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# Foreign direct investment and factor demand elasticities

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**Abstract**

This paper argues that the liberalisation of foreign direct investment (FDI) has made labour costs more important to domestic investment and long-run labour demand. It provides evidence from British and German data that is consistent with this view. First, high unit labour costs increase FDI outflows and lower FDI inflows. Second, the effect of unit labour costs on domestic manufacturing investment was more negative in the high-FDI 1980s than in the low-FDI 1970s, and this change was concentrated in high-FDI industries. The estimates suggest that the long-run labour demand elasticity may have risen substantially. © 2000 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

If higher labour costs induce firms to relocate production abroad, domestic employment will fall. In recent years, this has led some observers to argue that falling barriers to foreign direct investment (FDI) have made wage moderation more important for preserving employment. Unless wages are kept under control, the argument goes, capital will migrate to countries with lower labour


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costs, and unemployment will rise. If falling FDI barriers increase the elasticity of the capital stock with respect to costs, the underlying argument is perfectly consistent with standard labour demand theory. Hicks notes in *The Theory of Wages* that '[t]he demand for anything is likely to be more elastic, the more elastic is the supply of co-operant agents of production' (Hicks, 1932, p. 242).

This paper examines the implications of falling FDI barriers using data from Germany and Britain. The public perception of FDI liberalisation differs profoundly in these two countries. In Germany, it is seen as a threat that will either drive companies out of the country, or reduce Germany's high wages and generous social welfare benefits. By contrast, many British commentators see lower FDI barriers as an opportunity to attract companies that seek access to European markets but want to avoid continental 'inflexibility'. Most commentators in both countries take it for granted that labour costs are a major determinant of FDI, and that falling FDI barriers make wage moderation more important for keeping investment and jobs at home.

Britain's FDI inflows of around 2% of GDP, as well as its share of over 40% of all EU inward FDI (Eurostat, 1995), are among the British government's favourite statistics and have encouraged it to portray Britain as the 'enterprise centre of Europe'. FDI inflows to Germany, by contrast, have been below 0.5% of GDP for many years, causing great concern among policymakers and pundits. However, it is less often realised that outflows are also much higher in Britain (about 3% of GDP) than in Germany (about 1.5%) so that *net* FDI outflows are rather similar in the two countries (see OECD, 1995). Hence, Britain's higher inflows may simply reflect a different industrial structure, with a greater role for multinationals, rather than more attractive locational conditions.

Most policy debates take it for granted that FDI translates straight into physical investment.[1] It is therefore interesting to see what has happened to capital formation in Britain and Germany. While the aggregate investment rate is substantially lower in Britain than in Germany, manufacturing investment, which may be more relevant to the relocation debate, is quite similar (Bond and Jenkinson, 1996). Both countries have seen their investment rates fall considerably since the early 1970s, but their relative positions have remained quite

[1] Whether this assumption is justified is subject to debate. Graham (1995) argues that in general FDI should be viewed as a *source* of funds and not a *use* of funds. He finds that in the case of US-owned foreign subsidiaries, the short-run effect of FDI flows on the subsidiary's fixed investment is significantly positive, but less than unity. Using aggregate FDI flows for all OECD countries, by contrast, Feldstein (1995) finds that net FDI outflows translate straight into lower domestic investment in the long-run, and he cannot reject a one-for-one relationship. The robustness of Feldstein's findings is challenged by Devereux (1996).