

**LABOUR MARKET REGULATION
AND FOREIGN DIRECT INVESTMENT**

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EXECUTIVE SUMMARY

Foreign Investment in Western Europe

Over the last two decades, the importance of foreign direct investment has grown globally, and in recent years, the EU has become the main area receiving FDI. European economic integration is expected to have a major role in changing the scale and direction of investment flows in the EU. It has created the conditions for considerable industrial restructuring, which is anticipated to result in a redistribution (and relocation) of existing investment among multinationals in a number of sectors. Another key aspect of integration has been that it may change the way investment decisions are being made. Whereas before, proximity to national markets was the key determinant in investment strategies, the completion of the Single Market is likely to increase the importance of production factors - especially those relating to labour markets - in shaping investment strategies. Investment strategies are expected to become more sensitive to the production requirements of different sectors and the type of economic activity that is being located.

Foreign Investment and Labour Costs

Foreign investment decisions are sensitive to international differences in labour costs. Over the last decade, labour cost differentials within the EU have persisted. Although it has been argued that labour costs are less important once productivity differences are taken into consideration, evidence suggests that productivity variations bring about some cost convergence, significant gaps between countries remains. In addition, it appears from an examination of investment flows in high- and low-cost countries that flows are broadly responsive to nominal rather than real labour cost differences.

Moreover, when considering the role of labour costs in affecting foreign investment, it is useful to distinguish between wage costs and social protection costs. It has been argued that it is unnecessary to separate these two types of costs, both in theoretical terms but also in terms of business behaviour, as companies are only interested in bottom-line total compensation cost differences. However, there does seem to be evidence of companies reacting to perceived high levels and steep increases in indirect labour costs.

Foreign Investment and Labour Market Regulation

Labour market regulation should be considered as a series of discrete areas covered by statutory legislation or collective agreement, whose combined effect can be witnessed in different types of labour flexibility. The importance of labour flexibility can be seen in the growing recognition that industrial competitiveness is linked to the ability of individual firms to adapt to changes in markets, products and production technologies, both short- and long-term. This ability can be considered as several different types of flexibility: *numerical* (such as dismissal legislation and the use of atypical employment), *temporal* (such as working time), *pay* (such as minimal wage legislation) and *functional* (or the ability to reassign workers to different tasks within the production process). Labour market regulation has an impact on all four areas,

though there is concern that there may be a trade-off between the first three and functional flexibility. In addition, the nature of industrial relations at national level can be an important factor, depending on the extent to which it facilitates or restricts the ability of the firm to alter pay and employment conditions to match its individual circumstances.

Evidence has been cited on the extent to which companies can use the threat of diverting investment to extract concessions on employment conditions. In all four areas of flexibility, national differences in labour market regulation can be found, with Ireland and the UK emerging as the most liberal countries overall, and Belgium and Spain as the most restrictive (though more research is required on the issue of functional flexibility).

The effects of EU social dimension measures on foreign investment are limited to date. Few measures have been implemented and in most cases, they only affect a small proportion of mobile investment. More concern has been expressed about potential areas of future EU action - such as atypical employment or national level information and consultation. Furthermore, the UK opt-out has not altered FDI patterns greatly.

Overall, it seems that differences in national regulatory frameworks have either not been significantly changed by current EU measures or firms are more interested in these differences than the application of EU policies. However, questions remain though about the extent to which social dimension regulation at the EU level is preventing 'social dumping' occurring in labour standards at the individual plant and company level.

Keywords: Foreign Investment, Labour Market Regulation, Employment Policy, Social Chapter

TABLE OF CONTENTS

Executive Summary	2
1. Introduction	5
2. Foreign Investment in Western Europe	7
2.1 Introduction	7
2.2 Recent Trends	7
2.3 Determinants of Foreign Investment Location	14
2.4 Summary	18
3. Foreign Investment and Labour Market Factors: Labour Costs	20
3.1 Introduction	20
3.2 Wage Costs	20
3.3 Social Protection Costs	28
3.4 Summary	30
4. Foreign Investment and Labour Market Factors: Labour Market Regulation	32
4.1 Introduction	32
4.2 Definition of Labour Market Regulation	33
4.3 Labour Flexibility and Foreign Investment	35
4.4 National Variation in Labour Flexibility	42
4.5 Summary	48
5. Foreign Investment and the Social Dimension of the European Union	50
5.1 Introduction	50
5.2 The Social Dimension of the European Union	50
5.2 Specific Measures and Foreign Investment	51
5.3 Summary	54
6. Future Research	56
6.1 Introduction	56
6.2 European Integration, Redistribution of Investment and Location Factors	56

6.3	Productivity, Wage Levels and Social Protection Costs	57
6.4	Labour Market Regulation, Productivity and Investment	58

Bibliography	60
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1. INTRODUCTION

The European Policies Research Centre at the University of Strathclyde in Glasgow is pursuing a research programme to study the relationship between the level of labour market regulation in the EU and the investment strategies of multinational companies. Initially, the research had several objectives:

- to determine the influence of perceptions of national labour market flexibility on current and foreign investment decisions as well as on the type of investment made (eg. labour-intensive production), relative to other factors of location;
- to assess the level of compliance of specific EU Social Chapter directives at the levels of both Member States and individual enterprises; and
- to study the impact of EU Social Chapter measures on investment location attractiveness and future investment in specific industries, relative to other location factors (eg. skill levels) and other processes, such as technological and organizational change.

The first stage of the programme has been developed with the financial assistance of the Directorate-General for Employment, Industrial Relations and Social Affairs in the European Commission. The first stage has involved a theoretical paper and pilot study with two specific aims: to define the key issues that should be addressed in the research programme; and to suggest a range of feasible methodologies for examining these issues. The present paper reports on the results of this first stage.

