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A race to lower standards? Labor standards and location choice of outward FDI from the BRIC countries

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ABSTRACT

Scholars argue that multinational corporations tend to locate their investment in countries with lower labor standards, but empirical results are highly inconsistent. In this paper, we investigate the effect of differential labor standards on the location choice of outward greenfield foreign direct investment (FDI) from Brazil, Russia, India and China (i.e. the BRIC countries). We find robust evidence that while there is a tendency toward the attraction of FDI by lower labor standards in developed countries, such a "race" is absent in FDI directed to developing countries. Location choice is highly path dependent upon previous trading relations between the home and the host country, which hampers the MNCs' ability to arbitrage. Conversely, capital mobility at the industry level is found to intensify the race to lower standards.
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1. Introduction

In the debate on whether globalization has gone too far (Rodrik, 1997), a central concern of policy-makers as well as researchers is that multinational corporations (MNCs) may relocate jobs from high to low standard countries, forcing a competitive downward spiral of labor standards. This is how the thesis of a "race to the bottom" (RTB) was originated in which such a race by corporations was criticized as a race "*not of diligent but of laxity*" (Liggatt, 1933). It is featured strongly in the heated debate among politicians and academics in the era of unprecedented movement of capital (Hansen, 2012; Meardi, 2006; OECD, 2001) and the prevailing trend toward increased labor market flexibility across the globe (Siebert, 2006; Standing, 1997; UNCTAD, 2003, 2009).

This paper investigates whether there is a causal linkage between labor standards and location choice of outward Greenfield FDI from Brazil, Russia, Indian and China – the BRIC countries. Therefore, we investigate whether MNCs "race" to lower standards in their location choice. The question of whether nation states strategically lower their labor standards to attract FDI is beyond the scope of this paper. We contribute to the literature in a number of ways. Theoretically, we probe the impact of labor market regulations not only from the production cost but also the transaction cost perspective, providing a new understanding of the impact of labor regulations on FDI. We also consider that potential host countries differ significantly with respect to their economic, social and cultural features (Krugman, 1994). Their significant institutional differences may lead to the presence of multiple equilibriums in which the effect of labor standards on FDI varies, a possibility not considered in previous studies. Third, we incorporate the insights from the behavioral approach, which interprets the internationalization of firms as an incremental learning process (Eriksson, Majkgård, & Sharma, 2000; Johanson & Vahlne, 1977). As an important force influencing the decision making of MNCs, this can interact with the tendency of seeking lower standards. Conversely, we suggest that industry mobility, as an *exogenous* factor that is innate to the production and distribution process of an industry, can significantly moderate MNCs' liberty in choosing countries with lower labor standards over those with higher ones. Our theoretical framework therefore provides us with a richer understanding of the complex relationship between host labor market regulations and MNEs' location choice.

Empirically, we adopt a mixed logistic regression method that considers both country characteristics and firm attributes to estimate the relationship between labor standards and location choice. We also use a novel firm level dataset of the Greenfield FDI undertaken by firms from Brazil, Russia, India and China. To our knowledge, this is the first study examining the relationship between BRIC FDI and labor market regulations. BRIC countries have a share of 46.3% of global GDP growth in our study period, and together, they are poised to dominate the global economy later this century the way Europe and the United States once did. Their outward FDI has outpaced that from the world in recent years (UNCTAD, 2010). As their influence on the global economy grows, so do the risks for the sustainable world development, such as to what extent the rights of labor can be balanced against the rights of capital.

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Although the BRIC countries exhibit considerable variations with respect to their forms of government, political histories, economic systems and growth, their relevance for our research is that they all exhibit weak labor protection compared to more established economies due to combined forces such as increasing competition exposed by globalization, abundant labor supply, and their comparative advantage in relatively labor intensive industries (Arbache & Menezes-Filho, 2000; Desai & Idson, 2000; Frankel & Kuruvilla, 2002). Capitalizing on the flexible labor market in their home countries unattainable to their Western counterparts, BRIC MNCs may find it challenging to adjust their expectations and practices in host countries with more stringent labor protections (Alvarez, 2010; CNN International, 2007; EIRiS, 2009). The main contribution of our paper is in presenting an analytical framework to understand firm level factors that either hinder or heighten firms' arbitrage behavior by incorporating insights from different theoretical traditions.

Our findings can be summarized as follows. First, we find that the tendency to locate FDI in countries with lower standards is present only in developed countries but not in developing countries, demonstrating multiple equilibriums driven by significant institutional differences across countries. Second, previous trading relations between the home and the host country substantially reduce the tendency of seeking lower standards, indicating that location choice is highly path dependent. Third, we use two different industry mobility indicators, and find that higher mobility significantly intensifies the race to the bottom, suggesting that lower relocation cost facilitates MNCs to engage in fiercer inter-jurisdictional arbitrage to maximize global efficiency. The remainder of the paper is organized as follows. In Section 2, we outline the literature background of our study. We develop our hypotheses in Section 3. We explain our empirical strategy in Section 4. In Section 5, empirical results are presented. Section 6 discusses the results and concludes the paper with some managerial and policy implications.

