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FDI location and size: Does employment protection legislation matter? ☆

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ABSTRACT

This paper investigates the effect of Employment Protection Legislations for regular and temporary employment on Japanese firm-level FDI into Western Europe during the late 1980s and late 1990s. We find employment protection does matter in the location choice of Japanese investors and it has an adverse effect on FDI-related employment size. There is a clear direct impact from legislation on regular employment while the impact of the legislation on temporary employment is much weaker. Moreover, only the regulation of temporary work agencies matters and not that of fixed-term contracts. In the 1990s, most European countries focused on increasing flexibility for temporary employment while sometimes reinforcing protection on regular employment, a policy which had no clear beneficial impact in terms of attracting job creating foreign direct investment.

1. Introduction

This paper investigates how countries' labor market institutions affect the decisions by multinational enterprises on where to locate their foreign direct investments (FDI) across otherwise quite similar economies. Specifically, we analyze the role of employment protection legislation on Japanese multinational firms' decision to locate an affiliate in Western Europe. The question is: do differences in labor market flexibility influence the geographical distribution of the demand for labor by FDI when other "standard" location choice factors are taken into account? The analytical framework rests upon two different streams of literature, that on FDI location choice and that on the impact of institutions on the demand for labor.

The extensive FDI location decision literature traditionally includes host-specific labor costs as a measure of location attractiveness. These studies typically focus on explicit wage-related labor costs and yield mixed conclusions. This is in part the case because wage costs do not necessarily represent adequately overall employment costs.[1] Recently studies have begun to examine the role of labor market policies (implicit employment costs) in FDI location decision. Unfortunately, none of them examines how employment generated by foreign investment is affected by such policies.

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[1] According to the OECD, in 2003, the non-monetary cost of labor, i.e., tax wedge for a one-earner family with two children was as high as 40% in France and as low as 7.4% in Ireland. Moreover, employment protection measures vary by a factor of 8 between the highest and lowest in OECD countries (OECD, 2004).

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The role of labor market institutions has been studied extensively in the context of the demand for labor by existing firms in the 1980s. Recently the topic attracted attention again with the rising interest in the link between institutions and economic performance in general and the labor market in particular (Botero et al., 2004). Nevertheless, while theories about the short- and long-term impact of cost-increasing employment legislation (EPL) predict an adverse effect on employment, empirical studies remain divided as to its significance and magnitude.

By combining these streams of literatures this paper addresses two shortcomings of previous studies. First, empirical results about the impact of employment protection are inconclusive partly because only existing firms are investigated although much job creation and destruction arises from firms' entry and exit. By looking at employment related to FDI location choices, and in particular greenfield investments, we capture the firm's entry decision among several alternative countries. Second, this study fills a gap in the FDI location literature by considering how non-wage costs (i.e., fixed labor costs) embodied in labor institutions affect location choice.

The study considers some 1600 new investments, covering about 140,000 workers, by Japanese firms into all affiliate industries in 15 Western European countries in 1985–1990 and 1995–2000. Recently developed indexes in OECD (1999) for protection in regular and temporary employment are used in addition to traditional host-specific FDI location factors. We find that employment protection does matter in the location and employment-size decision by Japanese investors, with protection for regular employment particularly harmful relative to protection for temporary employment. Yet, in the 1990s, European countries primarily liberalized temporary work and, while temporary work agencies may have positively influenced employment in some selected sectors, there has been little significant overall impact on job creation.[2] Hence, European countries' focus on liberalizing temporary employment has not been successful in attracting employment-generating FDI from Japanese multinationals.

The paper proceeds as follows. Section 2 surveys the relevant EPL and FDI literatures. Section 3 outlines the FDI and EPL data used in the study, while Section 4 provides the estimation results. Section 5 concludes.

2. Survey of literatures

This study merges two sets of literature: that on employment creation and employment protection legislation and that on the FDI location decision. We first survey the main issues of concern in each area and then discuss the implication of merging them.

2.1. Employment protection and employment

The stubbornly high levels of unemployment in Western Europe compared to North America in the 1980s and 1990s gave rise to a wealth of theoretical and empirical studies on the role played by the comparatively high employment protection enjoyed by European workers. Only the main studies are surveyed here as comprehensive surveys are available (see for examples, Buechtemann, 1993; OECD, 1999; Addison and Teixeira, 2003; and Betcherman et al., 2001).

The concept of “employment protection” covers a large set of policies[3] and the most commonly considered are those restricting layoffs in downturns (e.g., periods of notice and severance pay), those affecting hiring flexibility (e.g., availability of and conditions for fixed-term contracts), and those altering the employment-hour trade off (e.g., maximum working hours per week and conditions for overtime payment). From a theoretical standpoint, any of these policies may alter the initial decision of a firm about its input-mix as well as the dynamic adjustment of employment through the business cycle.

Theoretically, EPL has been modeled mostly as deviations from a neo-classical labor market and, typically, it raises the cost of labor thereby affecting the choice of inputs. In the short-run, EPL modifies firing and hiring decisions and turnover is smaller (Bertola, 1990). In the long-run, the impact on employment/unemployment is less clear as it depends among other things on the persistence of shocks, the timing of implementation, the flexibility of wages and the parameters of the labor demand (Bentolila and Bertola, 1990; Bertola, 1992; Hamermesh, 1993b).[4] Also a general change in employment protection does not have the same impact as a group-targeted change in EPL because of spillover effects (Dolado et al., 2007). For example, when temporary jobs become less protected than permanent jobs, temporary worker flows increase in expansion and recession and if firing costs for permanent workers are sufficiently high, turnover in temporary jobs may become so high that unemployment increases (Dolado et al., 2002).

Empirically, the challenge is to design a satisfactory quantitative measure for what is most often an extremely complex set of legislations. Earlier studies take into account only legislations that involve directly measurable cost; Lazear (1990) uses the number of months of severance pay or notice for blue-collar workers with 10 years experience as a proxy for the whole system of employment protection. Others have built rankings based on an interpretation of the legislations (Grubb and Wells, 1993; OECD, 1994) or on information from employers' surveys (Emerson, 1988; IOE, 1985). Recently, OECD (1999) built legislation-specific indexes and aggregated them for a comprehensive EPL indicator. Finally, Heckman and Pagés (2000) is one of the few attempts to evaluate the full cost of EPL in monetary terms by constructing an index that represents the discounted cost of dismissing a worker

[2] This does not exclude other benefits from liberalizing temporary work such as providing job experience for workers otherwise condemned to long spell of unemployment as well as acting as an information tool about first entrants to employers.

[3] See OECD (1999), Annex 2.A., for details on these policies in practice.

[4] These policies are not necessarily cost increasing. Pissarides (2001) argues they can be part of an optimal insurance arrangement between employers and employees and do not necessarily reduce employment. See also Freeman (2002) for a general discussion of the advantages of the European work organization vs. the more flexible North American model.