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Multinational enterprises and domestic wages: The contingent effect of skill composition

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ABSTRACT

While previous literature has extensively shown that foreign-owned firms pay higher wages than domestically owned firms, the examination of intra-industry wage spillovers between foreign-owned and domestic companies has received much less attention, particularly among non-core EU economies. In this paper, we contribute to the literature on wage spillovers of foreign multinational enterprises onto domestic firms by considering whether the presence of MNE subsidiaries in the Spanish manufacturing industry affects wages in domestic firms in the same industry. Although no evidence supports the existence of wage spillovers from MNEs onto domestic firms on aggregate, we show that the effect of this outside presence on domestic wages is significantly more positive in step with the higher level of workers' skills in domestic firms. Because only workers in domestic firms with a highly skilled workforce will benefit from wage spillovers from the foreign firm presence in the industry, policy makers need bear in mind that not all FDI will automatically generate spillover benefits to domestic firms.

1. Introduction

A considerable body of literature exists on the impact foreign direct investment (FDI) has on host labor markets, which can be traced back to Dunning (1958). Early studies within this research stream have focused on the nature of employment opportunities provided by foreign-owned companies and their contribution to productivity, particularly in developing countries (see, e.g., Enderwick, 1985). Although previous research has generally accepted that the employees of subsidiaries of foreign multinational enterprises (MNEs) receive higher wages than those in domestic companies (Ferner, 1994; Lipsey, 2004), the impact this MNE mark-up has on domestic companies has, surprisingly, been far less explored (see, e.g., Driffield & Taylor, 2000). Evidence concerning wage spillovers arising from FDI is mixed, particularly among developed countries (see Lipsey, 2004, for a survey of the literature on FDI and wages). And, whenever wage spillovers exist, their magnitude has been found to be rather small (Cantwell, 2001; Conyon, Girma, Thompson & Wright, 2002; Driffield & Girma, 2003; Figlio & Blonigen, 2000; Girma, Greenaway & Wakelin, 2001; Griffith, 1999; Görg, Strobl & Walsh, 2007; Keller, 2004; Lipsey & Sjöholm, 2004; Ono & Odaki, 2011; Sjöholm & Lipsey, 2006). This literature has been concerned mainly with FDI localized in higher-order centers disregarding peripheral sites (e.g., Santangelo, 2004). We thus take this as an invitation to contribute to this literature by analyzing whether the presence of foreign-owned firms in the Spanish manufacturing industry has an effect on domestic wages in such an industry (i.e., intra-industry wage spillovers between foreign-owned and domestic companies). The Spanish economy represents a relevant case of an economy classified as a peripheral developed economy in

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the European context. The stock of inward FDI in Spain has increased ten times between 1990 and 2010 (Meardi, 2012). For the purpose of analyzing the importance of wage spillovers that may occur due to the presence of foreign firms in the same industry as the observed firms, we use previously unexplored firm-level data from the Spanish Survey of Business Strategies for the 1992–2008 period.

The question of whether a significant foreign presence leads to wages being ratcheted up among domestic companies is important at a theoretical level. If foreign firms keep most of their high value-added operations in their home countries – with their operations in the host market consisting primarily of lower value-added assembly operations – foreign-owned firms would have relatively low skilled workers and hence relatively low wages. In this case, the role of foreign investors in transmitting productive knowledge would be limited. In contrast to this, foreign companies may overcome the costs of entering the host market through the exploitation of some specific advantage relative to their domestically owned competitors. If foreign firms are unable to effectively appropriate all the benefits of innovative and in-firm knowledge, wage spillovers onto domestic firms may be observed. Thus, in terms of wage spillovers, FDI may be beneficial in some situations but not in others.

