

Foreign Direct Investment and Wage Inequality: Evidence from China

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Summary. — This study provides micro-level evidence on the close link between foreign participation and wage inequality. We investigate the wage premium and the wage spillover effect of foreign-invested enterprises in the Chinese manufacturing sector. The results indicate a significant foreign premium in both wage and non-wage compensation. The presence of foreign and Hong Kong, Macao and Taiwan (HMT) investment results in a significantly negative spillover in terms the wage level in domestic firms, and discourages wage growth in such firms. Overall, the evidence suggests that exposure to foreign investment increases inter-enterprise wage inequality. © 2010 Elsevier Ltd. All rights reserved.

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1. INTRODUCTION

The host country effect of foreign direct investment (FDI) has been studied extensively in the literature. Many developing countries adopt aggressive FDI promotion policies based on the belief that FDI has a beneficial effect on their economy. Such policies must be justified by both theoretical and empirical studies. Current theories, however, yield ambiguous predictions on the effect of FDI. For example, the pro-competition effect of foreign entry may be negative in the short run if multinationals reduce the profit margin and market share of domestic firms, but may be positive in the long run if competition from multinationals forces local firms to increase their efficiency. Technology externalities from FDI may enhance the efficiency of local firms by giving them access to the advanced technology (or intangible firm-specific assets) of multinationals through several channels, such as imitation, labor mobility, and vertical links. The empirical evidence is similarly mixed, and offers no consensus on the impact of FDI on the local economy (see, e.g., Brown, Deardorff, & Stern, 2003; Gorg & Greenaway, 2004; Lipsey, 2004).

One important issue that arises in this context is the distribution effect of FDI in developing countries. Goldberg and Pavcnik (2007) have shown that most developing countries have experienced increased inequality contemporaneously with globalization. This study focuses on the link between FDI and inter-enterprise wage inequality. Foreign participation may have a composition effect in that foreign wage differentials directly contribute to inter-enterprise wage inequality. Competition and technology externalities from multinationals may also have indirect wage spillover effects. Foreign wage spillovers from different channels have the potential to increase or decrease the wage level in domestic firms, and thus whether there is a net spillover effect is an empirical question. Our study contributes to this strand of the literature by using Chinese firm-level data to examine foreign wage differentials and spillovers.

The case of China has unique value for such a study. As the world's largest transition economy, China has experienced rapid globalization and achieved rapid economic growth. Since

adopting the “open door” policy in the early 1980s, China has become the largest FDI recipient among developing countries, and foreign trade and FDI have been recognized as important engines of economic growth. The other side of the coin is that inequality in China has substantially increased as globalization has progressed. This situation provides a good opportunity to examine the close link between FDI and inequality.

We find foreign participation to be a contributing factor to wage inequality. First, our results suggest that there are significant differentials in wage and non-wage compensation among firms with different types of ownership. Foreign-invested enterprises (FIEs) offer the highest wages, whereas private firms and collectively owned enterprises have the lowest wage levels. Second, the presence of foreign and Hong Kong, Macao, and Taiwan (HMT) investment has a significantly negative spillover effect on the wage level in domestic firms. Third, wage growth in multinationals is significantly higher than that in domestic firms. Moreover, the presence of FIEs discourages wage growth in domestic firms, and thus enlarges the wage gap between foreign and domestic enterprises. Collectively, this evidence suggests that access to FDI increases inter-enterprise wage inequality.

The remainder of this paper is organized as follows. Section 2 provides some institutional background to the host country wage effect of FDI. Section 3 describes the data and provides an overview of foreign participation in China. Foreign wage differentials and spillovers are investigated in Section 4, and Section 5 concludes the paper.

2. THE HOST COUNTRY WAGE EFFECT OF FDI

There is a large body of literature on the wage effect of foreign participation in host countries. Such research can be

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broadly classified into studies on foreign wage differentials and studies on foreign wage spillovers (Brown *et al.*, 2003; Lipsey, 2004). FIEs may offer higher wages than local firms because they are larger, more capital intensive, and more skill intensive than local firms. FIEs may also pay higher wages than local firms for labor of a given quality, for several reasons. First, due to government restrictions or asymmetric information, foreign firms may operate in a restricted or even segmented labor market, and have to pay higher labor costs than local firms to identify and attract qualified workers. Second, internal fairness policies within multinational enterprises (MNEs) may prevent a large wage disparity from emerging between employees of similar quality in different countries, thereby increasing wages in low-wage regions. Third, FIEs may pay higher wages to reduce labor turnover and thus minimize the leakage of intangible, firm-specific assets. Fourth, FIEs may offer higher wages to compensate for the possible disadvantages of employment in an MNE. For example, workers may prefer local firms, and may have to be compensated to overcome this preference. Workers may also face greater pressure and labor demand volatility in FIEs than in local firms.

