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Employment effects of foreign direct investment: New evidence from Central and Eastern European countries

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ABSTRACT

This paper examines the role of FDI as a determinant of employment by using a dynamic labor demand model applied for a panel of 20 Central and Eastern European Countries during the period 1995–2012. Our results indicate that FDI leads to a phenomenon of creative destruction. The introduction of labor saving techniques leads to an initial negative effect on employment, while the progressive vertical integration of foreign affiliates into the local economy eventually converges toward a positive long run effect. However, this phenomenon is only observed in EU countries. Our analysis thus gives partial support to the worries that FDI may displace jobs. Still, the relative importance of FDI as a determinant of employment is modest compared to economic restructuring and output growth. Finally, our results show evidence of a skill bias of production in foreign affiliates, as human capital favors a positive contribution of FDI to employment.

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1. Introduction

The recent economic crisis has conducted, besides financial aspects, to a severe increase in unemployment in a large number of countries. Policy makers are therefore in search of viable solutions in order to increase labor demand and regain the path toward a long-term growth. The implications are all the more important for Central and Eastern European countries (CEEC), who have witnessed both job creation and job destruction during the fundamental changes that accompanied transition from planned to market economy.

The relatively rapid output growth experienced by CEEC during the nineties was accompanied by massive labor shedding. High foreign direct investment (FDI) inflows in the region were accompanied by a euphoric expectation that foreign investors would accelerate the restructuring process, by an infusion of both capital and new technology, and that they would also maintain employment (Hunya and Geishecker, 2005). However, the impressive speed of integration into the European Economic Community through international trade and FDI has not prevented job losses, generating growth without creating new jobs (Schadler et al., 2006; Boeri and Garibaldi, 2006). Foreign affiliates often replaced local suppliers by imported inputs and domestic firms downsized due to intensified competition from more productive foreign firms (Hunya and Geishecker, 2005). However, after the initial phase of restructuring, the vertical integration of foreign affiliates into the local economy was associated with job creation (Radosevic et al., 2003), within foreign firms at the beginning, but also within domestic firms in a later stage. However, the overall impact of FDI on employment is still difficult to disentangle, as effects of opposite directions are at work.

If there seems to be a general consensus regarding the benefits of FDI on host country's productivity and wage levels (Hanousek et al., 2011), empirical research has failed so far to provide consistent results about the overall effect of FDI on employment. Empirical studies have found both positive (Radosevic et al., 2003; Bandick and Karpaty, 2011) and negative effects (Girma, 2005; Jenkins, 2006).

In our paper we investigate the impact of foreign direct investment on aggregate employment in CEEC, using a dynamic panel framework. Our estimation is based on an extension of the theoretical model of Greenaway et al. (1999), where we substitute trade for FDI as a measure of international integration. According to this theoretical model, we anticipate a role of FDI not only in the accumulation of capital and labor, but also in the efficiency of their use, as FDI could potentially influence total factor productivity through technology transfer. As employment depends on productivity, we further expect FDI to influence employment in host countries.

Our paper contributes to the scarce literature on FDI and employment in general, and to the strand of literature investigating FDI in CEEC in particular. We first build a simple theoretical framework to reveal the influence of FDI on labor demand. Compared to the existing literature, we further adopt a different empirical approach, by estimating a labor demand equation in growth rates instead of levels, which are subject to non-stationarity concerns. We consider a sample of 20 CEEC, both members and non-members of the European Union (EU). As opposed to Onaran (2008), who focused on the manufacturing sector, which accounts for only half of FDI in CEEC, we extend the sample to the whole economy, therefore considering potential effects on employment in the service sector as well. Next, we provide an updated evidence for the FDI-employment relationship in CEEC, as we consider late transition and post-transition period (1995–2012). Research conducted so far was dealing almost exclusively with the transition context (Hunya and Geishecker, 2005; Radosevic et al., 2003; Bruno et al., 2006) and had focused on leading CEEC like Hungary, Poland or the Czech Republic. These studies usually adopted an industry level approach, while we adopt a macroeconomic approach. This allows to extend the country coverage, but also to better capture total employment dynamics, as FDI may induce changes across sectors through vertical linkages. Finally, we consider some additional determinants of employment, like economic restructuring or human capital, which could be relevant for employment in CEEC.

Our main results indicate that FDI leads to a form of creative destruction on the labor markets in CEEC. A short-term job destruction effect is followed by long term job creation. However, this phenomenon seems limited to the EU countries. Furthermore, the importance of FDI as a determinant of employment appears to be limited compared to economic restructuring and output growth. Overall, the internationalization of production, as given by both trade and FDI, seems to lead to a decrease in the labor intensity of production in CEEC.