2. Literature review

A frequent critique of globalization is that it can lead to a race to the bottom. More specifically, the race to the bottom hypothesis hinges on two important propositions. First, political scientists argue that states engage in policy competition to attract taxpayers, industry and other mobile units, such as FDI, that benefit state economies (e.g. Berry, Fording, & Hanson, 2003; Konisky, 2007; Woods, 2006). Second, economists suggest that MNCs may seek to increase their profits by investing in countries with less restrictive standards (Drezner, 2006; Gorg, 2005; Javorcik & Spatareanu, 2005; Keller & Levinson, 2002). While these are common concerns associated with globalization, empirical evidence from both disciplines remains inconclusive and insufficient, and studies on the relationship between FDI and labor market regulations remain particularly limited (Bellak & Leibrecht, 2011, p. 1726; Javorcik and Spatareanu, 2005, p. 375).

The current study does not tackle the first proposition of whether there are inter-state strategic interactions regarding how countries set up and adjust their labor standards in response to other countries' decisions. Instead, we address the second proposition, namely, whether MNCs choose where to invest based in part on the labor market regulations of potential host countries. Apart from potential welfare implications of the question, there are good reasons to study the impact of regulations on FDI in the International Business (IB) context. In contrast to the proliferating attention to the normative and cultural-cognitive institutions (e.g. Kostova & Zaheer, 1999; Xu & Shenkar, 2002; Gelbuda et al., 2008), the impact of regulatory institutions on FDI remains under-explored. But regulatory standards are a very important component of the formal institutions of a country (North, 1990; Scott, 1995). Regulatory institutions are explicitly codified in the forms of laws, rules and legislations (Streeck & Schmitter, 1985; Williamson, 1991) that can be easily interpreted, planned and strategically manipulated by corporations.

For the purpose of the study, we define labor standards as legal and regulatory restrictions on the *non-wage* component of employment conditions (Ghose, 2003). Labor standards concern issues such as freedom from forced labor and discrimination, freedom of association and protection of the right to organize collective bargaining, equal remuneration, abolition of child labor and minimum wage. Rising standards for all the working people is regarded as being synonymous with development (Singh & Zammit, 2000). From the standpoint of the neoclassical theory of the firm, there is a strong consensus on the dampening effect of higher labor standards on market entries of MNCs (Lafontaine and Sivadasan, 2009). Higher labor standards adversely affect operational flexibility of MNCs. For instance, while strict hiring rules restrict temporary work agencies and the use of fixed-term contracts, tight firing rules make it difficult and costly for employers to lay off workers. Anticipating such constraints, foreign MNCs as well as domestic firms become reluctant to invest, which can then lead to chronic unemployment (Feldmann, 2009; Stel, Storey, & Thurik, 2007; World Bank, 2004a, 2004b). Higher labor standards also require employers to provide employment protection and other welfare benefits, which directly cut down profit margin (Javorcik and Spatareanu, 2005).

Despite the compelling theoretical view and widely expressed concerns among business owners, empirical studies are hardly conclusive. This is all the more remarkable since a number of studies employed the same dataset from surveys administrated by the Bureau of Economic Analysis (BEA) of the US Department of Commerce. Some studies find that more stringent labor standards deter US FDI (Cooke, 1997; Cooke & Noble, 1998); others do not (Traxler & Woitechm, 2000). Bognanno, Keane, and Yang (2005) instead find mixed results depending on how labor standards are measured. Instead of analyzing the relationship between labor standards and FDI entries, Lafontaine and Sivadasan (2009) find that strict rules of hiring and firing *delay* the entry and reduce the number of outlets of an anonymous US fast food chains in 48 countries in the period of 2000 and 2003. Research based on data out of US FDI delivers equally mixed results. Kucera (2002) find no evidence that MNCs favor countries with lower standards. By contrast, Ham and Kleiner (2007) find that FDI flows into OECD countries between 1985 and 2000 were negatively associated with the rigidities of labor regulations. Supporting evidence is also found in Javorcik and Spatareanu (2005) and Gorg (2005) using European data.

3. Integrating other theoretical perspectives: hypotheses development

A few common traits shared by previous studies have motivated our research. First, most of them have focused on FDI from developed economies. But with the accelerated globalization, developing countries are now an indispensable part of the global economy. The behavior of FDI from developing countries is receiving increasing attention, with particular interest in the case of China (e.g. Buckley et al., 2007; De Beule & Duanmu, 2012; Duanmu, 2012; Kolstad & Wiig, 2012; Li & Liang, 2012; Wang, Hong, Kafouros, & Boateng, 2012). But no studies have investigated how developing country firms respond to labor market conditions home or abroad (Sanyal & Menon, 2005, p. 825). Second, previous studies have employed narrowly defined indicators of labor standards, missing the complexities of labor market regulations across countries. Third, with the only exception of Lafontaine and

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