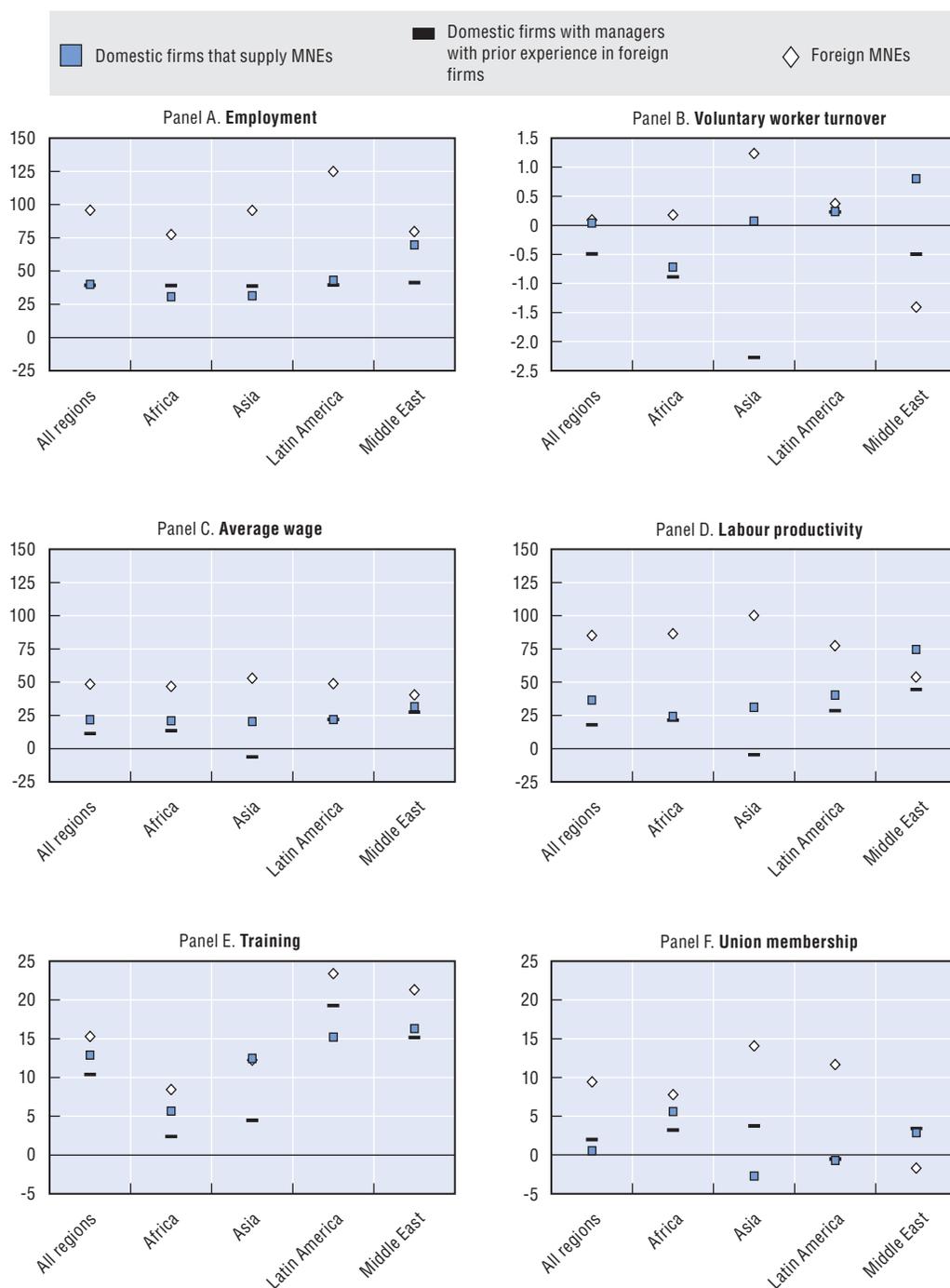
Locke *et al.* (2007b) conclude that the benefits of codes of conduct are likely to be greater and more enduring when they are integrated into the management structures that govern production and when the interests of workers in employment and production are represented in effective institutions. However, even when these requirements are met, private codes of conduct do not provide a substitute for public regulation. They are best seen as a useful complement to public law enforcements activities.<sup>b</sup>

a) In 2004, Nike employed just over 24 000 direct employees (mostly in the United States). Almost all its products were manufactured outside the United States by 800 independent suppliers employing together about 0.6 million workers located in 51 different countries.

b) Note that a comprehensive evaluation of private codes of conduct published by Ethical Trading Initiative (ETI, 2006) suggests that the experience of Nike is by no means unique and Nike's experience is likely to be relevant for many MNEs that make use of independent suppliers in developing countries.

Figure 5.4. **A comparison of employment conditions and productivity in domestic firms that engage with MNEs and with other local firms<sup>a</sup>**

Average percentage differences by host region<sup>b</sup>



StatLink  <http://dx.doi.org/10.1787/348821802117>

- a) The comparison group consists of domestic firms that neither supply MNE nor have a manager with prior experience in a foreign firm. As a result, the descriptive statistics for foreign MNEs presented here differ somewhat from those presented in Figure 5.3.
- b) "All regions" includes the four regions shown and central and eastern European countries (CEE). Asia includes low-income Asia only.

Source: OECD estimates based on World Bank Enterprise Survey. See Annex Table 5.A1.4 for details on variable definitions.

analysed. Thus, worker mobility could be an important channel for wage spillovers. However, as the analysis is limited to private returns (i.e. the returns to workers who change jobs), it does not provide any direct information about the presence of wage spillovers (i.e. the impact on the wage of incumbent workers in the domestic firm). Further work will be necessary to establish whether human capital accumulated in foreign firms may spillover to incumbent workers in domestic firms, as a result of worker mobility.

### **Summing up**

The evidence for positive effects of inward FDI on wages and working conditions in local firms is considerably weaker than that for such effects within foreign affiliates. The evidence for Indonesia suggests that, consistent with previous empirical studies, positive wage spillovers largely reflect a distributional effect that arises as a result of the competition for local labour by foreign firms that expand their production activities. The role of productivity-driven wage spillovers appears to be limited in general, but may be more important in the presence of stronger linkages between local firms and MNEs in the supply chain or through worker mobility.

The presence of productivity-driven wage spillovers may, in principle, provide a rationale for policies to promote FDI, including specific incentives targeted at potential foreign investors. However, the evidence for such spillovers is weak and also suggests that FDI tends to increase wage inequality. The latter is confirmed in the literature in the context of many other developing countries (Goldberg and Pavcnik, 2007). Moreover, the review of case studies about the impact of private codes of conduct in MNEs on working conditions in the supply chain suggests that poor labour practices in independent supplier firms remain a concern despite the use of increasingly sophisticated monitoring arrangements by some MNEs. Public initiatives in the fields of monitoring and technical assistance may help to strengthen the effectiveness of private codes of conduct in raising labour practices in the supply chain.

## **4. Promoting socially responsible investment**

This section discusses how governments can promote inward FDI and strengthen the contribution of MNEs to improving wages and working conditions in host countries. First, policy measures are discussed that are meant to maximise the potential contribution of FDI to overall welfare. Given the heterogeneous nature of FDI, this involves both promoting the volume and the quality of FDI. It then looks at various government instruments that are explicitly designed to minimise the social cost of FDI and maximise its contribution to social development.

### **4.1. Promoting foreign direct investment**

The existing empirical literature and the new empirical evidence presented in this chapter suggest that inward FDI tends to have a positive social impact on workers in foreign-owned firms, and to a lesser extent, also on workers in domestic firms that engage with MNEs. Countries can use different instruments to promote inward FDI, while also ensuring that labour standards are respected.

### ***Removing regulatory obstacles to FDI and taking measures to enhance the overall investment climate are key to promoting inward FDI***

The positive effects of inward FDI for workers on host economies suggest reducing regulatory barriers to FDI. Such barriers often take the form of entry restrictions and regulatory provisions that differentiate between foreign and domestic entities.<sup>46</sup> The OECD Policy Framework for Investment (OECD, 2006) emphasises in this regard the importance of most-favoured nation (MFN) and national treatment as general principles. MFN treatment means that an investor from one country is treated no less favourably than an investor from any third country by the regulatory authorities of the host country. National treatment provides that host governments treat foreign-owned firms no less favourably than domestic firms. Exceptions to MFN and national treatment need to be evaluated regularly to ensure that their rationale remains valid. A key issue in this context is to determine whether it is appropriate to make use of mandatory performance requirements, which have sometimes been imposed by developing countries in an effort to maximise the benefits from FDI. The use of mandatory performance requirements has been criticised as it does not take into account the endogenous response of MNEs to their imposition. For example, an obligation on foreign investors to take a local partner may induce MNEs to conduct less sophisticated activities abroad or to adopt older technologies in their foreign operations to reduce the risk of technology transfer (Moran, 2007).<sup>47</sup> Rather than imposing performance requirements on foreign investors, governments are increasingly seeking ways to strengthen the integration of foreign firms in local economies through positive incentives (OECD, 2005a).<sup>48</sup>

Beyond removing regulatory barriers to FDI, governments can encourage inward FDI by promoting a healthy investment climate where both uncertainty and the cost of doing business are reduced. Apart from economic and political stability, uncertainty also relates to the protection of property rights and the effectiveness of contract enforcement (OECD, 2006). This also includes the protection of foreign investors against the risk of expropriation (the seizure of private property by governments in the broader public interest) through the provision of adequate compensation and effective dispute settlement mechanisms. An unresolved issue is to what extent compensation is appropriate for loss of private value as a direct result of public regulation (OECD, 2005b). This is an important issue as policy uncertainty is often mentioned as one of the main constraints on doing business in developing countries (World Bank, 2005). A sound investment climate also encompasses the quality of infrastructure, not too restrictive employment protection legislation, transparent administrative procedures and effective anti-corruption measures.<sup>49</sup>

### ***Lowering labour standards or weakening their protection in an effort to attract FDI is ineffective***

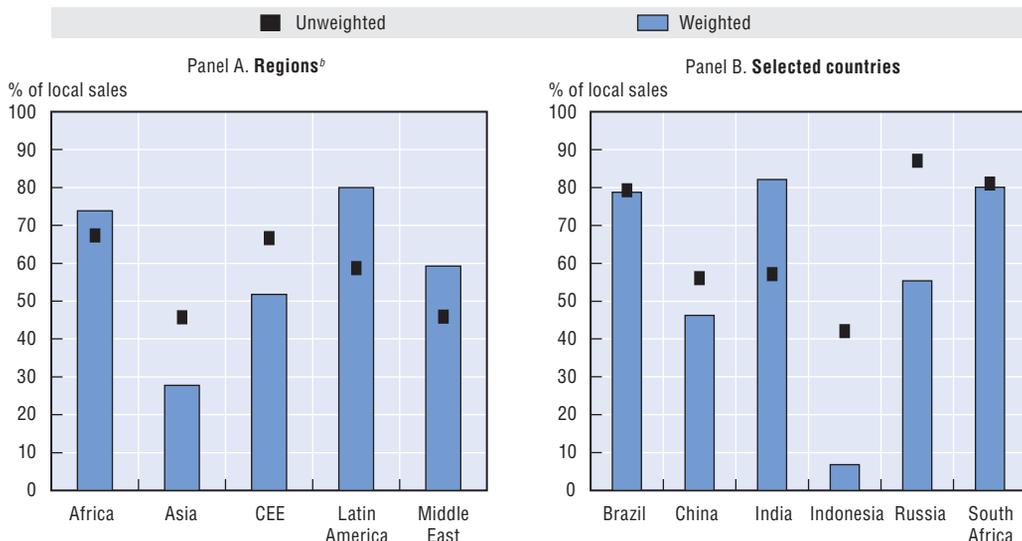
In the debate on MNEs and labour standards, much attention has been paid to the possibility that governments from developing countries may lower labour standards, including by violating core labour standards, to attract FDI, potentially triggering a so-called “race-to-the-bottom” in labour standards by inducing other countries to follow suit. For lower labour standards to raise FDI, two conditions would have to be met: i) reducing production costs needs to be the main motivation for FDI; and ii) lowering labour standards should reduce unit labour costs. The validity of these two hypotheses is discussed briefly below. Note that even if lowering labour standards would encourage FDI, it might also be expected to change the composition of FDI and its corresponding benefits.