For this paper, in addition to a review of existing literature and statistical analysis, interviews have been held with UK policy-makers (in the Department of Education and Employment and the Department of Trade and Industry), EU officials, academics, employers organization representatives, European trade union officials and senior managers in multinational companies. In particular, we wish to acknowledge Jim Mackley and John Morley of Directorate General V for their advice on several aspects of the research.

The report is structured in four chapters. Following this introduction, the second chapter provides an *analysis of foreign investment patterns in the EU*. Trends are examined using Eurostat and OECD data on country and sector investment flows with a view to identifying the main recipients of FDI. Different location factors in investment decisions are classified, and the existing and future importance of labour market factors is placed in context.

In the third chapter, the *effect of EU labour cost differentials on foreign investment* is assessed. Labour costs are divided into wage costs and social protection costs, and national differences in both sets of costs are examined with regards to their potential impact on corporate investment strategies.

The issue of *labour market regulation and foreign investment* are reviewed in the fourth chapter. Different types of regulation are defined and related to distinct forms of labour flexibility in the organization of production. National variation in these forms of flexibility are studied and linked to different investment strategies.

In the last chapter, a *research agenda* for future stages of the programme is presented, in which our views on how the research programme should be developed are discussed.

2. FOREIGN INVESTMENT IN WESTERN EUROPE

2.1 Introduction

Foreign investment patterns need to be reviewed before the role of labour market factors in investment strategies can be considered. The first section of this chapter provides a statistical analysis of recent trends worldwide as well as in Western Europe. This is followed by a theoretical overview of the different types of location factors influencing investment strategies and the extent to which European integration may be changing the role of the different factors.

2.2 Recent Trends

2.2.1 Global Foreign Investment Flows

It is worthwhile placing European investment flows within the wider context of the rising importance of foreign direct investment (FDI) globally. For OECD countries, this can be seen by the increase in the value of outward investment flows from 0.5 percent of GDP in 1982 to a peak of 2.2 percent in 1989 (OECD, 1995a). Overall, over the last twenty years, FDI has grown significantly faster than GDP - consequently, inward investment flows in the OECD rose from 0.7 percent of combined GDP in 1974 to 1.3 percent by 1994. Although this period of rapid growth was followed by decline in the early 1990s as a result of recession, more recently, global FDI flows reached US\$ 196 billion in 1994, an increase of 11 percent on the previous year.

Growth in FDI has been attributed to the interaction of several factors. Changing corporate strategies have led to the increasing mobility of parts of the production process, reflecting both the intensifying pressures on firms to internationalize and expand beyond domestic markets as well as greater ease in operating on a global scale (CEC, 1993b). In examining the shift in multinational strategies, several interrelated processes of internationalization can be identified (Raines and Bachtler, 1992; Howells, 1990).

- In *sales* markets, shorter product life-cycles and increasing international competition have made it imperative for many firms to establish a local presence in different international markets. Firms have had to maximize sales in shorter time periods in order to recoup product innovation costs.
- For *technology and product development*, the increasing costs of R&D have catalyzed international cooperation agreements and joint ventures as companies have found it more difficult to carry innovation costs on their own.
- *Sourcing* has encouraged internationalization as greater competition has made sub-contracting and supply patterns more international.

Further, as multinationals are adopting more global perspectives, it has become easier to operate global organizational strategies as a result of technological innovations (especially in telecommunications and information technology) which have given firms greater flexibility in developing internationally-extended organizations.

At the same time, changes in host government attitudes to FDI have not only encouraged increasing investment flows, but have led to increasing competition for mobile investment. In the context of national and regional economic development, the benefits of FDI that have been perceived include a range of direct and indirect effects (The English Unit, 1991).

- For *employment and income gains*, investing firms can create jobs and increase the income of a region directly.
- *Multiplier effects* arise as investing firms have an indirect impact on a local economy through demand for the supplies of local goods (such as production components and sub-contracting) and services.
- *Better performance and quality of local firms* can take place where locally-based companies become more efficient through the increase in domestic competition caused by multinational investors as well as through learning new management and production techniques via collaboration with investors.
- *Improved education and training provision* has been encouraged by the production demands of many investors, resulting in the introduction of new skills into a regional economy through training given by the investing firm.
- *Technology transfer* can occur as new technologies and product innovations are introduced into the local economy by an investor, particularly through transfer to sub-contracting or other firms in collaboration with the investing firm.

While the scale of these effects varies with individual circumstances, in general, FDI has been acknowledged as a significant catalyst for economic regeneration and restructuring within countries. In consequence, the attitude of governments have been increasingly positive towards foreign investment. This has taken place indirectly by government policies to increase trade liberalization and financial deregulation on a worldwide scale, promoting more economic linkages between different national economies and making it easier in turn for companies to develop trade and investment links across international boundaries. Although questions have continually been raised about the desirability of allowing direct foreign control over parts of the economy, government policies have also directly become more receptive to foreign investment. The processes of deregulation of foreign ownership controls and privatization in state industries have created favourable investment environments and greater acquisition opportunities. Further, to capture the beneficial effects of FDI, national and regional economic development policies in different countries are frequently designed to attract new investment, most notably through the greater use of financial incentives for investors and the establishment of inward investment agencies with special responsibilities for attracting foreign investment.

2.2.2 Western European Foreign Investment Flows

Western Europe - and the EU in particular - continues to benefit from these developments, especially in terms of inward investment flows. Although in recent years the US has been the main country destination of FDI - in 1993 and 1994, it received over

US\$ 81.4 billion (Table 2.1) - as an *economic region*, the EU has been the most important host of FDI, gaining US\$ 102.4 billion in the same period. Moreover, the EU's share of global foreign investment has been increasing - rising from 36.5 percent of total FDI stocks in 1988 to 43 percent in 1992 (UNCTAD, 1994).