There is overwhelming empirical evidence to support the claim that foreign firms pay higher wages than domestic firms after controlling for firm characteristics such as size, worker quality, industry, and location. The estimated foreign wage premium is 6–22% in the United States (Feliciano & Lipsey, 2006; Lipsey, 1994), 4–26% in the United Kingdom (Conyon, Girma, Thompson, & Wright, 2002; Driffield & Girma, 2003; Girma, Greenaway, & Wakelin, 2001), about 30% in Mexico and Venezuela (Aitken, Harrison, & Lipsey, 1996), and 10–50% in Indonesia (Lipsey & Sjöholm, 2002, 2004). Chen, Demurger, and Fournier (2005) use a Chinese household survey to investigate earnings differentials across firms of different ownership types and find that FIEs offer much higher wages than domestic enterprises. Recent studies have controlled for both worker heterogeneity and the selection bias of foreign acquisitions. For example, Heyman, Sjöholm, and Tingvall (2007) use matched employer-employee data to control for employee characteristics, and find that the foreign wage premium is significantly reduced as a result. Almeida (2007) finds that foreign acquisitions of domestic firms have a small effect on human capital and on average wages in acquired firms. Girma and Gorg (2007) find substantial heterogeneity in the post-acquisition wage effect depending on the nationality of the foreign acquirer and the skill group of the workers.

The more interesting question is how the presence of FDI affects the wage level and wage growth in domestic firms. Positive wage spillovers help domestic firms to catch up with their foreign counterparts, whereas negative wage spillovers enlarge the wage gap between foreign and domestic firms. Theoretical studies of the effect of FDI on the wage level in domestic firms focus on pecuniary channels and technology externalities. The pecuniary channels of FDI refer to competition between multinationals and domestic firms in both factor markets and product markets. First, competition between FIEs and local firms in the labor market may significantly increase labor demand, and thus oblige local firms to increase their wages to attract a better qualified workforce. The opposite effect may occur if FIEs “poach” the best workers and thus lower both the quality of labor and the wage level in local firms. Second, foreign participation in product markets may result in positive or negative competition effects. On the one hand, foreign participation may force local firms to reduce their margins and become more efficient. On the other hand, competition from multinationals may reduce the market share of local firms, which drives such firms under the minimum effi-

ciency scale or even crowds them out, and thus generates negative spillovers.

Technology externalities are also important channels of foreign spillovers. Multinationals, which usually carry superior technology, may generate a positive technology spillover to domestic firms through several channels. First, local firms may adopt new technologies introduced by multinationals through imitation (the demonstration effect). Second, local firms may gain access to the knowledge capital of multinational firms through the labor mobility channel, in that workers previously employed by multinationals may transfer knowledge to local firms by switching employers or starting their own firms. Third, multinationals may transfer technology to firms that are potential suppliers of intermediate goods or are potential buyers of their own products (forward and backward links). These technology externalities may positively affect the efficiency of local firms and improve the domestic wage level.¹

Given that the spillovers from pecuniary channels and technology externalities take place at same time, the net wage spillover effect of FDI is an empirical question. The evidence from previous studies is mixed.² For example, Aitken *et al.* (1996) find a lack of foreign wage spillovers in Mexico and Venezuela, but identify some wage spillovers in the United States. Girma *et al.* (2001) study FDI in the United Kingdom and find no overall spillover effect on wage levels. Bedi and Cieslik (2002) study the case of Poland and find that workers in industries with a greater foreign presence enjoy higher wages and strong wage growth. Driffield and Girma (2003) find a positive wage spillover effect, but note that it is confined to the region in which FDI takes place. Feliciano and Lipsey (2006) find no evidence of wage spillovers from foreign establishments to domestic establishments in the United States.

In the case of China, most studies focus on the effects of FDI spillovers on the productivity of domestic firms, and return ambiguous empirical evidence. For example, Hu and Jefferson (2002) find that FDI generates negative productivity spillovers for domestic firms in the electronics industry, but not in the textile industry. Wei and Liu (2006) find that FDI creates positive intra- and inter-industry productivity spillovers. Hale and Long (2007) find no evidence of systematic positive productivity spillovers from FDI. Liu (2008) shows that FDI lowers the short-term productivity level, but raises the long-term rate of productivity growth among domestic firms within an industry. In terms of foreign wage spillovers, Braunstein and Brenner (2007) find that working in both foreign-invested enterprises and provinces with a higher level of FDI results in higher wages than those paid in other enterprises and regions in both 1995 and 2002. Our study complements the previous literature by investigating how foreign participation affects inter-enterprise wage inequality in China.

3. FOREIGN PARTICIPATION IN CHINA

China has experienced rapid globalization during the reform period. Both FDI inflow and trade volume have substantially increased since China adopted the “open door” policy in the early 1980s. China has become one of the largest trading nations in the world and the largest FDI recipient among developing countries. Most previous studies on globalization in China rely on aggregate data, with only a few studies using enterprise-level data to investigate FDI. In this study, we describe foreign participation and the characteristics of FIEs in China based on two firm-level datasets.

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