Broadly speaking, there are two main motivations for MNEs to invest in a certain location: to supply a local market more cheaply (“market-seeking” or “horizontal” FDI) or to produce a good or service more cheaply (“efficiency-seeking” or “vertical” FDI). While efficiency-seeking FDI could potentially induce a race-to-the-bottom in labour standards when MNEs seek out locations where production costs are lowest, there is no reason to believe that this should happen in the presence of market-seeking FDI. The relative importance of efficiency and market-seeking FDI may thus give a first indication of the extent to which countries can compete for FDI on the basis of low labour costs. A simple way to assess this is by looking at the shares of sales by foreign affiliates that are sold locally or exported (Blonigen, 2005). Figure 5.5 presents data on the composition of foreign-affiliate sales based on the World Bank Enterprise Survey (WBES). It suggests that market access is the predominant motive for FDI and not, as is sometimes asserted, the desire to reduce production costs. Local sales account for the majority of foreign-affiliate sales in most developed and developing country regions. An important exception is low-income Asia, where foreign affiliates make the majority of their sales through exports.<sup>50</sup> Thus, while reducing production costs does not appear to be the main driver of FDI in general, it may well be the main motive in certain industries and countries. However, even if FDI is predominantly motivated by reducing production costs, it does not necessarily follow that reducing formal labour standards will encourage FDI.<sup>51</sup>

Is FDI attracted by poor labour practices? In general, there is no evidence to suggest that weaker formal labour standards increase inward FDI. Analysing differences in national labour regulations, OECD (1996, 2000b) find little support for the hypothesis that weaker labour market regulation provides a catalyst to FDI. However, formal labour

Figure 5.5. **The role of market access and production costs for FDI**

Percentage of local sales of foreign affiliates by host region and country<sup>a</sup>



StatLink  <http://dx.doi.org/10.1787/348851777447>

CEE: central and eastern Europe.

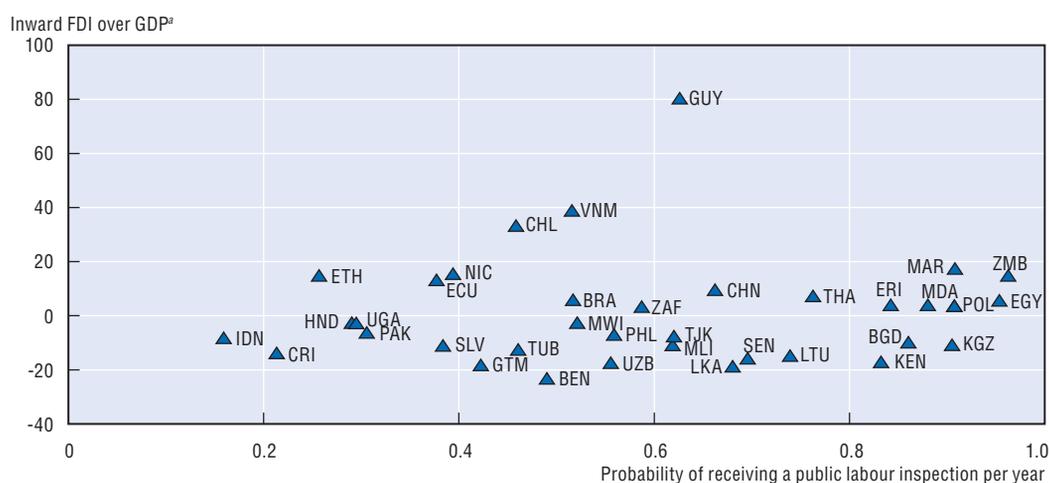
a) The unweighted local sales shares are simple averages across firms, whereas the weighted local sales shares are weighted by sales. While the weighted shares are preferable from a conceptual point of view, the unweighted results are less sensitive to outlier observations.

b) Asia includes low-income Asia only.

Source: OECD estimates based on World Bank Enterprise Survey. See Annex Table 5.A1.4 for details on variable definitions.

standards are not necessarily a good predictor of actual labour conditions due to weak enforcement in some developing countries. Indeed, it is possible that developing countries seek deliberately to attract FDI by not enforcing *de jure* labour standards.<sup>52</sup> Figure 5.6 relates the component of inward FDI that cannot be explained by either market size (a proxy for market-seeking FDI) or the level of development (a proxy for efficiency-seeking FDI) to the strength of labour-law enforcement. *Prima facie*, the evidence in Figure 5.6 suggests that the degree of labour-law enforcement (the probability of receiving a public labour inspection in a given year) is unrelated to inward FDI.<sup>53</sup> Complementary evidence by the World Bank (2005) also does not suggest that greater integration in world markets induces non-compliance with labour regulations in developing countries. Indeed, previous studies find that, if anything, FDI tends to be attracted by better rather than worse core labour practices (Kucera, 2002).<sup>54</sup> The absence of a negative relationship between inward FDI and core labour practices may not be all that surprising as lowering labour practices may adversely affect productivity and the working environment more generally. MNEs are also under increasing pressure from consumers and home country governments to ensure that minimum labour standards are respected in their foreign operations.

Figure 5.6. **Inward FDI and labour law enforcement**



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- a) Inward FDI over GDP is defined as the residual from a regression of this variable on GDP and GDP per capita. The conditional correlation between FDI over GDP and the probability of receiving a public labour inspection in a given year is positive but statistically insignificant (0.04). The unconditional correlation is 0.06, but also statistically insignificant.

Source: OECD estimates based on World Bank Enterprise Survey. See Annex Table 5.A1.4 for details on variable definitions.

In short, the empirical evidence suggests that lowering core labour standards or weakening workers' protection does not facilitate, and may even discourage, FDI inflows. This provides further support for the view of the OECD and its members that it is inappropriate to relax labour standards to encourage inward investment (OECD, 2006). The OECD Guidelines for Multinational Enterprises, moreover, ask MNEs to refrain from seeking regulatory exemptions from non-OECD governments that, despite the empirical evidence, may be inclined to grant such exemptions (OECD, 2000a). Box 5.4 discusses to what extent governments have allowed lower working conditions in export processing zones (EPZs) in order to provide a more competitive environment to foreign investors.

#### Box 5.4. Export Processing Zones (EPZs)

Export processing zones are “industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being (re-)exported again” (ILO, 1998). The number of EPZs has expanded rapidly as countries have shifted from import-substitution policies to export-led growth policies. In 2006, 130 countries had EPZs adding up to a total number of 3 500 EPZs employing 66 million workers (40 million in China) (Singa Boyenge, 2007). Moreover, EPZs are increasingly diverse in scope and design. In addition to covering the traditional labour-intensive manufacturing and assembly activities, they now also encompass high-tech science parks. Zones may relate to designated geographic areas but also targeted industries. Most EPZs offer superior access to infrastructure as well as some fiscal incentives.

Compared to policies that remove obstacles to trade and investment and measures to improve the investment climate on a national basis EPZ policies are sub-optimal and may even be welfare reducing when they introduce new distortions in the economy. However, as establishing EPZs is financially and politically less demanding than undertaking an overall reform of the national investment climate, it may be a useful first step with demonstration effects to promote broader market-oriented reforms. Cost-benefit analyses suggest that some EPZs have contributed to development, others have been unsuccessful in attracting FDI, promoting exports and generating formal jobs (Engman *et al.*, 2007). The success of EPZs depends on many factors including infrastructure, the rule of law and linkages with the host economy.

EPZs have been the subject of considerable social concerns over low wages and poor working conditions. In general, the same labour standards apply in EPZs as in the rest of the economy. Nonetheless, some countries have adopted specific labour laws in the context of EPZs, including Djibouti, Panama and Zimbabwe, while in other countries national labour standards apply with certain exceptions, in particular with reference to hours of work and minimum wages or restrictions to freedom of association and collective bargaining (ILO, 2008). There is some indication that EPZ-specific labour provisions are becoming less common. A number of countries have recently lifted restrictions on freedom of association and collective bargaining (*e.g.* Bangladesh), while others have taken steps to bring EPZ standards more closely in line with national standards. For example, Nigeria and Pakistan are in the process of enacting legislation granting freedom of association to EPZ workers (ILO, 2008).

In terms of earnings, workers in EPZs tend to be better off than their counterparts outside the zones. While wages are sometimes lower on average in labour-intensive EPZs than in formal jobs outside the zones, the alternative for many EPZ workers, and particularly women, would be to work in the informal sector where average wages are considerably lower (Madani, 1999). Cling *et al.* (2005) find that EPZ workers in Madagascar earn 6% to 17% more than comparable workers outside the zone. The picture for non-wage working conditions tends to be more mixed. While the respect for the rights of freedom of association and collective bargaining may be weaker in EPZs and excessive working hours more common, even when national standards apply, EPZ workers tend to have better access to social security and health care than their counterparts in the host economy (ILO, 2008).

In order to enhance labour practices in EPZs, governments should be encouraged to further harmonise labour standards in EPZs with those in the wider economy and increase their efforts to enforce them effectively. Governments may also wish to collaborate more closely with responsible buyers that have a vested interest in raising labour practices in their supply chains (see Box 5.6 for more details on such an approach).

***Specific incentives to promote inward FDI may be useful in some circumstances but need to be applied with care***

In addition to removing regulatory barriers to FDI and establishing and maintaining a healthy investment climate, governments may also wish to develop policies that are directly aimed at promoting inward FDI and their potential benefits by providing some form of preferential treatment to foreign firms. From an efficiency perspective, such policies can be justified in the presence of market failures related to either information imperfections or positive externalities flowing from FDI (productivity spillovers).<sup>55</sup>

Investors may have to incur considerable costs to overcome information imperfections in the context of international investment. As information imperfections can have important welfare implications (Greenwald and Stiglitz, 1986), they can provide a rationale for governments to engage in the provision of various information services. Such services could include image-building activities to foster the perception of countries as a location for FDI; matching services between potential investors and domestic partners or suppliers;<sup>56</sup> facilitation services to assist in establishing and maintaining a business; and policy advocacy to promote policies that enhance the investment climate (Wells and Wint, 1990). Charlton and Davis (2007) provide compelling evidence that investment promotion can help to attract additional inward investment.<sup>57</sup>

A second rationale for countries to engage in investment-promotion activities is the presumed importance of knowledge externalities that may be associated with inward FDI. In the presence of positive externalities, the privately optimal level of foreign investment falls short of the socially optimal level, providing a justification for public intervention through the use of fiscal or regulatory incentives.<sup>58</sup> Regulatory incentives have sometimes been used by countries as a “cheap” alternative to fiscal incentives. However, the discussion above suggests that exempting foreign investors from national labour provisions is not an appropriate instrument to attract FDI.