After the US, the principal recipient countries in the world have been in the EU - the UK and France, which had US\$ 25.6 billion and US\$ 22.7 billion respectively in 1993-94. Other countries attracting large shares of FDI have included, perhaps surprisingly, several smaller European economies, such as Belgium, Luxembourg and Spain. In contrast, a number of large economies have not performed as well in terms of FDI, notably Italy and Germany (indeed, the latter experienced a net outflow of foreign investment in this period).

<i>Country</i>	<i>1993-94 net flows (US\$ mn)</i>	<i>1994 flows as share of GDP</i>	<i>1984-88 flows as share of GDP</i>	<i>1989-94 flows as share of GDP</i>
US	81,437	0.9	0.9	0.7
Japan	912	*	*	*
UK	25,596	1.1	1.5	2.2
France	22,651	0.8	0.5	0.9
Belgium/Luxembourg	19,354	3.9	1.4	4.4
Spain	14,967	1.7	1.5	1.9
Sweden	10,609	3.5	0.6	1.7
Netherlands	8,708	1.0	1.0	2.0
Denmark	6,574	3.3	0.2	1.4
Italy	6,228	0.2	0.4	0.3
Portugal	2,619	1.4	1.1	3.2
Greece	977	1.3	1.4	1.4
Ireland	88	0.2	0.4	0.2
Germany	- 2,763	- 0.1	0.1	0.2

* - Negligible amounts.

Source: OECD, 1995a.

In terms of the importance of foreign investment in the national economy, FDI appears to be more significant to smaller countries, such as Belgium, Luxembourg and Portugal. All three have enjoyed high and rising ratios of FDI to GDP in recent years - particularly Belgium and Luxembourg, which had the highest figure among EU countries in 1994 (Table 2.1). However, the UK has been the only other EU country where high volumes of inward investment have been matched by its high share of economic activity. The UK had an average ratio of 2.2 percent between 1989 and 1994, increasing from an average of 1.5 percent for the previous five years. Some countries have experienced recent surges in FDI - notably Sweden (whose ratio in 1994 was 3.5 percent) and Denmark (3.3 percent in the same year) - but as with the volume of FDI flows, inward investment appears to have had a much less significant role in Germany and Italy.

The main external sources of FDI in the EC have been the US and Japan. Between 1986 and 1991, the US accounted for 25 percent and Japan for 13 percent of foreign investment flows into the Community (*Financial Times*, 1994). Although flows into Western Europe from US and Japan have not grown as rapidly in more recent years, the Community remains a consistently important location for FDI - in 1993-94, 41.5

percent of US foreign investment came to the EU (*Survey of Current Business*, 1995). In terms of destinations, both countries have shown preference for the UK - by 1993, over forty percent of total US and Japanese investment had been located there (OECD, 1995b). The second most popular destination for Japanese multinationals has been the Netherlands, whereas US companies have tended to be drawn to Germany (perhaps surprising, given Germany's low FDI profile overall).

The EU has also had the largest investment outflows in recent years. For 1993-94, EU outward investment amounted to US\$ 179.5 billion, greater than the combined total for North America (US\$ 135 billion) and Japan (US\$ 31.4 billion) in the same period (OECD, 1995a). The principal EU investor country has remained the UK (second to the US in the world), followed by Germany, France and the Netherlands (Table 2.2). It is worth highlighting the fact that there has been considerably larger investment outflows than inward FDI in the UK, Netherlands and Germany, as well as to a lesser extent in Italy. In contrast, inward flows in Spain have far exceeded its outward investments.

<i>Country</i>	<i>1993-94 net flows (US\$ mn)</i>	<i>1994 flows as share of GDP</i>	<i>1984-88 flows as share of GDP</i>	<i>1989-94 flows as share of GDP</i>
US	116,293	0.9	0.4	0.7
Japan	31,425	0.4	0.7	0.9
UK	55,402	2.9	3.2	2.5
France	22,888	0.8	0.8	1.5
Belgium/Luxembourg	18,713	3.2	1.2	3.3
Spain	6,840	0.9	0.2	0.5
Sweden	7,685	3.3	2.7	3.2
Netherlands	21,509	3.5	2.2	4.1
Denmark	5,420	2.7	0.5	1.6
Italy	11,505	0.4	0.5	0.5
Portugal	301	0.2	0.1	0.4
Greece	*	*	*	*
Ireland	*	*	*	*
Germany	29,260	0.7	0.9	1.1

* - Negligible amounts.

Source: OECD, 1995a.

At present, outward investment flows are particularly significant in Belgium, Luxembourg, the Netherlands and Sweden (Table 2.2). Over the last decade, the importance of outward FDI has increased in all EU countries apart from the UK (though it remains high here as well) and Italy (where it has been relatively constant). Outflows relative to economic activity have been notable in Belgium and Luxembourg (rising from 1.2 percent of average GDP in 1984-88 to 3.3 percent in 1989-94) as well as the Netherlands (increasing from 2.2 to 4.1 percent in the same period). Although Germany has had high volumes of outward FDI in recent years, they have accounted

for a small share of overall GDP. This has been reflected in the share of foreign affiliates in national turnover in many EU countries - between 1980 and 1990, this has gone up in France, the UK and Ireland (especially in the latter, where foreign subsidiaries accounted for 55.5 percent of manufacturing GDP), but has *decreased* in Germany (OECD, 1994).