Following work on this topic, the extent to which an outside presence in an industry increases wages for domestic firms in the same industry may be conditional on certain circumstances. Spillovers have been proposed to "depend crucially on the conditions for local firms" (Blomström, 2002: 177). In particular, previous literature has underlined local absorptive capacity as a key factor for local firms to benefit from optimal potential spillovers. In this regard, Blomström and Kokko (1998) indicated that "the positive effects of foreign investment are likely to increase with the level of local capability of absorbing these" (p. 247). In line with this research, we claim that the beneficial wage effects of an outside presence are not distributed evenly, but instead are concentrated in domestic companies that are better placed to benefit from the introduction of new technology and managerial knowledge from foreign-owned companies. Although our results show no evidence to support the existence of positive wage spillovers from foreign investment onto domestic companies, one exception is that of highly skilled domestic firms, whose skill intensity raises the domestic wage effect of the presence of MNE subsidiaries. Therefore, not every domestic firm has the ability to absorb new technological or managerial knowledge from foreign-owned companies.

This paper contributes in several ways to the literature on spillovers of MNE subsidiaries onto domestic firms. On the one hand, the impact of MNE activities on economic development has been investigated mainly in developing and less developed economies (Santangelo, 2004, 2009). Our knowledge regarding the implications for domestic firms of the presence of foreign MNEs in their industry is still sketchy, particularly among developed countries. In this sense, FDI in Spain has been a prominent driver of Spain's economic growth over the past forty years (Villaverde & Maza, 2011). In this country, there is a substantial level of foreign-owned jobs relative to total employment in manufacturing – foreign-owned companies accounted for 16% of employment in manufacturing in 2006 (see Eurofound, 2009). Therefore, this paper adds to our understanding of the value and interest of FDI in Spain as a peripheral economy. On the other hand, because previous literature regarding Spain has focused on the productivity effects of the presence of foreign MNE subsidiaries (Barrios & Strobl, 2002; Merino de Lucas & Salas, 1995), the specific effect of an outside presence on domestic wages has not been analyzed in this country. To the best of our knowledge, there is no similar study for Spain that attempts to explain and test wage spillovers between foreign MNE subsidiaries and domestic firms.

The remainder of the paper is structured as follows. Section 2 sets out the theoretical background, while Section 3 develops the hypotheses. Section 4 describes the data and variables, and discusses the empirical method applied. Finally, Section 5 discusses the findings and Section 6 concludes.

2. Theoretical background

While previous literature on MNEs has typically found that MNEs pay higher average wages than domestically owned firms (Combs, Liu, Hall, & Ketchen, 2006; Driffield & Taylor, 2006; Lipsey, 2004; Way, 2002),[2] the presence of foreign-owned firms in an industry may also bid up wages among domestic firms. MNE subsidiaries bring with them a certain amount of proprietary technology that constitutes their firm-specific advantage and allows them to compete successfully (Caves, 1974; Dunning, 1973; Koutsoyiannis, 1982; Markusen, 1995). Domestic firms may have access to technologies they do not possess if multinationals transfer technologies to the host country. In addition, the subsidiaries' managerial knowledge – which along with technological knowledge is a major type of knowledge embedded in FDI that influences a firm's productive efficiency, and hence its competitive advantage (Teece & Pisano, 1994) – is subject to transferability toward domestic

[2] Several explanations exist for a positive wage differential between MNEs and domestic companies. First, consistent with the economic theory of the MNE, MNEs pay efficiency wages to reduce worker turnover and the accompanying leakage to rival firms of the proprietary technology introduced by the MNE (Ono & Odaki, 2011). Wage differentials may also arise because the MNEs' organization of production requires them to employ more skills-intensive employees than domestic firms (Driffield & Taylor, 2006). Third, foreign-owned firms may pay a wage premium to deter unionization or buy out restrictive job practices (Doms & Jensen, 1998). Fourth, foreign firms may pay higher wage levels than domestic firms on average because of their lack of knowledge of the local labor market and the ensuing higher search costs they may have to incur (Bellak, 2004). Finally, the role of expatriate management – even though expatriate managers usually represent a small percentage of the international workforce (Lowe et al., 2002) – is also a plausible explanation for why MNE subsidiaries' average pay is higher than that of their domestic counterparts in the same industry (on average an expatriate's salary is approximately three times that of an equivalent local employee; Reynolds, 1997).