Fiscal incentives, however, may be potentially effective in promoting FDI. Nevertheless, governments that make use of such incentives need to periodically evaluate their appropriateness and relevance (OECD, 2006).<sup>59</sup> First, governments should make sure that the benefits from additional FDI outweigh the costs. The analysis presented in Section 3 does not suggest that significant benefits necessarily arise from FDI.<sup>60</sup> Even if they do, they have to be weighed against the costs of providing the incentives. Second, fiscal incentives may provoke rent-seeking behaviour among government officials. This is more plausible the greater is the level of discretion in determining incentives and the lower is the level of transparency and accountability of investment promotion agencies. Rent-seeking may be a particular concern in developing countries where institutions are weaker.<sup>61</sup> Finally, governments need to take account of the effects that fiscal incentives may have on third countries and the possible responses that this may trigger. When governments compete for FDI on the basis of fiscal incentives, they may become ineffective in generating additional investment and instead mainly serve to redistribute rents from taxpayers to foreign firms. Finally, the use of fiscal incentives should not be a substitute for pursuing policy measures to create a healthy investment environment.

**4.2. How to ensure minimum labour practices in the foreign operations of MNEs?**

Although the evidence presented so far suggests that workers in foreign-owned firms, and to a lesser extent, workers in domestic firms that engage with MNEs, tend to enjoy

better wages than their counterparts in other firms, average tendencies hide substantial heterogeneity in labour practices in the foreign affiliates of MNEs and their supplier firms. Non-compliance with national and international labour provisions in countries with weak rules of law by OECD MNEs and, in particular, their independent suppliers, continues to represent a pressing concern among consumers and policy-makers in many OECD countries. This sub-section looks at what governments can do to deal with specific instances of non-compliance and the persistence of poor working conditions in MNEs and their supply chains. It first discusses initiatives and proposals addressed to host-country governments that seek to promote minimum labour standards and to strengthen incentives for their enforcement. It then reviews initiatives and proposals to strengthen the incentives of MNEs to comply with national and international labour provisions and for responsible business conduct (RBC) more generally.<sup>62</sup> While the focus is on the foreign operations of MNEs, most of the policy instruments discussed in this section apply to all business that have an international dimension to their operations and not just MNEs or their independent suppliers.

***Poor labour practices in the foreign operations of MNEs to a large extent reflect weak public enforcement of national and international labour provisions***

In order to analyse the role of governments in ensuring minimum labour practices in the foreign operations of MNEs, one may start by asking why poor labour practices arise in the first place. To what extent do poor labour practices in the foreign operations of MNEs reflect inadequate formal protection of labour rights in host countries or non-compliance with national labour provisions?

The role of inadequate formal labour protection can be analysed by looking at the extent to which universal labour rights are inscribed into national labour legislation. The ILO Declaration on Fundamental Principles and Rights at Work (1998) represents the most widely accepted effort to define a set of core labour standards that may be considered universal, in the sense that it is widely believed that they ought to apply in all countries irrespective of the level economic and societal development. The Declaration covers four areas of labour rights: i) freedom of association and the right to collective bargaining; ii) the elimination of forced or compulsory labour; iii) the abolition of child labour; and iv) the elimination of discrimination in respect of employment and occupation. Each category is associated with two ILO conventions.<sup>63</sup>

Currently, the large majority of countries has formally subscribed to some or all parts of the ILO Declaration. Table 5.8 gives an overview of the state of ratification of each of the eight conventions under the Declaration across regions and selected countries. As of 1 February 2008, the member states of the ILO have on average ratified more than seven out of eight conventions under the Declaration (89% of the member-convention combinations have been ratified).<sup>64</sup> Ratification tends to be lower among Asian countries than in other regions. Legal traditions appear to be an important factor in explaining ratification, whereas economic variables such as GDP per capita or trade openness do not play an obvious role (Chau and Kanbur, 2001).<sup>65</sup>

Not surprisingly, the general support for the ILO Declaration is also reflected in national labour law. Flanagan (2006) shows that ratification of ILO conventions is strongly correlated with national labour provisions. Indeed, many developing countries where poor labour practices in the operations of OECD-based MNEs have been a concern tend to have reasonable *de jure* labour standards in many areas, in some cases comparable to those in developed countries. While in some countries important improvements can still be made,

Table 5.8. **Ratifications of the fundamental labour rights conventions**

	Freedom of association and collective bargaining		Elimination of forced and compulsory labour		Elimination of discrimination in respect of employment and occupation		Abolition of child labour	
	Convention 87	Convention 98	Convention 29	Convention 105	Convention 100	Convention 111	Convention 138	Convention 182
<b>Regions (181)</b>	<b>148</b>	<b>158</b>	<b>172</b>	<b>170</b>	<b>164</b>	<b>166</b>	<b>150</b>	<b>165</b>
Africa (53)	48	52	53	53	50	53	46	49
Americas (35)	33	32	33	35	33	33	29	34
Asia (42)	17	23	35	31	30	29	26	33
Europe (51)	50	51	51	51	51	51	49	49
<b>G7 countries</b>	<b>6</b>	<b>5</b>	<b>5</b>	<b>6</b>	<b>6</b>	<b>5</b>	<b>5</b>	<b>7</b>
Canada	23-03-1972	–	–	14-07-1959	16-11-1972	26-11-1964	–	06-06-2000
France	28-06-1951	26-10-1951	24-06-1937	18-12-1969	10-03-1953	28-05-1981	13-07-1990	11-09-2001
Germany	20-03-1957	08-06-1956	13-06-1956	22-06-1959	08-06-1956	15-06-1961	08-04-1976	18-04-2002
Italy	13-05-1958	13-05-1958	18-06-1934	15-03-1968	08-06-1956	12-08-1963	28-07-1981	07-06-2000
Japan	14-06-1965	20-10-1953	21-11-1932	–	24-08-1967	–	05-06-2000	18-06-2001
United Kingdom	27-06-1949	30-06-1950	03-06-1931	30-12-1957	15-06-1971	08-06-1999	07-06-2000	22-03-2000
United States	–	–	–	25-09-1991	–	–	–	02-12-1999
<b>O6 countries</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>5</b>	<b>6</b>	<b>6</b>	<b>5</b>	<b>5</b>
Brazil	–	18-11-1952	25-04-1957	18-06-1965	25-04-1957	26-11-1965	28-06-2001	02-02-2000
China	–	–	–	–	02-11-1990	12-01-2006	28-04-1999	08-08-2002
India	–	–	30-11-1954	18-05-2000	25-09-1958	03-06-1960	–	–
Indonesia	09-06-1998	15-07-1957	12-06-1950	07-06-1999	11-08-1958	07-06-1999	07-06-1999	28-03-2000
Russian Federation	10-08-1956	10-08-1956	23-06-1956	02-07-1998	30-04-1956	04-05-1961	03-05-1979	25-03-2003
South Africa	19-02-1996	19-02-1996	05-03-1997	05-03-1997	30-03-2000	05-03-1997	30-03-2000	07-06-2000

StatLink  <http://dx.doi.org/10.1787/350144833320><no value>

– Not ratified.

Source: ILO, ILOLEX database.

poor labour practices in the foreign operations of MNEs do not seem to reflect in the first place the inadequate formal protection of core labour rights.

To what extent then do poor labour practices in the foreign operations of MNEs reflect non-compliance with national labour provisions? Due to the lack of systematic information on compliance levels among MNEs and their suppliers, it is not possible to address this question directly. Nevertheless, it is possible to make a number of useful observations. First, empirical evidence suggests that there is no strong link between higher formal labour standards and better actual labour practices (Flanagan, 2006). This provides a first indication that labour standards are not enforced evenly across countries. Second, labour-law enforcement tends to be considerably weaker in developing than in developed countries. This can be seen from Table 5.9, which provides summary indicators of two aspects of labour-law enforcement: i) the probability of receiving a labour inspection in a given year; and ii) the probability of receiving a fine when subjected to a labour inspection. It shows that public labour inspections are conducted more regularly in developed and transition economies than in developing countries.<sup>66</sup> Moreover, inspections in developing countries tend to be less rigorous, as indicated by the relatively low probability of getting a fine when being inspected in Africa and Asia. While, in principle, this could indicate that compliance with national labour laws is particularly high in those regions, it seems more likely that this reflects the ineffectiveness of governments in enforcing labour laws. The reasons for this may be economic, political or institutional. Countries may not want to enforce labour standards because they fear this will weaken competitiveness and deter foreign investors or there may be political reasons not to enforce labour standards,

Table 5.9. **The enforcement of labour laws**

	Probability of receiving at least one public inspection per year		Probability of receiving a fine conditional on getting a visit	
	Mean	Number of observations	Mean	Number of observations
Africa	0.62	2 917	0.05	1 088
Asia <sup>a</sup>	0.61	10 062	0.04	4 369
Central and eastern Europe	0.82	7 373	0.12	614
Latin America	0.46	5 583	0.13	1 706
Middle East	0.92	1 977	0.37	63
Western Europe <sup>b</sup>	1.00	1 041	–	–
Brazil	0.52	1 639	0.16	833
China	0.66	3 841	0.02	2 495
Indonesia	0.16	711	0.18	113
Russia	1.00	229	–	–
SouthAfrica	0.59	584	0.01	337

StatLink  <http://dx.doi.org/10.1787/350150581042>

– Not available or insufficient number of observations.

a) Asia includes low-income Asia only.

b) Western Europe includes Ireland and Spain only.

Source: OECD estimates based on World Bank Enterprise Survey. See Annex Table 5.A1.4 for details on variable definitions.

particularly in authoritarian regimes. However, in the majority of countries, this is likely to reflect the inability to enforce labour legislation effectively due to institutional weaknesses and insufficient resources.<sup>67</sup>

### **Linking de jure or de facto labour standards to market access in trade agreements**

One way to promote better labour practices in the foreign operations in OECD-based MNEs may be to strengthen the incentives of national governments to transpose core labour standards into national law and/or to enforce national labour provisions effectively. Governments may be encouraged to take such actions if *de jure* or *de facto* labour standards are linked to market access by including labour provisions in trade agreements. The basic idea is that market access may be denied to products from a country where global labour standards are routinely violated by local exporters or the affiliates of foreign MNEs by imposing trade sanctions.<sup>68</sup> The possibility of trade sanctions creates a “level-playing field” across all exporting firms irrespective of the nationality of the owner. The economic rationale for linking labour standards to trade is based on the presumption that countries can increase their competitiveness by weakening the protection for labour standards and thus may be tempted to enter into a race-to-the-bottom in labour standards, although human-rights considerations can provide an alternative rationale for linking trade to core labour standards. As was discussed above, the available evidence casts doubt on the belief that trade linked to FDI is generally dominated by a search for the lowest possible labour standards.