An important feature of recent inward and outward FDI flows in the EU has been the increasing investment activity among Member States. Intra-Community investment flows rose from 41.3 percent of total inward investment in 1984 to 53.3 percent by 1989 (Eurostat, 1992). Over that period as a whole, 53.9 percent of foreign investment in Community countries was accounted for by other Member States, often amounting to more than the flows coming from the US and Japan. For example, the UK was responsible for 15.1 percent of total inward investment in the Community between 1984 and 1989, as compared to 12 percent for the US. Similarly, the share of German employment working outside Germany increased in the EU relative to the rest of the world from 23.6 percent to 28.4 percent between 1980 and 1990, suggesting a shift by German companies to EU locations (OECD, 1994).

As a whole, the UK has been both the main destination and source of intra-Community FDI in recent years. Nevertheless, investment to and from other Community countries has not been relatively as important in overall UK flows as in other major EU investing countries - of the EU countries, Italy and France have the highest shares of inward and outward investment flows with other EU countries (Table 2.3).

<i>Country</i>	<i>Outward</i>	<i>Inward</i>
Italy	62.5	51.7
France	59.6	56.2
Germany	50.3	38.5
Netherlands	44.1	41.7
UK	26.1	30.8

Source: OECD, 1995a.

The growth in intra-EU investment flows and the increasing inward FDI in the region has in large part been attributed to the effects of the completion of the Single Market. Admittedly, it is difficult to establish a direct linkage in all cases - without a counterfactual scenario, it cannot be assumed that these investment changes would not have taken place anyway - and to separate the influence of the global pressures on corporate reorganization and investment strategies from the influence of changes in Europe. Nonetheless, increasing economic integration has traditionally been closely associated with growth in new investment - the changes to existing investment and the recent surge in investment activity in the EU suggests that this is continuing to take place (UNCTAD, 1992; Dunning and Robson, 1987).

Following the introduction of the 1992 programme in the mid-1980s, the restructuring of multinational firms in many sectors seemed to be accelerated, changing FDI

patterns in Western Europe. The 1992 programme involved the removal of remaining trade barriers with the intention of creating a pan-European market in industries that had been previously been fragmented into national markets by a variety of trade protection measures. As one of the key aims of the programme was to increase the competitiveness of European firms compared to US and Japanese companies by promoting competition in European markets, the programme was designed to produce industrial restructuring (Cecchini, 1988).

From the perspective of multinationals, restructuring will be encouraged by increasing production economies of scale and rationalization of industrial organization as a result of price competition in protected sectors, especially for so-called 'multidomestic' companies which have pursued essentially national investment strategies on an international scale (Dicken *et al*, 1994). The actual approach to restructuring will result from an interaction of existing corporate strategies and the new investment environments arising from integration. How (and if) restructuring will take place depends greatly on variables relating to country, sector and type of investment.

(i) *Country*

The changing FDI patterns can be seen in the apparent reactions of firms based inside and outside the Single Market. One of the key responses to the 1992 programme appears to have been a wave of first-time investment by extra-EU firms, particularly from the US and Japan. Between 1985 and 1991, the number of Japanese manufacturing companies with a base in the EC-12 grew from 188 to 676; in 1987-88 alone, the number of Japanese manufacturing ventures in the Community increased by 40 percent (UNCTAD, 1992). Firms seem to have been motivated by a mixture of the new business opportunities as well as by a fear of exclusion from participation in the market. In business surveys, non-Community companies expressed concerns that the process of European integration could be used to prevent foreign firms from taking advantage of the market liberalization, unless they were located within the EU (Bachtler and Clement, 1989).

For firms already based in the EU, a twofold impact can be identified. First, there has been a notable increase in the levels of foreign investment by existing companies. US multinationals recorded a rise in the capital expenditure of their foreign affiliates in the EC-12, increasing from 40.4 percent of total expenditure on all affiliates around the world in 1985 to 46.1 percent in 1990 (UNCTAD, 1992). Second, there has been a partial redistribution of foreign investment within the EU as greater economic integration has created incentives for firms to alter production and distribution patterns. Depending on the sector and the firm's existing organization, this has taken a number of forms. Many diversified firms have reorganized in order to allocate different product lines to individual production sites, often not resulting in any overall change to the shares of investment maintained in different countries. For some companies competing in single-product industries, changes in investment strategies have led to concentration of production investment in particular sites, resulting in expansions and reinvestments at certain locations, disinvestment and closures in others. At present, evidence demonstrating the 'Europeanization' of multinationals has been principally anecdotal (via case study reports in the media) and partially distorted by the dampening effects of the recession, but it remains widely anticipated as the most important of the effects of integration on company behaviour in the EU.

(ii) *Sector*

By industry, the effects of the 1992 programme on foreign investment have been estimated as potentially substantial in particular service and manufacturing sectors. Already, foreign investment in Community service sectors has grown more rapidly than in manufacturing, possibly in response to new opportunities caused by integration. In 1984-85, services received 23.3 percent of total Community inward investment but by 1988-89, this had increased to 34.1 percent (Eurostat, 1992). For example, as a result of the 1992 programme's measures in the financial service sectors, European markets have been opened to greater competition from foreign firms, so that it has become easier for financial service multinationals to establish subsidiaries across the EU. Possibly as a result, over half of total FDI in services in the Community during the 1980s has gone into financial service sectors.

Similarly, the 1992 programme has the potential for triggering substantial

rationalization of international production in specific EU manufacturing sectors. It has increased both the opportunities for firms to serve the Single Market from fewer manufacturing locations (and make use of economies of scale where they have not been fully exploited) as well as the need to expand into the European market because of the greater competition in domestic markets (UNCTAD, 1994). Research by the European Commission calculated that sectors likely to be significantly influenced by the 1992 programme represent approximately half of the value added in Community industry. The sectors can be divided into five categories (CEC, 1990):

- capital and R&D-intensive sectors (such as pharmaceuticals, motor vehicles and office equipment);
- capital- (but not R&D-) intensive sectors (including many food industries);
- skilled-labour-intensive sectors (such as industrial machinery);
- labour-intensive sectors (such as clothing, textiles and footwear); and
- sectors with low capital and labour intensities.

