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The labor market effects of foreign owned firms ☆

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Abstract

Foreign firms have a more educated workforce and pay higher wages than domestic firms even after controlling for worker quality, at a given moment in time. This does not imply that foreign ownership improves the labor market outcomes of the workers since foreign investment may be guided by unobservable firm and worker characteristics correlated with schooling or wages. This paper asks whether foreign investors acquire firms with high human capital or wages, or whether foreign acquisition improves these outcomes. Using a matched employer–employee data set, I find that foreign acquisitions of domestic firms have small effects on the human capital and on average wages of the acquired firms. Instead, foreign investors “cherry pick” those domestic firms that are already very similar to the group of existing foreign firms.
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1. Introduction

A large empirical literature documents that, in the cross-section, foreign firms are larger, more productive, more capital intensive, pay higher wages and have a more skilled workforce than

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domestic firms. This suggests that foreign investors may have a positive effect on the welfare of the workforce of the host economy. This argument has been used to justify regional or national industrial policies to attract and secure foreign investment. But, while cross-sectional differences are large, they are not necessarily causal. For example, they may arise because foreigners acquire domestic firms that already have a more educated workforce and pay higher wages than the average firm, because foreign investment leads to an increase in the demand for skills and average wages of the acquired firms, or both. Disentangling correlation from causality is crucial for understanding the welfare effects of foreign investment in the host economy and for designing appropriate policies.

In this paper, I analyze the interaction between foreign ownership and labor market outcomes using a Portuguese matched employer–employee data set during the nineties. The paper addresses the following questions: (1) Do foreigners acquire domestic firms with high human capital and that pay higher wages even after controlling for worker quality? (2) Does foreign ownership improve the labor market outcomes of the acquired firms? To quantify the effects of foreign ownership, I analyze the evolution in total employment, human capital of the workforce and average wages conditional on worker quality following a foreign acquisition of a domestic firm.[1] The main findings of the paper can be summarized as follows. Most of the large cross sectional differences between foreign and domestic firms are explained by foreigners "cherry picking" the domestic firms. In the years prior to the acquisition, firms that will become acquired are already larger, employ a more educated workforce and pay higher hourly wages for a given worker quality (both to low and high educated workers) than the average domestic firm in the sector. Moreover, before the foreign acquisition firms are already very similar to the group of existing foreign firms. Consistently with the few theories of foreign acquisitions, these findings strongly suggest that foreign acquisitions are not random. When foreign firms enter a new country and/or a new product market, by acquiring an existing firm it is more likely that they choose firms with relatively high productivity and with technological characteristics that are similar to their own (Hennart and Park, 1993; Buckley and Casson, 1998). Otherwise, foreigners would face very high costs of adapting the technology, changing the workforce and gaining experience in the host country. In Portugal the costs of adjusting the workforce are particularly high since it has one of the most restrictive employment protection regulations in the world. I also find evidence that the change in the nationality of the ownership has little effect on different labor market outcomes of the acquired firms. By comparing the same firms before and after the acquisition, I find that following the acquisition the size of the firm increases but that there is no significant change in the human capital of the average worker in the firm.[2] Moreover, there is evidence that following the acquisition average wages increase slightly in manufacturing firms but these results are in stark contrast with the large cross sectional estimates of the foreign wage premium. Suggestive evidence shows that this might not be specific to foreign acquisitions since wages go up by similar magnitudes following domestic acquisitions.

The Portuguese case is interesting because it combines two important features. First, Portugal had a permissive legal framework for the operation of foreign firms that translated into substantial

[1] Other papers have used foreign acquisitions to quantify the foreign wage premium (e.g., Aitken et al., 1996; Conyon et al., 2002a; Lipsey and Sjoholm, 2002). See Navaretti and Venables (2004) for a survey.

[2] I find that employment in the firm increases on average by 14% following the foreign acquisition. However, this evidence should be interpreted cautiously since there is also evidence of selection of foreign investment into firms where employment was growing faster prior to the acquisition.

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