Proposals for including labour standards in the WTO encountered fierce opposition, mostly from developing countries. At present, the WTO does not include any labour provisions and this is unlikely to change in the foreseeable future. The main arguments against including labour standards in the WTO are economic – based on the perception that they are protectionist in nature – and political – reflecting disagreement about the definition of global labour standards. It has also been argued that the WTO simply lacks the capacity to enforce labour standards effectively.<sup>69</sup>

However, labour provisions have been included in a growing number of Regional Trade Agreements (RTAs) and the Generalised System of Preferences (GSP).<sup>70</sup> The United States

has probably been the most active in this respect by routinely negotiating labour provisions, usually as side-agreements, in its RTAs since 1993. The labour provisions that are included tend to conform to a general template (Kolben, 2007): it includes the (aspiratory) aim of transposing ILO's core conventions into domestic legislation, and the obligation to "not fail to effectively enforce its labor laws ... in a manner affecting trade between the Parties".<sup>71</sup> Failure to enforce one's own laws could, in principle, eventually result in sanctions.<sup>72</sup>

A notable example of a recent agreement which seeks to use positive incentives rather than negative ones (e.g. trade sanctions to promote compliance with core labour standards), is the US-Cambodian trade agreement that was concluded in 1999 (see Box 5.6 for more details). The trade agreement introduced positive incentives by making the extension of quota limits dependent on the level of compliance with international and national labour laws. This induced the Cambodian Government to accept the involvement of the ILO in an innovative monitoring initiative to enhance compliance.<sup>73</sup> However, the potential of similar trade-based initiatives in the future is not clear as the use of quotas in the WTO was completely eliminated with the expiration of the Multi-Fibre Arrangement in 2005. The scope for positive incentives based on tariff preferences is also unclear since tariff preferences go against the principles of the WTO and the ongoing liberalisation of trade continues to erode the value of tariff preferences.<sup>74</sup>

ILO conventions and proposals for linking labour standards to trade put the prime responsibility for poor labour practices on national governments. While these approaches may help to strengthen incentives to protect basic labour standards and reduce the temptation of some governments to allow poor labour practices in order to gain a competitive advantage, they are likely to be less effective when poor labour practices reflect institutional weaknesses. A complementary approach is to focus directly on the responsibility of business to respect national and international labour legislation. The initiatives and proposals discussed below seek to strengthen the incentives of MNEs for compliance with labour standards and for offering enhanced employment conditions more generally. This can be done by focusing on non-market and market incentives. Each will be discussed in turn.

### ***What is the scope for legally binding instruments to hold MNEs accountable for their operations abroad?***

A number of attempts have been made to hold MNEs legally accountable for their operations abroad, especially in countries where the rule of law is weak, by imposing direct obligations under international law. The most far-ranging proposal to impose direct obligations on MNEs under international law are the draft norms on the responsibilities of transnational corporations and other business enterprises with regard to human rights, put forward by the UN Sub-Commission on the Promotion and Protection of Human Rights in 2003. While acknowledging the primacy of national authorities in enforcing human rights, the draft norms attribute to MNEs and other businesses a corresponding responsibility within their "spheres of activity and influence" and call for the establishment of appropriate institutions to monitor corporate compliance. The draft norms, however, have not been ratified and it seems unlikely that this will happen in the future.<sup>75</sup>

Nevertheless, MNEs may be held legally accountable for their operations abroad through the exercise of extraterritorial jurisdiction by national courts under certain circumstances. Under international law, extraterritorial jurisdiction is recognised when one of the parties involved is a national; extraterritoriality is "reasonable"; and, it does not

interfere with the internal affairs of other states (Ruggie, 2008a). The legal community is divided as to the precise circumstances in which the protection of human rights, including labour rights, would justify extraterritorial jurisdiction. As the scope for imposing direct obligations under international law on MNEs to make them legally accountable for their operations abroad seems limited at present, most governments continue to rely on CSR initiatives and soft-law instruments to deal with these issues.

### ***Mobilising market incentives: the role of soft-law instruments***

The incentives for MNEs to comply with and exceed national and international labour standards depend on demand and supply conditions. The demand for socially responsible labour practices (and responsible business conduct more generally) depends on buyer preferences and the visibility of labour practices in the production process. Policy initiatives can shape preferences for responsible labour practices by raising awareness about poor labour practices. For the latent demand for responsible labour practices to be activated, however, labour practices need to be made visible to buyers. Akerlof (1970) has shown that in the presence of information asymmetries that create uncertainty about product quality (in this case responsible business conduct), buyers tend to base their decisions on average quality, thereby driving high-quality suppliers (here, socially responsible businesses) out of the market. The main problem is the absence of a credible way for suppliers to disclose information about the quality of labour practices in the production process to buyers. Sellers may be able to overcome this problem by building reputations. This explains, in part, why MNEs with highly visible brands have tended to be more active on the CSR front than their more anonymous independent suppliers. However, information asymmetries in the market for responsible business conduct may also justify public measures to collect and disseminate credible information about labour practices.

The supply side of responsible business conduct may be characterised by a choice problem over alternative, publicly available technologies. For example, firms may adopt so-called “low-road” competitive wage technologies associated with poor labour practices in production or “high-road” efficiency-wage technologies with better labour practices. Typically, the choice of technology is driven by the desire to maximise profits. To the extent that firms adopt “low-road” technologies because they are unaware of “high-road” technologies, policy-makers can help by enhancing awareness among managers. While managers of successful MNEs are likely to be fully aware of the various organisational models available, this may not necessarily be the case for smaller firms, especially in developing countries where management practices are often deeply rooted in social norms and knowledge of modern production and management techniques can be limited.<sup>76</sup> Moreover, “low-road” technologies may get locked in even when “high-road” technologies are more profitable in the long-run, due to the presence of significant switching costs and credit-market imperfections. This may provide a justification for providing technical assistance to firms who wish to improve labour practices and extending the availability of micro-credit to such firms in developing countries.

### ***Multilateral initiatives can promote responsible business conduct by raising awareness of poor labour practices***

A growing number of multilateral initiatives have been launched to promote awareness and strengthen the impact of responsible business conduct. The most important examples are the UN Global Compact (1999), the OECD Guidelines for Multinational

Enterprises (1976, revised in 2000) and the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, also known as the MNE Declaration (1977, last revised in 2006).

The UN Global Compact (GC) is a voluntary initiative directed towards businesses that seeks to align corporate behaviour around ten universal principles in the areas of human rights, labour standards, the environment and anti-corruption and to promote the contribution of businesses to the UN's goals for sustainable development. The universal principles are derived from the Universal Declaration of Human Rights; the ILO Declaration on Fundamental Principles and Rights at Work; the Rio Declaration on Environment and Development; and the UN Convention against Corruption. To achieve these objectives, the Global Compact promotes the adoption and implementation of its principles into the strategies and operations of businesses and facilitates co-operation between businesses, UN agencies and civil society organisations.

The OECD Guidelines and the ILO MNE Declaration are recommendations by adhering governments, supported by employer and worker organisations, which are directly addressed to MNEs.<sup>77</sup> Explicit support of governments is considered important as it fosters the credibility of the instruments. The basic premise of the guidelines is that internationally-agreed principles can help to prevent misunderstandings and build an atmosphere of confidence between MNEs and the societies in which they operate (OECD, 2000a). Similarly, the MNE Declaration is intended to encourage the positive contribution that MNEs can make to economic and social progress and to minimise and resolve the difficulties arising from their operations (ILO, 2006).

The OECD Guidelines and the MNE Declaration differ in terms of their coverage, scope and follow-up mechanisms. First, the OECD Guidelines establish non-binding standards in a wide range of areas related to sustainable investment such as human rights, disclosure of information, anti-corruption, taxation, labour standards, environment, competition and consumer protection, whereas the MNE Declaration is solely concerned with labour standards.<sup>78</sup> Second, the MNE Declaration represents a truly global instrument, as it is addressed to all MNEs, while the OECD Guidelines only relate to MNEs that operate in and from adhering countries.<sup>79</sup> Finally, the MNE Declaration does not provide a mechanism to address specific instances, while the OECD Guidelines allow for active mediation in specific instances through the system of National Contact Points (NCPs). It is this specific-instance facility of the guidelines that accounts for the growing interest in the guidelines as an international instrument for promoting responsible business conduct. Box 5.5 discusses the OECD Guidelines and the NCP system in more detail.

### ***Better Work: a promising new initiative to raise labour practices in the supply chain***

The largely uncoordinated approach to promoting responsible business conduct taken by the international community so far has proved an effective strategy for policy experimentation and helped increase its visibility in policy debates. Nonetheless, the impact of these public initiatives in stimulating the demand and supply for responsible business conduct appears to have been relatively limited. Efforts to raise the visibility of responsible business conduct on the demand side have been mostly left to non-governmental initiatives.<sup>80</sup> For example, SA8000 makes CSR products more visible to consumers through certification; the Global Reporting Initiative helps investors by developing and promoting reporting guidelines for corporate social responsibility to

### Box 5.5. The OECD Guidelines for Multinational Enterprises and the system of National Contact Points (NCPs)

The OECD Guidelines for Multinational Enterprises, adopted in 1976 and revised in 2000, are the most comprehensive government-supported corporate responsibility instrument in existence today. Their forty adhering governments – 30 OECD countries and ten non-OECD countries representing all regions of the world and accounting for 85% of foreign direct investment – are committed to encourage enterprises operating in their territory to observe a set of widely recognised principles and standards for responsible business conduct wherever they operate.

The promotion of high-level standards for employment and industrial relations is one of the most important features of the guidelines. In particular, Chapter IV on Employment and Industrial Relations:

- Promotes the effective abolition of child and forced labour, non-discrimination, the right to employee representation, and the protection of health and safety of workers.
- Provides, in the event of closure of an entity involving collective lay-offs or dismissals that enterprises should give reasonable notice to representatives of their employees and co-operate with the employee representatives and appropriate governmental authorities so as to mitigate to the maximum extent practicable adverse effects.
- Asks companies, in the context of *bona fide* negotiations with representatives of employees on conditions of employment, not to threaten to transfer activities from the country concerned to other countries in order to influence those negotiations unfairly.

The OECD Guidelines also ask companies to refrain from seeking or accepting exemptions to labour and other regulatory standards, and to encourage, where practicable, business partners, including suppliers and sub-contractors, to apply principles of responsible business conduct.

Adhering countries take up the obligation to set up National Contact Points (NCPs), with the general aim of furthering the effectiveness of the guidelines. NCPs main duties are to undertake promotional activities, handle enquiries relating to the implementation of the guidelines and discuss with the parties concerned on all matters covered by the guidelines. NCPs operate in accordance with the criteria of visibility, accessibility, transparency and accountability.

NCPs promote awareness and understanding of the guidelines through a variety of activities such as the provision of prospective investors with information on the guidelines, the organisation of multi-stakeholder events and seminars and the development of dedicated websites. Adhering governments are also increasingly making reference to the guidelines in export-credit and investment-guarantee programmes.

The OECD Guidelines are most widely known, however, for their unique implementation mechanism – the specific instance facility – which commits NCPs to contribute to resolving disputes and reducing tensions with respect to the implementation of the guidelines. Requests to the NCPs for their services can be made by any party. Eight years after the revision of the OECD Guidelines, which reinvigorated the (previously little effective) NCP system, more than 160 specific instances have been raised at the NCPs. Most of the specific instances, so far, have dealt with employment and industrial relations issues. The increasing share of these instances related to labour issues in non-OECD countries suggests that the OECD Guidelines are playing a growing role in the improvement of labour conditions.

**Box 5.5. The OECD Guidelines and the system of National Contact Points (NCPs) (cont.)**

The NCP will first make an assessment of whether the issues raised merit examination and respond to the party or parties raising them. Where the issues raised merit further examination, the NCP will offer to help the parties resolve the issues. For this purpose, it may *inter alia* seek advice from relevant national authorities and offer, with the agreement of the parties involved, to facilitate access to consensual and non-adversarial means, such as conciliation or mediation, to assist in dealing with the issue. While in the course of the proceedings confidentiality should be maintained, agreements or other results of the proceedings are, as a general rule, made publicly available.