These are sectors which have been heavily regulated at national level, resulting in internationalization strategies for firms that required developing an investment presence in individual national markets.

(iii) Type of investment

Changes in the types of foreign investment can be associated with different investment strategies pursued by firms in these sectors. Although considerable variation can be expected depending on the characteristics of the investor, firms with an existing investment presence in several locations in the EU are anticipated (at least in the short term) to focus on investment *redistribution* between sites, involving expansions, disinvestments and relocations, whereas new investors in the EU (whether extra-EU multinationals or nationally-based EU companies expanding into other EU markets) would lead to investment *creation* via greenfield or acquisition investments. The different investment strategies have distinct implications for employment and economic development in host regions and countries. An acquisition of a domestic company by a foreign firm is unlikely to have as extensive an impact (at least in the short-term) on employment and investment within a locality as a 'greenfield' investment as new investors will create new jobs and establish new linkages with local suppliers.

At present, it is difficult to estimate the shares of investment redistribution and creation in current FDI flows within the EU. Data on different types of investment are not collected and categorized systematically, though it is possible to indicate general levels of activity. For example, it has been estimated that greenfields accounted for over half of Japanese investment in the main Community host countries during the 1980s (Potter and Djan Tackey, 1992). Similarly, the number of mergers and acquisitions in the EU appears to have escalated as a result of the 1992 programme. Between 1987-88 and 1992-93, the annual number of mergers and majority acquisitions involving EU firms rose from 3,021 to 4,831 (CEC, 1993a). Mergers between companies based in the same Member State have dominated, accounting for approximately two-thirds of all activity, but cross-border deals have been growing as rapidly as domestic ones.

With regards to relocation investment, the data problems are more substantial. Although there is considerable anecdotal evidence about the restructuring of multinational companies in response to European integration (see for example, Ramsay, 1995), systematic studies have not been undertaken. Research into investment strategies is made more complicated by the existence of unrecorded shifts in investment. For example, it is often not possible to link an expansion of investment by a company in one site with its running down of a plant in another location, especially when the events do not take place simultaneously. In some cases, the types of investment strategy are linked - in the past, it has been found that a large number of closures frequently follow from post-acquisition restructuring (McDermott, 1989). Moreover, the extent to which restructuring is a reaction to new opportunities in the Single Market rather than rationalization because of the recession or other specific commercial factors cannot be gleaned from the existing data. The methodological problems associated with this kind of research will be examined in greater detail in Section 6.

2.3 Determinants of Foreign Investment Location

Numerous business surveys have identified the factors that shape foreign investment strategies and ranked them in importance. Such factors have been relatively consistent for the majority of investment decisions, though in recent years, changes in the European economy through integration may be altering the importance of each set of factors. In the next section, the different factors are reviewed from a theoretical perspective, followed by a consideration of how the Single Market programme has been changing these factors' impact on investment strategies.

2.3.1 Factors Influencing Location

The common thread running through the extensive literature on industrial location is the recognition that all foreign investment decisions by companies are unique: they are influenced by a bundle of factors that are individual to specific circumstances. The decisions are not only determined by the characteristics of a particular site relative to other locations, but also by the context of the company's operations, business strategy and markets. Locational factors must also be seen from a dynamic perspective, especially in cases of expansion of existing investments where what matters is often how a site's attractiveness changes relative to other sites operated by the company. Moreover, the role of personal factors continues to render many multinational investment decisions ambiguous (Dickson and Judge, 1987).

In spite of the difficulties in generalizing about foreign investment decisions, there are still groups of factors that have a determining influence on corporate strategies. From the perspective of the firm, the factors are often considered as a series of costs that companies aim to minimize by locating in specific areas. These costs are considered not just in strategic decisions to export to new markets or set up foreign investments, but also in deciding between competing locations. The costs can be classified as the

following: markets; the establishment of the investment, production; distribution; the business environment; and the social and cultural environment.

(i) *Market costs*

Market proximity has been consistently cited in surveys of foreign investors as the main factor behind location decisions, particularly in the EU (CEC, 1993b). Successive enlargements of the Community and the increasing internationalization of trade and investment flows have drawn investment from multinationals over several decades - most recently, this has been seen in the surges of investment in Spain and Portugal following their membership of the Community. The location of a manufacturing plant in a key national market - or in an area with good access to the wider Community market - has important cost advantages over exporting. These are not only the costs of transporting between countries, but can include the attraction of lower costs in acquiring and responding to market information (easier to obtain in close proximity).

Trade and other regulatory barriers to imported products can also encourage firms to locate within a target market. For example, the imposition of anti-dumping measures by the European Commission was a determining factor in deciding Japanese printer manufacturers to locate assembly plants within the Community, as it enabled them to avoid tariff barriers on their exports into the EC (*Financial Times*, 1988).

When considering market factors, a distinction should be made between commercial and industrial markets. *Commercial* markets usually consist of a large number of consumers for a particular standardized product, located over a relatively wide geographical area of sales, for whom the goods are often end-user products. Firms making investment for commercial market factors tend to be in a position to balance market proximity issues against other location determinants as they can have greater latitude in location because their markets are not linked to certain sites (though there are often constraints on the choice of country). In contrast, firms in *industrial* markets often invest in order to be close to single customers and are limited to specific locations because of the need to frequently adapt products to their customer needs. As a result, foreign investments by large manufacturing-assembly companies often draw secondary investments by suppliers from their home countries, as has taken place with several Japanese automobile and electronics companies investing in the Community.

