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Perspectives on topical foreign direct investment issues

Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)

Managing Editor: Matthew Conte (msc2236@columbia.edu)

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Outward FDI and home country employment

by

Riccardo Crescenzi, Roberto Ganau and Michael Storper*

Policymakers often see inward FDI (IFDI) as a key to economic development and outward FDI (OFDI) as a drain on domestic employment and innovation. This reluctance to embrace active, two-sided internationalization is matched by deep ambiguity in scholarly work on the actual economic impacts of OFDI. However, IFDI and OFDI are often inextricably connected, with economic benefits flowing from the two-way internationalization of the local economy.

The empirical literature on OFDI has mostly explored impacts internal to investing firms, often overlooking impacts on the wider domestic economy on a local level.[1] Depending on the nature of the investment, different combinations of labor substitution and complementarity effects may shape home-economy employment differently. Vertical OFDI—involving the relocation abroad of specific parts of the value chain—can induce substitution effects between domestic and foreign labor in the short and medium run. Conversely, in the long run, cost-saving OFDI increases productivity through a scaled-up demand for domestic labor, the consequence of firm growth that stems from internationalization. Horizontal OFDI—involving the relocation abroad of entire business activities (mostly production)—might generate negative home country employment effects due to offshoring. But, if foreign production is mostly supported by inputs and intermediate components from domestic facilities or parent companies, increased sales by foreign affiliates will positively affect the home country.[2]

When considering the net economy-wide impacts, an analysis of OFDI in the US suggests an overall positive link between "greenfield" OFDI and domestic employment levels in local labor markets where investing companies are located. This suggests that local job creation at home and abroad are complementary effects of both horizontal and vertical OFDI, rather than substitutes.

However, the employment returns of OFDI vary greatly across industries and regions. Higher local returns to OFDI are associated with high-tech manufacturing and service industries that employ skilled domestic workers. More highly skilled domestic workers are difficult to replace with labor outside the US when engaging in vertical OFDI and are also more likely to contribute to offshored activities in horizontal OFDI. On balance, less developed domestic regions benefit the most when local firms engage in OFDI in high-tech manufacturing and services industries. This suggests that OFDI might offer opportunities for structural transformation in less developed regions, by helping local activities to move up the global value and knowledge hierarchy by investing abroad. However, this effect might also increase intra-regional inequalities between high-skilled and low-skilled workers.

Public policies that encourage OFDI could be beneficial to local employment. However, policymakers should carefully consider some key aspects:

- First, OFDI is often coupled with increases in intra-regional and inter-personal inequalities. This might work against inclusive and sustainable growth. Governments should adopt complementary measures to spread the benefits of OFDI, such as through training and up-skilling.

- Second, regional investment promotion agencies (IPAs) should support the dynamism of local ecosystems with the goal of reinforcing local linkages between domestic MNEs and local suppliers.[3] For example, while Local Content Units—dedicated government bodies that connect new investors with potential local suppliers—have mostly focused on the development of input/output linkages of inward investors, they should extend their action to domestic firms with foreign operations.

- Third, regional IPAs, with their sectoral targeting,[4] are best placed to ensure that OFDI policies are flexibly tailored to country and region socioeconomic specificities and earmarked to priority sectors where appropriate skill complementarities and absorptive capacity[5] are in place locally.[6]

New evidence offers encouraging insights and suggests that OFDI could be beneficial for less developed regions in home countries. Although more evidence is urgently needed on what tools work in practice, countries should start considering which individual policies could help them maximize OFDI benefits.

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[*] Riccardo Crescenzi (r.crescenzi@lse.ac.uk) is a Professor of Economic Geography at the London School of Economics; Roberto Ganau (roberto.ganau@unipd.it) is an Assistant Professor of Applied Economics at the University of Padova; Michael Storper (storper@ucla.edu) is a Distinguished Professor of Regional and International Development at UCLA. The authors wish to thank Jan Knoerich, Joserra Perea and an anonymous peer reviewer for their helpful peer reviews.

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For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Matthew Conte, at msc2236@columbia.edu.

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