The NCPs operate in accordance with the objective of functional equivalence, which allows adhering countries considerable freedom over the way the NCPs are organised. Most NCPs have a multi-government agency structure, and many of them are tri- or quadripartite (business, trade and NGOs are also represented). A few NCPs have recently adopted new structures to increase stakeholder involvement. The OECD Investment Committee has recently conducted a survey of the performance and operational procedures of the NCPs and the key findings are summarised in OECD (2008b).

business; and the Ethical Trading Initiative promotes and improves the implementation of corporate codes of conduct in the context of working conditions in supply-chain firms. On the supply side, technical-assistance programmes to firms that would like to raise labour practices, but have difficulty doing so because of the potentially significant costs associated with deep organisational changes, are rare (see Box 5.6 for an exception). Also, more could be done to deepen the understanding of how responsible business conduct affects firm productivity, particularly in developing countries, by encouraging systematic research into this area and disseminating best practices.

The Better Work Program, a joint initiative launched by the International Finance Corporation (IFC, a member of the World Bank Group) and the ILO in 2006, seems a promising initiative to raise working conditions in the workplaces of firms in the supply chain. Better Work goes beyond existing public soft-law initiatives that largely focus on raising awareness, by strengthening both the demand and supply for responsible business conduct. The latent demand for responsible labour practices among international buyers is activated by improving transparency about labour practices in supplier firms, through the involvement of the ILO in the monitoring of compliance and the dissemination of information on labour practices. The supply of responsible business conduct is stimulated by providing technical assistance and credit to firms that wish to raise labour practices. Importantly, supplier firms may have strong incentives to raise labour practices as this allows them to gain access to markets with buyers that are willing to pay higher prices for their products. The Better Work Program builds on the relative success of an earlier initiative by the ILO, Better Factories Cambodia, that grew out of a bilateral trade agreement between Cambodia and the United States to raise labour practices in the garment sector (see Box 5.6).

### Box 5.6. **Better Factories Cambodia**\*

Textiles have long received special treatment in the multilateral trading system. Since 1974, trade in textiles was governed by the so-called Multi-Fibre Arrangement (MFA) that allowed importing countries to impose quotas on specific products when import surges in these products could seriously undermine domestic industry. During the Uruguay Round of the GATT negotiations concluded in 1995, it was decided to gradually phase out the MFA over a period of ten years under the Agreement on Textiles and Clothing (ATC).

Cambodia, not being a member of the GATT, had relatively free access to the markets of developed countries once it started to develop its textiles industry in the 1990s. As its share in the US market increased rapidly in the late 1990s, the US Government came under pressure from domestic producers to bring Cambodia into the quota system. The ensuing bilateral trade agreement for textiles between the United States and Cambodia signed in 1999 linked market access with labour standards as had become standard practice for the United States in its bilateral trade agreements. However, rather than providing negative incentives, by allowing for sanctions in the presence of widespread violation of worker rights, the US-Cambodian trade agreement introduced positive incentives, by establishing quotas in line with current export volumes whose limits would be extended as the level of compliance of the Cambodian textiles sector with international and national labour laws rose. However, as market access incentives would soon lose their value with the expiry of the MFA and collective incentives tend to be weak due to coordination problems when raising working conditions is costly, the agreement was unlikely to have a lasting impact on working conditions on its own.

The bilateral trade agreement was complemented by an innovative initiative under the leadership of the ILO to monitor the degree of compliance with labour standards for the determination of quota limits. The ILO was approached for this task not only because of its expertise in the area of labour standards, but also because public inspections by the Cambodian authorities or private inspections by independent monitoring agencies did not carry sufficient credibility to inform policy decisions by the US Government. This, however, meant a significant departure from the activities conducted by the ILO. Thus far, the ILO had only been engaged in the monitoring of compliance of governments with ratified conventions and had not been directly involved in the monitoring of private agents or the inspection of workplaces. The monitoring initiative consists of two components that run in parallel.

First, compliance with national and international law is assessed in a comprehensive and transparent way. In order to ensure that the assessment of compliance was representative for the industry as a whole, the Government of Cambodia made the allocation of export permits conditional on programme participation. However, this does not address the free-rider problem associated with collective incentives. To address this, the decision was taken eventually to publish information on individual firms that systematically violate labour standards in addition to the sector-wide synthesis reports that were provided from the beginning. The implications of this decision for the program were far-reaching. Most importantly, reputation-sensitive MNEs can rely on the ILO reports to select factories that are in compliance and no longer have to engage in the private monitoring of supplier firms. As a result, the rules-based system introduced by the trade agreement was effectively replaced by a market-based system, which ensured that Cambodia could remain an attractive location after the expiration of MFA in 2005.

**Box 5.6. Better Factories Cambodia\*** (cont.)

Second, technical assistance and training is provided to help improve working conditions and competitiveness. Training is necessary to make sure that managers are familiar with applicable labour laws and to effectively integrate respect for labour standards into their management systems. Perhaps even more important, however, is to show to managers how better working conditions can help improve productivity and competitiveness. If working conditions can be raised without increasing unit labour costs, the scope for responsible business practices is not limited by the willingness of consumers to pay and it may be possible to successfully replicate the experiment in Cambodia in other countries.

Better Factories Cambodia has been a success in many respects. In almost ten years, employment in the garment sector increased from 80 000 to 350 000 in October 2007 (Polaski, 2006; ILO, 2007). At the same time, working conditions have improved significantly, although problems remain, particularly with respect to occupational health and safety and overtime work. Violations of core labour standards, such as child and forced labour are rare (ILO, 2007). The Cambodian government asked the ILO to continue its monitoring initiative after the expiration of the MFA agreement. The programme is currently in the process of becoming fully sustainable without the outside help of the ILO by establishing a new institution. In an effort to replicate the success of Better Factories in other countries, the ILO and the IFC have jointly launched the Better Work program in 2006. As with the Better Factories programme, the main tenets are compliance and technical assistance. The Better Work programme will start with three pilot projects in Vietnam, Jordan and Lesotho.

\* See Kolben (2004) and Polaski (2006) for detailed discussions of this initiative.

## Conclusion

Drawing from the extensive literature and new empirical analysis for three developed countries (Germany, Portugal and the United Kingdom) and two emerging economies (Brazil and Indonesia), this chapter suggests that, overall, multinational enterprises tend to promote higher pay in the countries in which they operate. However, it also suggests that the effects on wages depend on many factors such as the level of development of home and host countries and the way MNEs organise their operations abroad. The effects are stronger for workers in foreign affiliates than for those in independent supplier firms and more important the larger the technology gap between the home and host countries. The question whether MNEs also promote better non-wage working conditions is more complex and the analysis in this chapter only presents a first attempt to address this question. The findings suggest that while non-wage working conditions in foreign firms tend to differ from those in comparable domestic firms, working conditions do not necessarily improve following a foreign takeover.

Do the potential benefits of FDI in terms of higher wages for workers also help to improve the performance of the labour market as a whole? This question is difficult to address. First, it depends on the implications of FDI for labour market inequality or labour market segmentation. Consistent with the previous empirical literature, the findings in this chapter suggest that inward FDI may raise earnings inequality, particularly in developing countries, by raising the relative earnings of skilled workers. The chapter does not address the possibility that FDI may contribute to labour market segmentation, but the existing literature provides little evidence to suggest that FDI leads to an expansion of the informal sector or non-compliance with labour standards (Goldberg and Pavcnik, 2007).

Second, it depends on the effects of FDI on overall welfare. The positive wage effects of inward FDI may be a *prima facie* indication of the positive impacts of FDI resulting from the transfer of modern production techniques 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.

In this context, FDI-friendly policies can be a useful component of an integrated policy framework for development. However, they should not be considered as a substitute for broader policies aimed at improving the business environment more generally. 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. Inward FDI can be usefully promoted by removing specific regulatory obstacles to FDI. Under certain circumstances, it may also be appropriate to provide specific incentives to potential foreign investors, but the evidence here is rather weak. Lowering core labour standards in an effort to provide a more competitive environment for potential investors is likely to be counter-productive. Doing so is likely to discourage FDI from responsible MNEs (with potentially important social benefits), 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. In the context of the supply chain, public initiatives could also play a potentially important role in raising labour practices. Public monitoring arrangements could strengthen market incentives for responsible business conduct among supplier firms by generating greater transparency in labour practices. Technical assistance and credit facilities may be useful to help supplier firms overcome obstacles to raising labour practices, thereby making their products more attractive to responsible buyers.

## Notes

1. The work for this chapter was conducted in the context of mandates for further OECD analysis resulting from the discussions on “Globalisation, Equity and Growth” during the meeting of OECD Ministers in May 2007, the meeting of G8 Labour and Employment Ministers in May 2007 and the Heiligendamm G8 Summit in June 2007.
2. A classic example is the decision of Intel, a global electronics company, to establish a semiconductor-assembly and test plant in Costa Rica (World Bank, 2006). The effects of the entry of Intel on the economy went far beyond expectations. Amongst other things, it placed Costa Rica on the map as a potential location for foreign investors, contributed to its improved investment climate and helped strengthening its knowledge base.
3. The chapter focuses predominantly on the consequences of *inward* FDI in OECD and non-OECD countries. Chapter 3 of the 2007 *OECD Employment Outlook* discusses some of the implications of *outward* FDI and offshoring in OECD countries (OECD, 2007a).
4. The econometric analysis makes use of linked employee-employer data from administrative sources. Because of the confidential nature of these data and their complicated structure, a small network of researchers was established by the Secretariat to conduct the econometric analysis on the basis of a common methodology. The analysis for Brazil and Portugal was conducted by Pedro Martins and that for Germany and the United Kingdom by Richard Upward. The firm-level analysis

for Indonesia was conducted by the Secretariat. The choice of countries was driven by data availability. A more detailed presentation of the econometric analysis can be found in Hijzen *et al.* (2008a).

5. Throughout, the chapter concentrates on FDI in manufacturing and to a lesser extent the services sector. It does not cover specific issues raised by FDI in extractive industries and infrastructure. For more on FDI in extractive industries, see Moran (2006) and UNCTAD (2007).
6. The latter are likely to be particularly important for MNEs that source labour-intensive inputs from developing countries. In the case of Nike, for example, the number of indirect employees may be more than twenty times the number of direct employees. See Box 5.3 for more details.
7. Developing countries are here defined as non-OECD countries. Using other common classifications does not change the main insight that developing countries have become increasingly important as countries for inward and outward FDI.
8. Employment effects are likely to be particularly important in countries where formal employment opportunities are limited.
9. Nevertheless, OECD (1996) suggests that concerns by certain developing countries that enforcing core labour standards would negatively affect economic growth or their international competitiveness are unfounded.
10. Ethical Investment Research Services (EIRIS) is an independent, non-profit research organisation that conducts research on CSR for investors. EIRIS research is compiled using information supplied by companies such as annual reports, sustainability/CSR reports, company websites, and EIRIS survey responses, but also makes use of a variety of non-company sources. The database allows users to score company policies on the basis of a wide range of CSR criteria including several indicators on working conditions. For a more in-depth analysis, see OECD (2008c).
11. The relatively weaker performance of UK companies relative to other European companies may result from selection bias due to the greater coverage in EIRIS of smaller companies in the United Kingdom.
12. An advantage of the EIRIS database is that it allows one to look at the extent of CSR policies rather than simply whether or not firms have any sort of code of conduct in certain areas. Edwards *et al.* (2007) observe that US MNEs are more likely to have labour codes than European MNEs. The present analysis suggests that these are, nevertheless, likely to be less extensive than in European MNEs.
13. Note that there can be no “one-size-fits-all” approach to corporate social responsibility as preferences for CSR differ across countries (OECD, 2001).
14. Davis *et al.* (2005) consider regulation the most important driver of CSR.
15. This is confirmed by Edwards *et al.* (2007) who report that European MNEs are much more likely to negotiate CSR policies with employee representatives than North-American MNEs where such policies tend to reflect the exclusive initiative of the management.
16. The World Bank Enterprise Survey (WBES) is a large firm-level database covering mostly developing countries. It covers mainly manufacturing and certain services for registered firms with more than ten employees.
17. More controversially, Porter and Kramer (2006) argue that the actual social impact also represents the appropriate benchmark to evaluate the corporate social responsibility of MNEs rather than, more narrowly, the extent to which corporate reputations for responsible business conduct are harnessed and stakeholder expectations satisfied. According to Porter and Kramer, CSR involves maximising “shared value”, i.e. benefits that accrue to both business and society and, in the present context, to outcomes that raise both labour practices and firm profitability. Shared value may come about not just through the implementation of cost-increasing CSR policies that lead to higher product prices (the “demand-side” of CSR), but also through the integration of CSR into management strategies that raise both labour practices and long-term productivity (the “supply-side” of CSR). The extension of CSR to the supply-side expands the scope for CSR beyond the “willingness to pay” by consumers and investors for better labour practices. However, it also makes it harder to distinguish the impact of CSR from the social impact of day-to-day business. See Section 4.2 for a related discussion of CSR.
18. Halegua (2007), for example, suggests that US MNEs operating in China tended to oppose the new Labour Contract Law that entered into force 1 January 2008, as they may have had to apply labour provisions more rigorously than their local counterparts due to pressure from US consumers.