(ii) *Establishment costs*

The costs of establishing an investment in a new location are often sufficiently large to determine between competing sites. These costs are varied and include the costs of finding suitable sites as well as additional preparation of the sites to meet the company's requirements (such as the provision of adequate roads). These costs can be mitigated by government policies for attracting inward investment through financial support, provision of training and supplying local site information to investors.

Given the increasing competition for large mobile investment projects, many EU governments offer financial incentives to draw companies to specific regions. While the importance of these incentives in investment decisions are discounted by many firms,

the size of individual awards in recent years suggests that they are influential in deciding between locations. Further, the costs of finding appropriate sites can be reduced by the competition between government inward investment agencies that are usually amenable in providing important information about locations. Companies often cite the cooperative attitude of these agencies as a factor in their decisions - as for example in the case of English Partnerships, which played a crucial role in attracting the European manufacturing centre of Samsung to North East England (*The Times*, 1995).

(iii) *Production costs*

The availability and costs of the inputs into the production process have been second to market proximity as the key set of factors affecting investment decisions. Inputs can include a range of different elements. In some cases, an important consideration in locating production investment is access to raw materials whose transport cost may be prohibitive, particularly in the foods and drinks sectors because of the problem of perishables. Similarly, several manufacturing sectors require the close integration of supply networks with the main producer. As a result, firms may want to place themselves in locations with an established supply network that can meet their needs, a factor that has influenced many automobile producers locating in the Community.

A critical aspect of the production process in many industries is the cost and quality of labour. Labour is one of the most important production costs for firms. Depending on the nature of the labour-intensity of the industry, it can be as significant a consideration for firms as market proximity. In addition to the costs of labour, the availability of a skilled (and adaptable) workforce has been increasingly singled out by companies as one of the crucial determinants of an investment decision. As labour factors - and the regulations governing the use of workers in the production process - are the subject of the following two chapters, the importance of the issue will not be dwelt on here.

As well as access to a skilled labour supply, specific industry skills are often important, whether embodied in individual workers or in supplier companies. Where foreign investments are R&D-intensive, it may be important for there to be available local research personnel or a cluster of innovative firms that can provide key technologies or become research partners to the investing firm. Education infrastructure is assessed both for its supply of graduates with appropriate labour skills and for the collaboration opportunities with the research units of universities.

(iv) Distribution costs

Market proximity can be partly compensated by a strong transport infrastructure in the region where investment is considered. Good rail and road links are often essential for manufacturing plants for rapid supply deliveries and wide distribution of finished products. Access to international airports can be crucial for firms which may require the swift movement of personnel between countries. In addition, the quality of telecommunications can also be decisive in investment decisions, particularly where regular contact between the parent and subsidiary may be necessary.

(v) Business environment costs

Differences in the business environments of competing investment locations can affect investors' perceptions of the ease of operating in different locations. These factors include local and national taxation as well as regulations governing environmental issues, health and safety standards, and employment conditions (as will be discussed in later sections). A more liberal regulatory environment is often associated by investors with reduced operating costs and the scope for changing the organization of production in the investment (or indeed closing down the investment). Another part of the business environment from the perspective of investors is the existence of an adequate business services sector for the provision of general and specialist financial services.

(vi) Social and cultural costs

Although rarely decisive as factors, social and cultural issues are frequently considered by investors in their location decisions. Familiarity is important in this regard. For example, a common language with the investor reduces the psychological different-ness of a foreign location. Further, quality-of-life factors and the attractiveness of an area to relocating staff can often reinforce a location's strength.

2.3.2 European Integration and Location Factors

As noted above, the process of European economic integration has been expected to produce significant shifts of investment within the EU as a result of industrial restructuring, as well as attracting new inflows of investment from companies outside the EU wanting to take advantage of the Single Market. Although its effects should be understood within a wider set of global changes in corporate investment behaviour, as many European multinational companies are increasingly organizing themselves to operate on a global rather than a European scale, for many companies, European integration can potentially have a significant impact on corporate operations within the European market. The changes are not likely to be limited merely to the *scale* of foreign investment flows within the EU. While they have not altered the types of factors that influence investment decisions, they have implications for their relative importance.

In theory, the most immediate change should be that commercial factors should have less influence in determining investment at a national level, depending on the sector. Multinationals become less concerned with specific national locations if the European economy can be considered a unified market. The reduction of this factor can be attributed to the removal of regulations that had restricted access to national markets. Key measures in this regard include the harmonization of technical standards in products across the EU, the decline in the preferential bias in public procurement and government contracts to nationally-based bidders, and the greater ease of foreign service firms establishing subsidiaries in national markets.

If national markets decline in importance as a factor, what will come to matter most in location decisions is not so much geographical location as the availability of key production inputs and the environment in which production is taking place. Consequently, other location determinants may become more significant - particularly production and distribution costs, and the business environment. This equally affects new investors in the EU as well as companies considering reorganization of their existing investments in different Member States.

Further, the type of investment may also be affected by the Single Market. Studies of changing corporate strategies in those industries most affected by the 1992 programme suggest that the emergence of the Single Market will prompt multinationals to locate different business activities according to different sets of determinants. Rather than organizing production, administration and distribution facilities on a national basis, companies are beginning to concentrate these functions in centralized locations in the EU. Consequently, new patterns of foreign investment can be expected as different regions and countries not only demonstrate increasing specialization in particular industries but also in specific business functions.

For each type of function - manufacturing, administration, R&D and distribution - certain factors are likely to be more influential than others (*Corporate Location*, 1995).