19. However, in developing countries where the respect for labour and human rights presents real problems, reputation-sensitive MNEs may also have stronger incentives to offer better employment conditions to low-skilled workers than domestic firms.
20. As for western Europe, data in the WBES are only available for Ireland and Spain, this region was not included in Figure 5.3. Average wage differences between MNEs and local firms in those countries are not statistically different from zero.
21. The productivity gap between foreign and local firms is larger than the wage gap in most countries, implying that the wage share of total output is lower for MNEs. This might be an indication that worker bargaining power is weaker in foreign than in local firms, perhaps because fewer *comparable* outside job opportunities are available for workers in such firms. Even if this interpretation should be accurate, it does not mean that workers in foreign firms are worse off than their domestic counterparts. It would just mean that the premium associated with working in a foreign firm may not be as large as it would have been otherwise. It must be emphasised, however, that the descriptive statistics in Figure 5.3 may not reflect worker bargaining power in MNEs. Another possible explanation for lower wage shares could be that MNEs are more capital-intensive than domestic firms.
22. In order to address these problems, one ideally would like to make use of a panel of linked employer-employee data. Linked employer-employee data provide information on both individual workers and their firms. Panel data of this type allow one to follow workers across firms and to keep track of the ownership status of their firms. Aggregation bias is completely removed once the unit of analysis is shifted from the firm to the employee. Composition bias is effectively dealt with by explicitly controlling for the observable characteristics of individual workers. Selection bias is greatly reduced by controlling for observable worker and firm characteristics, as well as any unobservable characteristics that are constant over time.
23. Annex Table 5.A2.1 summarises key studies contributing to this literature.
24. For example, Lipsey and Sjöholm (2004a) ask whether foreign wage premia may simply reflect differences in worker composition between foreign and domestic firms. In order to address this possibility, they use plant-level data for Indonesia with detailed information on the composition of workers across educational categories. They find that, while differences in average labour quality account for a significant part of the raw foreign wage premium, the estimated foreign wage premia remain large: wages in foreign-owned plants are 12% higher for production workers and 20% for non-production workers. Te Velde and Morrissey (2003) present similar findings for five Sub-Saharan African countries.
25. Heyman *et al.* (2007) show, using firm-level data for Sweden, that the wage difference between foreign-owned firms that were established through greenfield investment and comparable domestic firms tends to be larger than that between foreign-owned firms that were established through M&A and comparable domestic firms. This may be plausible as greenfield investment requires attracting new workers, possibly by offering higher wages, whereas this is not necessarily the case for takeovers.
26. But also note that greenfield investment tends to be relatively more important in developing countries.
27. Using linked employer-employee panel data Almeida for Portugal (2007), Earle and Telegdy for Hungary (2007) and Huttunen for Finland (2007) all find small positive effects for foreign takeovers of domestic firms on average wages. However, they do not control for worker fixed effects, unlike the studies cited below.
28. Using the same data but a somewhat different methodology, Andrews *et al.* (2007a) also find that foreign takeovers raise individual wages by 3% in Germany. The results for Portugal differ somewhat from earlier results in Martins (2006) but are in the same range as those reported in Almeida (2007). The differences with Martins (2006), whose study is the most similar to the present one in terms of methodology and set-up, can be attributed to the fact that the present analysis controls for lagged wages whereas Martins (2006) did not. The time period is also slightly different.
29. The discussion, here, focuses on the effects of worker movements from domestic to foreign firms. The effects of movements from foreign to domestic firms will be discussed in more detail in Section 3 in connection with possible wage spillovers to the broader labour market.
30. These results are of the same order of magnitude as those reported by Lipsey and Sjöholm (2006) who use the same data for a somewhat different time period. They find that foreign takeovers raise production-worker wages by 17% and non-production workers by 33%.

31. The worker-level results for Brazil are very different from the firm-level results presented in Table 5.4, which suggested that skilled workers gain most. However, the difference in the estimated coefficients for the two skill groups is not statistically significant in Table 5.4. Moreover, the worker-level results are not directly comparable with the firm-level results, as the former take account of stayers only and skill groups are defined differently.
32. This may reflect a greater need for coordination in the context of vertical FDI than for horizontal FDI.
33. In Germany, for which actual hours of work are not available and standard hours are used instead, there is no difference between foreign and domestic firms. This may reflect the fact that in Germany sectoral collective agreements have a major influence over standard working hours (Lee *et al.*, 2007).
34. The relationship between foreign ownership and hours of work is complicated as one needs to take account of the relationship between ownership and both employee and employer preferences over hours of work. Neither is clear. To the extent that foreign takeovers increase hourly earnings, they may either increase or decrease employee preferences over hours of work: employees may desire to work more because the “cost” of not working increases, but it is equally possible that they wish to work less when their income increases. Employer preferences over working hours may also change. For example, MNEs may be more likely to comply with national labour provisions than domestic firms and this may either increase or decrease the number of hours employers prefer: labour provisions that increase the cost of employment (such as employment protection legislation) may be expected to increase preferences for long working hours, while statutory regulation of working hours may decrease preferences for long working hours. Foreign and domestic firms may also differ in the extent to which they wish to allow for greater flexibility in working hours in an effort to reduce worker turnover.
35. This indicates that foreign firms employ on average less low-pay workers than domestic firms.
36. In order to analyse this issue, the econometric model had to be extended with interaction terms between the dummy variable indicating whether workers or firms are covered by collective agreements and the treatment dummy, the relative time dummy and the interaction of the two. As the dummy of collective-agreement coverage is held constant at  $t = -1$ , it was not necessary to include this variable also separately.
37. The absence of any effect in Germany may reflect the small number of firms that are not covered by any collective agreement.
38. Due to both data limitations – the data are collected for administrative purposes and, as a result, it is not straightforward to identify instances of non-compliance with legal requirements – and methodological challenges – the present methodology relies crucially on comparing *average* differences between domestic and foreign-firmed firms –, this chapter does not analyse the extent to which a sub-set of MNEs may undermine labour standards in host countries.
39. The methodology used in the previous section is based on the assumption that cross-border M&A does not affect firms that do not change ownership status. To the extent that cross-border M&A is associated with spillovers to local firms, the estimation of takeovers effects in the previous section is contaminated by spillover effects. As long as spillovers are positive, this will lead to a downward bias of the estimated takeover effects.
40. See Görg and Strobl (2001) and Görg and Greenaway (2004) for overviews of the literature.
41. This can be represented in a diagram of demand and supply by an outward shift of the labour-demand curve and an inward shift of the labour-supply curve. The labour-demand effect on wages will be stronger, the less responsive is labour supply to changes in wages (inelastic labour supply). This is more likely to be the case when labour is relatively immobile across local labour markets. Note that in many developing countries local labour markets are characterised by an excess supply of unskilled labour which may be expected to mitigate the effect of foreign entry on wages for this group of workers. Similarly, the labour-supply effect will be larger, the more responsive labour demand is to a change in wages, which depends on the substitutability of labour for other factors of production and the degree of product-market competition. To the extent that labour demand tends to be more elastic for low-skilled workers, the labour-supply effect associated with foreign entry may be expected to play a more important role for this group of workers. See Chapter 3 of the 2007 edition of the *OECD Employment Outlook* for further details.
42. The usual explanation for the negative impact of FDI on the productivity of local firms is that foreign entry crowds out local competitors, which will reduce domestic firm productivity when there are increasing returns to scale (Aitken and Harrison, 1999). Despite negative productivity

- spillovers, the effect of FDI on average wages in domestic firms may still be positive due the effect of foreign entry on local labour demand (Driffield and Girma, 2003).
43. FDI, here, captures both greenfield investment and cross-border M&A. While greenfield investment should by definition increase foreign labour demand, the results for Indonesia presented in Table 5.1 also suggest that foreign takeovers increase labour demand.
  44. Differences in the elasticity of labour supply between production and non-production workers may explain why wage spillovers only affect non-production workers.
  45. During the 1990s, the US Government put considerable pressure on Indonesia to enhance working conditions by threatening to withdraw trade preferences that were granted to Indonesia under the US General System of Preferences (GSP). This contributed to a doubling of the statutory minimum wage during the 1990s and promises by the Indonesian Government to enforce compliance more vigorously. At the same time, consumer and human rights activists in the United States started a campaign against the exploitation of workers in the supplier firms of large US-based MNEs. Harrison and Scorse (2006) analyse the effects of both these developments for the wages and employment of unskilled workers in the Indonesian textiles industry. Their findings indicate that increases in both the statutory minimum wage and anti-sweatshop activism had a strong impact on the real wage of unskilled workers, raising their wage by 35% and 20%, respectively. However, whereas minimum-wage increases led firms to scale back unskilled employment by 10%, anti-sweatshop activism does not appear to have had an adverse impact on unskilled employment.
  46. See Koyama and Golub (2006) for a comprehensive analysis of regulatory restrictions on inward FDI for OECD and non-OECD countries. The analysis suggests that regulatory restrictions are generally more important in non-OECD countries than in OECD countries.
  47. While local content requirements that oblige foreign affiliates to source a minimum percentage of their inputs locally have been used to strengthen backward-linkages, these are forbidden under the Agreement on Trade-Related Investment Measures (“TRIMs Agreement”) of the WTO, as they are inconsistent with the principle of national treatment.
  48. The evidence on the effects of joint ventures for productivity spillovers is mixed. Whereas Blomström and Sjöholm (1999) find that spillovers do not depend on whether foreign investors have a local partner in Indonesia, Javorcik and Spatareanu (2007) show that having a local partner enhances spillovers in Romania. They argue that the use of older technologies in foreign affiliates may actually enhance spillovers because such technologies are easier to adapt by local firms.
  49. The importance of these factors for FDI is confirmed by the empirical evidence. For example, Dollar *et al.* (2006) provide evidence from the World Bank Enterprise Survey that various aspects of the investment climate including clearance times, power reliability, and the availability of financial services are important determinants of inward FDI.
  50. These figures are broadly consistent with those published by the US Bureau for Economic Analysis (BEA) for US affiliates for 1999 and 2004 which show also that the bulk of affiliate sales is made locally. In contrast to the World Bank Enterprise Survey (WBES), the BEA data do not reveal a low share of local sales in foreign affiliate sales in low-income Asia. Amongst other things, this may reflect the bias in the WBES towards manufacturing.
  51. Figure 5.5 provides a lower bound on the importance of market-seeking FDI as a host country may be chosen to serve several locations at a time. This is generally referred to as “export-platform FDI” and is likely to be particularly important for investment into the European Union and other regional trade areas (Ekholm *et al.*, 2007).
  52. The discussion in Box 5.5 on EPZs, nonetheless, suggests that, while labour practices can sometimes be poor, zone labour standards are generally not weaker than those outside.
  53. Without controlling for GDP and GDP per capita, one observes a weak positive correlation between FDI and labour law enforcement. This is not surprising as FDI tends to be more important in more developed countries where enforcement tends to be more effective.
  54. Kucera (2002) analyses how *de facto* differences in each of the four core labour standards affect FDI. In general, the results suggest no relationship between FDI and the quality of core labour practices across countries. Interestingly, even though freedom of association and the right of collective bargaining have a tendency to increase unit labour costs, FDI responds positively to higher *de facto* standards in this domain.
  55. See Hanson (2001) and UNCTAD (2003) for more details.
  56. Matching services are increasingly replacing the role of mandatory performance requirements (OECD, 2006).