- *Manufacturing plants*: where the availability of a skilled labour force (in particular sectors), labour costs, transport infrastructure, availability of suitable properties, and the business and employment regulatory environment are key location issues.
- *Administrative/headquarters functions*: particularly strong international transport

links (for management travel), telecommunications infrastructure and costs, the presence of a well-educated (and in some circumstances, multilingual) workforce, and labour costs (especially white-collar workers).

- *R&D centres*: notably the proximity to innovation clusters in the same and related industries (eg. science parks), specific (and often highly-qualified) labour skills, good telecommunications infrastructure and international transport links.
- *Distribution activities*: in which the importance of access to the European market is over-riding, making a central location, excellent transport infrastructure and property costs the main determinants of the investment decision.

Using these factors, Ernst & Young have attempted to predict which regions and countries in the EU are more likely to attract certain types of investment as a result of their bundle of location factors (*Corporate Location*, 1995). For example, Denmark has strong advantages for attracting electronics manufacturing plants and R&D centres, while North East Spain has a comparative advantage in automotive manufacturing and basic assembly operations. Belgium and the Netherlands have also benefited from large investments in distribution and administrative centres as a result of their central location in the EU, boosting their overall profile, though they perform less well in terms of manufacturing operations.

In consequence, the emerging patterns of foreign investment in the EU are increasingly shaped by the location of specific economic activities rather than whole companies, in which sectoral and production factors and their differences across the EU are playing a larger role in influencing decisions. These patterns are likely to remain volatile, as the further separation of different functions within multinationals could increase the mobility of foreign investment. The existence of a combined production, administrative and distribution unit at national level has been considered an important factor in maintaining an investment presence in a country. Without the reinforcement of this union of functions, individual plants could become more vulnerable to shifts in production cost factors.

2.4 Summary

Over the last two decades, the importance of foreign direct investment has grown globally, a trend evident not only in the increasing flows and their rising share of national GDP, but also in the more favourable attitudes held by governments to the economic effects of FDI. In recent years, the EU has become the main area receiving FDI. Differences exist in the significance of FDI in the Member States: for the UK and France, inward investment flows have been particularly high, while they have been limited in Germany and Italy. From outside the EU, the US and Japan have been the principal investor countries, though over the last few years, intra-European investment flows have grown substantially, most notably from France, Germany, the Netherlands and the UK.

Within a wider context of the globalization of production and international economic activity, European integration is anticipated to have a significant role in changing the scale and direction of investment flows in the EU. It has apparently catalyzed a surge of investment into the Community during the 1980s. Further, it is creating the conditions for considerable industrial restructuring, which is expected to result in a redistribution

(and relocation) of existing investment among multinationals in a number of sectors.

Another key aspect of European integration is that it may change the way investment decisions are being made. Whereas before, proximity to national markets was the key determinant in investment strategies, the completion of the Single Market is currently removing the relevance of national markets in many industries by creating a unified European market. The result is likely to be the increasing importance of production factors - especially those relating to labour markets - in shaping investment strategies. Investment strategies may become more sensitive to the production requirements of different sectors and the type of economic activity (whether production, distribution, administrative or other business function) that is being located.

Overall, the pattern of foreign investment within the EU should become more complicated, with the potential for significant employment effects if investment redistribution occurs on a large scale. To date, the process of investment redistribution - and the interaction of production cost factors, sector and type of investment - is not well understood and requires more research.

3. FOREIGN INVESTMENT AND LABOUR MARKET FACTORS: LABOUR COSTS

3.1 Introduction

As noted in the previous chapter, production factors may be having a greater influence on foreign investment decisions in recent years. Labour market factors have traditionally been the most important set of production factors assessed by firms, and among these, labour costs have hitherto been pre-eminent. The impact of labour cost differentials on the global distribution of foreign investment has recently been subject of concern in many developed countries. Increasingly, international manufacturers have taken advantage of lower wage costs in developing countries to shift production, particularly in labour-intensive sectors such as textiles and clothing. For example, 1995 hourly labour costs in the primary textile industry was US\$ 12.18 in the US, but only US\$ 0.52 in China, creating significant incentives for shifting production internationally (*Financial Times*, 1995a).

In Western Europe, labour cost differences are not as extreme, but given the fact that it is less costly to shift production between such geographically-close locations, it is clear that the differences can act as an incentive for multinationals in labour-intensive industries to relocate. Where new investment is coming from outside the Community, it may be more likely to be attracted to low-cost Member States.

However, labour costs - as with any location factor - cannot be considered in isolation. It must be assessed in the context of the skill levels of the workforce, the local infrastructure and the company production systems, as all these factors will influence labour productivity as well as the unit labour costs, an issue considered at greater length in the next chapter. In this chapter, the importance of labour costs as a FDI factor in the Community will be considered, both in terms of direct wages and non-wage labour costs associated with social protection charges. In each case, the type of cost is first examined as an existing location determinant and then in terms of how the factor's importance may be changed by European economic integration with regards to other factors.

3.2 Wage Costs

3.2.1 Role of Wage Costs in Foreign Investment Location

Evidence of the traditional importance of labour costs in determining foreign investment decisions has been mixed. As noted in the previous chapter, market proximity has been consistently cited as the key determinant in FDI flows for nearly all types of investment. In an Ernst & Young study for the European Commission (CEC, 1993b), labour costs have been more significant in locating manufacturing plants than for administrative functions, distribution centres, service-based activities or R&D facilities. Even so, in the case of manufacturing plants, wage levels were cited as the key production cost affecting

investment decisions, but were less important as a critical factor than market/customer access and the quality of transport infrastructure. Nevertheless, for some countries, low labour costs have been essential in attracting inward investment, such as Ireland, Portugal and Spain.