57. This requires addressing two methodological challenges. First, as investment-promotion efforts may not only stimulate inward investment but also expand in response to greater international investment activity, one needs to sort out cause and effect. Second, one has to disentangle the independent effect of investment promotion on FDI from that of unobserved factors that are correlated with both the investment climate and investment promotion. Charlton and Davis (2007) address these challenges by focusing on changes in priority areas across time and industries. Using data for 28 OECD countries, they find that industry targeting for investment promotion raises FDI by 41%.
58. Note that, even in the absence of positive externalities, there may be efficiency grounds to give preferential tax treatment to foreign investors because the elasticity of investment to corporate taxation tends to be higher for foreign than for domestic firms, particularly in small open economies (Gordon, 1986).
59. See also the *OECD Checklist for FDI Incentive Policies* (OECD, 2003), which is specifically designed to assist countries to assess the costs and benefits of such incentives.
60. It is important to realise that in addition to affecting the volume of FDI, regulatory or fiscal incentives may have an important impact on the composition of investment and its social impact. It does not seem implausible that the social impact of FDI that is driven by specific incentives may generate smaller benefits than that of FDI that is motivated by the intrinsic characteristics of a certain location. While this may be obvious in the context of FDI that is motivated by lower labour standards, it may also apply in the context of fiscal incentives. Fiscal incentives are often provided on a temporary basis thereby reducing the probability that foreign investors make a lasting impact and invest in building local reputations.
61. Harding and Javorcik (2007) demonstrate that investment promotion raises inward FDI in developing countries despite worries that industry targeting in developing countries may be less effective due to rent-seeking behaviour.
62. Note that the use of the term “responsible business conduct” is meant to be more general than the term “corporate social responsibility” in that it is not limited to voluntary business initiatives that go beyond legal requirements, but also includes compliance with national labour legislation.
63. Conventions are legally binding international treaties of general principles that countries may choose to adhere to. A country that ratifies a convention assumes the obligation to transpose the convention into national law and to report on its application at regular intervals.
64. Countries that have not ratified one or more of the conventions under the Declaration are asked annually to report on impediments to its or their ratification; the practice of the relevant rights and principles; and whether technical assistance is required.
65. Non-ratification does not necessarily mean that countries do not accept and protect the principles contained in the conventions, but could also reflect a general reluctance to take up international obligations to adhere to the full minutiae of the conventions in question.
66. This suggests that labour inspections – which are costly – increase with the level of development (proxied by GDP per capita).
67. For example, public inspectors in the Cambodian garment sector reportedly earn only one-third of the monthly average wage in the sector and slightly more than half the minimum wage in the sector. Such low wages clearly provide weak incentives to conduct rigorous inspections and foster multiple jobholding and bribe-taking among inspectors.
68. The bulk of world trade involves MNEs. The foreign affiliates of MNEs alone account for about one third of world exports (UNCTAD, 2007). The role of MNEs in world trade may be substantially larger when also accounting for exports by the domestic affiliates of MNEs and their foreign sub-contractors.
69. In the Singapore Declaration of 1996, the ILO was designated as the appropriate international institution to deal with labour standards.
70. These are systems of unilateral trade legislation in the European Union and the United States that grant specific preferences to developing countries.
71. CAFTA, Art. 16.1(1) as quoted in Kolben (2007).
72. An increasing number of International Investment Agreements (IIAs) also includes labour provisions. For a detailed discussion of labour provisions in IIAs, see OECD (2008d).
73. However, as the quotas were determined on a sectoral basis, the agreement in itself did not provide strong incentives for individual exporting firms to raise labour standards due to coordination

problems (e.g. free-rider behaviour). This was to some extent addressed by the decision of the Cambodian Government to make the allocation of export permits conditional on participation in the monitoring initiative.

74. The EU GSP also makes use of positive incentives by granting special preferences to countries that have ratified and effectively implemented core labour and human-rights conventions (OECD, 2000b).
75. According to the United Nations Secretary-General's Representative for Business and Human Rights, John Ruggie, the main problem with the draft norms is that by conferring state-like duties on corporations, it conflates the private and public spheres and renders rule-making problematic. See Ruggie (2008a and 2008b) for more details.
76. There exists a broad consensus about the elements that constitute such "high road" technologies (also called "high-performance management systems"). These are: investment in training; incentive compensation and performance management systems; decentralised decision making and worker representation, and information sharing with employees. At least in the context of developed countries, there is strong evidence that such management practices can help to enhance firm performance (Huselid, 1995; Ichniowski et al., 1997). Given this evidence, it is surprising that many firms, even in developed countries, have not implemented such practices. See Pfeffer (2007) for a discussion of possible mechanisms that account for the relatively low take-up of high-performance management practices.
77. Note that, at least in the case of the guidelines, it is not the intention "to introduce differences of treatment between multinational and domestic enterprises; they reflect good practice for all. Accordingly, multinational and domestic enterprises are subject to the same expectations in respect of their conduct wherever the guidelines are relevant to both" (OECD, 2000a).
78. The treatment of labour standards in the guidelines and the MNE Declaration is considerably more detailed than in the GC and extends beyond core labour standards.
79. These are the 30 member countries of the OECD plus Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania and Slovenia. Together these countries account for about 85% of the global outward stock of FDI. Nevertheless, the growing importance of South-South FDI strengthens the case for expanding the membership of the OECD Guidelines.
80. This may reflect the belief that businesses have a sufficiently strong interest to raise the visibility of responsible business conduct through self-regulation.

## ANNEX 5.A1

*Data Sources and Variable Definitions*Table 5.A1.1. **EIRIS policies**

Panel A. MNE policies on working conditions						
Measure	Definition	Very clear to clear evidence	Some evidence	No or little evidence	Total number of firms with presence in weak governance zone	Average score
Equal opportunities	How clear is the evidence of systems and practices to support equal opportunities and diversity?	2	1	0	1 356	0.71
Health and safety <sup>a</sup>	How clear is the evidence of health and safety systems?	2	1	0	1 357	1.05
Trade unions and employee participation	How clear is the evidence of systems to manage employee relations?	2	1	0	1 357	0.79
Training	How clear is the evidence of systems to support employee training and development?	2	1	0	1 357	0.67
<b>Total</b>		<b>8</b>	<b>4</b>	<b>0</b>	<b>1 356</b>	<b>3.23</b>

Panel B. MNE Policies on working conditions in the supply chain							
Measure	Definition	Very clear evidence	Clear evidence	Some evidence	No or little evidence	Total number of firms with presence in weak governance zone	Average score
Supply chain overall	What is the extent of policies, systems and reporting overall on global supply chain standards?	3	2	1	0	121	1.81

a) The health and safety criteria include senior responsibility, training awards and quantitative data for health and safety issues. When there is evidence that the company has two out of three elements, the evidence is qualified as clear.

Table 5.A1.2. **National data sources**

	Brazil	Germany	Indonesia	Portugal	United Kingdom
Data sources	RAIS, Global Mergers and Acquisitions Database (Thomson Financial Securities) and Orbis (Bureau van Dijk)	Institut für Arbeitsmarkt- und Berufsforschung (IAB) Establishment Panel and the employment statistics register of the German Federal Office of Labour (Beschäftigtenstatistik)	Survei Manufaktur, the Indonesian Census of Manufacturing (Statistical Office, BPS)	Quadros de Pessoal or "Personnel Records" (Ministry of Employment)	Annual Respondent's Database (ARD) for the firm-level analysis. Business Structure Database (BSD) and Annual Survey of Hours and Earnings (ASHE) for worker-level analysis
Unit of observation in business survey that is used for the analysis	Firm	Plant	Plant	Firm	Firm (called "enterprise")
Sample selection	All firms with at least one employee	All plants with employees subject to social security. Large plants are oversampled. The sample comprises about 1% of plants and 10% of employees	The census surveys all registered manufacturing plants with more than 20 employees	All firms with at least one employee	The "selected sample" of the ARD is a census of firms with 250 or more employees, and a sample of smaller firms. The BSD includes all enterprises whose plants are subject to VAT or social security
Sectoral coverage	Manufacturing and services	Manufacturing and services	Manufacturing	Manufacturing and services	Manufacturing and services
Time coverage	1995-2005	2000 and 2004	1997-2005 except 2001	1997-2004	1997-2005
Further remarks			The data for 2002 and 2003 use a different plant identifier		

Table 5.A1.3. **Variable definitions**

	Brazil	Germany	Indonesia	Portugal	United Kingdom
Foreign ownership	More than 50% of assets owned by a foreign entity (firm)	More than 50% of assets owned by a foreign entity (plant)	More than 50% of assets owned by a foreign entity (plant)	More than 50% of assets owned by a foreign entity (firm)	More than 10% of assets owned by a foreign entity (firm)
Employment	Log total number of employees	Log total number of employees	Log total number of employees	Log total number of employees	Log total number of employees
Average wage	Log total wage bill divided by employment	Log total wage bill divided by employment	Log total wage bill divided by employment	Log total wage bill divided by employment	Log total wage bill divided by employment
Individual wage	Log hourly wage	Log daily wage	Not available	Log hourly wage	Log gross hourly wage
Working hours	Log total working hours	Log standard working hours at plant-level available in 2001, 2002, 2004	Not available	Log total working hours	Log total working hours
Low pay	Dummy equal to one when earning the minimum wage or less	Germany does not have a statutory minimum wage	Not available	Dummy equal to one when earning the minimum wage or less	Dummy equal to one when earning the minimum wage or less
Collective agreement	Not available	Dummy equal to one when covered by multi-firm agreement (defined at plant-level)	Not available	Dummy equal to one when covered by multi-firm agreement (defined at plant-level)	Dummy equal to one when covered by a collective agreement
Job stability	The number of worker separations between t and t-1 over total employment at t-1	The number of worker separations between t and t-1 over total employment at t-1	Not available	The number of worker separations between t and t-1 over total employment at t-1	Not available
Industry	One-digit SIC codes (9)	15 categories	SIC codes 15-37 (23)	Two-digit SIC codes	One digit SIC92 codes (9)
Region	States (27)	States (11)	Provinces (34)	Regions (5)	UK Government Office Region (10)
Gender	Gender dummy equal to one when male	Gender dummy equal to one when male	Not available	Gender dummy equal to one when male	Gender dummy equal to one when male
Age	Age	Age	Not available	Age	Age
Skill	Based on education groups	Dummy for high, semi- and low-skilled based on highest educational qualification	Production and non-production	Based on education groups	Dummy for high, semi- and low-skilled based on SOC2000 one-digit categories
Tenure	Number of years	Number of years in current plant	Not available	Number of years	Dummy for more than one year in current firm

Table 5.A1.4. **Variable definitions and data sources**

Variable	Definition	Tables	Figures	Source
Employment	Log sum of permanent and full-time employees and temporary (or part-time) employees (adjusted by the length of contract duration)	5.6	5.3; 5.5	World Bank Enterprise Survey
Voluntary worker turnover	The number of permanent and full-time employees that left the plant for reasons other than dismissals or illness during the last year over the total number of employees		5.3; 5.5	World Bank Enterprise Survey
Average wage <sup>a</sup>	Total wages and salaries of permanent and full-time employees in constant USD divided by total employment	5.6	5.3; 5.5	World Bank Enterprise Survey
Labour productivity <sup>a</sup>	Log of total sales in constant USD over employment	5.6	5.3; 5.5	World Bank Enterprise Survey
Training	Dummy equal to one when plant offers formal training to permanent employees		5.3; 5.5	World Bank Enterprise Survey
Union membership	Percentage of the workforce that is unionised		5.3; 5.5	World Bank Enterprise Survey
Local sales	Percent of sales sold domestically among private firms		5.6	World Bank Enterprise Survey
Probability of receiving at least one public inspection per year	Average across countries/regions of dummy equal to one when total days spent in inspections or required meetings with officials is larger than zero	5.9	5.7	World Bank Enterprise Survey
Probability of receiving a fine conditional on public inspection	Average across countries/regions of dummy equal to one when total cost of fines or seized goods and the total days spent in inspections or required meetings with officials are strictly positive. Dummy equal to zero when totals days spent in inspections and required meetings with officials is strictly positive and total cost of fines or seized goods is zero	5.9		World Bank Enterprise Survey
Inward FDI over GDP	Foreign direct investment (FDI) is defined as an investment made to acquire a lasting interest in enterprises operating outside of the economy of the investor		5.1; 5.7	UNCTAD
GDP per capita	GDP in constant USD divided by total population		5.8	World Bank, World Development Indicators (WDI)
Foreign MNE	Dummy equal to one when the percentage of firm owned by foreign entity is larger than 50		5.3; 5.5	World Bank Enterprise Survey
Domestic MNE	Dummy equal to one when the percentage of firm owned by foreign entity is zero and firm has holdings and operations in other countries		5.3	World Bank Enterprise Survey
Domestic firms that supply MNEs	Dummy equal to one when the percentage of domestic sales sold to multinationals in the same country is larger than zero		5.5	World Bank Enterprise Survey
Domestic firms with manager with prior experience in foreign firm	Dummy equal to one when the top manager has at least one year of working experience in foreign firm prior to joining the current firm		5.5	World Bank Enterprise Survey

a) Variable deflated with the Producer Price Index or Wholesale Price Index and converted using the annual official exchange rates in USD from the International Financial Statistics database, International Monetary Fund.

## ANNEX 5.A2

*Summary of Previous Research on Foreign Wage Premia*Table 5.A2.1. **An overview of the literature on foreign wage premia**

Study	Country	Sample	Treatment <sup>d</sup>	Main findings
<b>I. Cross-sectional studies</b>				
Aitken, Harrison and Lipsey (1996)	Mexico, United States, Venezuela	1984-1990; 1987; 1977-1989, manufacturing	Foreign-owned	Positive and significant wage differences for Mexico and Venezuela after controlling for plant size, geographic location, skill mix and capital intensity, but not in the United States
Morrissey and Te Velde (2003)	Cameroon, Ghana, Kenya, Zambia, Zimbabwe	Pooled cross-sections for various years during 1990-1993, manufacturing	Foreign-owned	Foreign wage premia ranging from 8% to 23% after controlling for observable worker and firm characteristics
Sjöholm and Lipsey (2004)	Indonesia	1996, manufacturing	Foreign-owned	Wages in foreign-owned plants are 12% higher for production workers and 20% for non-production workers than in domestic plants
<b>II. Longitudinal studies – Firm-fixed effects</b>				
Almeida (2007)	Portugal	1991-1998, manufacturing	Foreign takeovers	Foreign takeovers have a small positive effect of 2-4% on average wages
Conyon, Girma, Thompson, and Wright (2002)	United Kingdom	1989-1994, manufacturing	Takeovers, asymmetric	Cross-border takeovers have small positive effect of 3.3% on average wages
Earle and Telegdy (2007)	Hungary	1986-2003	Takeovers, symmetric	Cross-border takeovers have a positive effect of 7% on average wages
Görg and Girma (2007)	United Kingdom	1980-1994, manufacturing	Foreign takeovers	Takeovers of UK firms by US firms increases the wage of both skilled and unskilled workers (4-13%), but takeovers by non-UK EU firms do not
Huttunen (2007)	Finland	1988-2001, manufacturing	Foreign takeovers	Foreign takeovers have a positive effect on wages. The wage increase occurs within one to three years from the acquisition
Sjöholm and Lipsey (2006)	Indonesia	1975-1999, manufacturing	Takeovers, asymmetric	Foreign takeovers have a positive effect of 10% on the average wage of blue-collar workers and 21% on the average wage of white-collar workers
<b>III. Longitudinal studies – Worker and firm fixed effects</b>				
Andrews, Bellman, Schank and Upward (2007)	West and East Germany	2000 and 2004	Takeovers and movers, asymmetric	For West-Germany foreign takeovers are associated with 3% increase in individual wage. The effects for East-Germany tend to be insignificant. Movers from domestic to foreign firms experience an increase in wages of 6%
Balsvik (2006)	Norway	1990-2000, manufacturing	Takeovers and movers, asymmetric	Foreign takeovers have a small positive effect of 3% on individual wages. Movers from domestic to foreign firms experience an increase in wages of 8%
Heyman, Sjöholm and Gustavsson Tinvall (2007a)	Sweden	1996-2000	Takeovers, symmetric	Foreign takeovers have a small negative effect of -2% on individual wages

Table 5.A2.1. **An overview of the literature on foreign wage premia (cont.)**

Study	Country	Sample	Treatment <sup>a</sup>	Main findings
Heyman, Sjöholm and Gustavsson Tinvall (2007b)	Sweden	1996-2000	Takeovers, asymmetric	Foreign takeovers increase wages of high-skilled workers by 2% and reduce wages of medium and low-skilled workers by 4% and 6%
Malchow-Møller, Markusen and Schjening (2007)	Denmark	2000-2002	Takeovers, symmetric	Foreign takeovers have small positive effect of 1% on individual wages
Martins (2006)	Portugal	1991-1999, manufacturing	Takeovers, symmetric	Foreign takeovers have small negative effect of -3% on individual wages

a) Some studies impose the assumption of symmetry on the treatment. In the present case, this means that the effects of changes in ownership from domestic to foreign and foreign to domestic are assumed to be of the same magnitude but of opposite sign. If this assumption is not imposed, but both changes are allowed, the treatment is said to be asymmetric.

## ANNEX 5.A3

## Econometric Methodology for Estimating Wage Spillovers

In order to analyse wage spillovers from FDI to domestic firms, consider the following production function of domestic firm  $i$  in industry  $j$  and region  $k$ :

$$Y_{ijk} = A_{ijk}(\varphi_{ijk}, \bar{\varphi}_{jk}) f_{ijk}(K_{ijk}, L_{ijk}) \quad [1]$$

where  $Y$  is gross output,  $A$  is total factor productivity, which is assumed to be a function of firm-specific and market-specific factors – including the presence of foreign investors in that market –,  $L$  is labour and  $K$  is capital. In perfectly competitive labour markets, wages will equal the marginal value product of labour. Formally, this can be represented as follows:

$$w_{ijk} = p_{ijk} \frac{\partial Y_{ijk}}{\partial L_{ijk}} = p_{ijk} A_{ijk}(\varphi_{ijk}, \bar{\varphi}_{jk}) f_{L}(K_{ijk}, L_{ijk}(w_{ijk})) \quad [2]$$

where  $w$  indicates the average wage in firm  $i$  in local labour market  $j$ ,  $p$  the price of output, and  $L(\cdot)$  the labour supply curve, with labour supply being a function of the elasticity of labour supply  $\nu$  times its own wage.

However, when search frictions are important, wages will generally be less than the marginal value product of labour and wage differentials for identical workers between domestic and foreign firms may persist. In this context, wages also depend on the available outside wage in both domestic and foreign firms. In order to account for the presence of search frictions, the model is augmented with two shift parameters: the average wage of domestic and foreign firms, respectively,  $\bar{w}^d$  and  $\bar{w}^f$ . Converting the augmented model into natural logarithms yields:

$$\ln w_{ijk} = \alpha_1 \ln p_{ijk} + \alpha_2 \ln \varphi_{ijk} + \alpha_3 \ln \bar{\varphi}_{jk} + \alpha_4 \ln K_{ijk} - \alpha_5 \nu \ln w_{ijk} + \alpha_6 \ln \bar{w}_k^d + \alpha_7 \ln \bar{w}_k^f \quad [3]$$

Rewriting (3) with respect to  $w$  yields the following reduced-form:

$$\ln w_{ijk} = 1/(1 + \alpha_5 \nu) (\alpha_1 \ln p_{ijk} + \alpha_2 \ln \varphi_{ijk} + \alpha_3 \ln \bar{\varphi}_{jk} + \alpha_4 \ln K_{ijk} + \alpha_6 \ln \bar{w}_k^d + \alpha_7 \ln \bar{w}_k^f) \quad [4]$$

Adding time subscripts, this gives the following estimable equation:

$$\ln w_{ijkt} = \gamma_i + \gamma_1 \ln \varphi_{ijkt} + \gamma_2 \ln \bar{\varphi}_{jkt} + \gamma_3 \ln K_{ijkt} + \gamma_4 \ln \bar{w}_{jkt}^d + \gamma_5 \ln \bar{w}_{jkt}^f + \delta_{jt} + \delta_{kt} + \delta_t + \varepsilon_{ijkt} \quad [5]$$

where  $\gamma_i$  represents a firm-fixed effect to control for unobserved time-invariant differences in productivity,  $\delta_{jt}$  an industry-specific trend to control for output prices,  $\delta_{kt}$  a region-specific trend to control for regional economic developments common across industries,  $\delta_t$  a time trend to control for macroeconomic developments such as the Asian crisis, and  $\varepsilon_{ijkt}$  a random

disturbance term. The firm-specific component of productivity is approximated by labour productivity defined as value-added per worker. It is assumed that the market-specific component of productivity depends solely on the share of employment in foreign firms over total employment, which is given by:

$$\log \bar{\phi}_{ij} = F_j = \frac{\sum_{i=1}^F L_{ij}^f}{\sum_{i=1}^F L_{ij}^f + \sum_{i=1}^D L_{ij}^d}$$

FDI has a positive effect on wages in domestic firms through its impact on local labour demand when  $\gamma_2$  will be positive, which will be the case as long as labour supply is not perfectly elastic ( $v < \infty$ ). If labour mobility between industries or regions is important,  $\gamma_2$  will understate the true impact of FDI on wages in domestic firms (Aitken *et al.*, 1996). After augmenting [4] with firm productivity, measured by value-added per worker,  $\gamma_2$  gives the impact of FDI on wages through its impact on local labour demand in foreign firms only.

To account for the possibility that the effects of FDI on wages in domestic firms differ across skill groups, the empirical model is also estimated separately for production and non-production workers. Employment of the other skill group is included as an additional control in those regressions.

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