Labour costs are an important factor because of the long-standing differences across the Community. The persistent variation of labour costs in the EU has been attested by numerous studies. Although there are differences among the various statistical databases for measuring industrial labour costs, the disparity among labour costs in the databases has remained relatively constant over time. According to Erickson and Kuruvilla (1994), the differences in labour costs in manufacturing among the EC-12 did not alter greatly between 1980 and 1986, as hourly compensation costs between the most expensive and cheapest countries in both years differed by approximately a factor of 6.5. Using different datasets, some convergence appears to have taken place by 1992, but again the scale of difference has been reduced to no lower than a factor of approximately five (Sysdem, 1995b; EIRR, 1994b).

While there has been little change in the overall *range* of differences, the ranking of Member State labour costs has altered over time. Examining the EC-12 between 1981 and 1992, industrial labour costs in Germany have overtaken those in Belgium to become the highest in the Community, though the growth in German labour costs can be partly attributed to the strength of the Deutsche Mark in the late 1980s and early 1990s (Table 3.1). Nevertheless, there has remained a broad division between the higher labour-cost countries in northern Europe, a middle-ranking group of countries including France, Ireland, Italy, Spain and the UK, and a group containing Greece and Portugal.

<i>Country</i>	<i>Total labour costs (UK=100, 1981)</i>	<i>Ranking (highest=1)</i>	<i>Total labour costs (UK=100, 1992)</i>	<i>Ranking (highest=1)</i>
Germany	145.4	2	169.0	1
Belgium	164.1	1	151.6 *	2
The Netherlands	143.1	3	141.6	3
Denmark	127.6	5	113.5	4
France	129.3	4	112.8 +	5
Italy	100.1	7	105.2 +	6
UK	100.0	8	100.0	7
Spain	120.6	6	95.7 +	8
Greece	53.6	9	39.5 *	9
Portugal	31.4	10	35.8	10

* - Figures for 1991. + - Figures for 1988.

Source: - Sysdem, 1995b.

It has been widely argued that the differences in labour costs are compensated by differences in productivity (EIRR, 1995; CEC, 1993b and 1990). The advantage possessed by countries with low wage costs diminishes, if not disappears, when unit labour costs (or the labour cost in producing one unit) are taken into consideration. Indeed, from a theoretical perspective, it might be expected that the cost of labour would converge within an economic union such as the Community due to labour mobility (moderate as it has been) and competitive pressures on high-cost countries. However, work on comparing international productivity differences has been difficult. Across the EU, there has been little harmonization in the definitions of productivity and the

economic activities being measure. Moreover, productivity comparisons are particularly sensitive to exchange rate fluctuations between EU countries and differences between Member States on the stage at which their economies are in the business cycle.

In general, it has been easier to measure relative changes in productivity within countries rather than compare levels across countries. Equating productivity in manufacturing with gross value added per employee (full-time equivalent), Eurostat figures show that it has risen for the EC-12 from ECU 27,200 in 1981 to ECU 39,500 in 1993 (at constant 1990 prices), representing an annual growth of 3.8 percent (CSO, 1995). Comparing the period 1985-90 with 1990-94, the rate growth in *real* labour costs (which take productivity into consideration) has increased in all EC-12 countries apart from Denmark, Ireland and Spain (where growth has remained constant) and Luxembourg (where it declined) (CEC, 1995b).

In spite of the methodological problems, research by Oulton (1994) has attempted to provide indicative comparisons of productivity (as defined as annual output divided by total annual hours worked) and real, or unit labour costs across the EU. The results produce a different labour cost ranking that offsets some of the labour costs differences, but not all (Table 3.2). Factoring productivity into labour costs narrows the differential among Member States - for 1990, it is only a difference of 2.6 times - but does not *equalize* labour costs across the EU. Hence, although Greece and Portugal not only have the lowest wage costs and lowest productivities (as would be expected), the opposite is *not* true: Belgium and Germany, with the highest labour costs in the EU, do not appear to have the highest productivities.

<i>Country</i>	<i>Total labour costs (UK=100, 1992) ^</i>	<i>Ranking (highest=1)</i>	<i>Unit labour costs (UK=100, 1992)•</i>	<i>Ranking (highest=1)</i>
Germany	169.0	1	97.8 •	8
Belgium	151.6 *	2	115.7	3
The Netherlands	141.6	3	98.7	7
Denmark	113.5	4	/	/
France	112.8 +	5	102.5	5
Italy	105.2 +	6	93.1	9
UK	100.0	7	100.0	6
Spain	95.7 +	8	124.3 •	2
Greece	39.5 *	9	115.0 •	4
Portugal	35.8	10	236.6 •	1

* - Figures for 1991. + - Figures for 1988. • - Figures for 1990. / - Data not available.

Source: ^ - Sysdem, 1995b; • - Oulton, 1994.

These trends have been confirmed by work by Erickson and Kuruvilla (1994) on changes in labour costs and productivity during the 1980s. While finding that the variation in labour cost levels in the EU were partly compensated by labour productivity differences, they concluded that “dramatic compensation differentials across the countries are *not* entirely offset by labour productivity differentials.” Further, it is important to bear in mind that productivity costs in different sectors can vary significantly between countries. For example, in defining unit labour costs as total labour costs divided by gross value added, Eurostat noted that in 1993, unit labour costs were lower in the Italian than the French office machinery sectors, in the French than the

German mechanical engineering sectors, and in the German than the Italian automobile sectors (CSO, 1995). Such differences can be explained by the capital intensity of the sector (which increases gross value added) and the extent to which sub-contracting takes place (lowering gross value added), but they do indicate the importance of considering sectoral differences in real labour costs.

In understanding the potential effects of labour costs in investment decisions, it is important to assess their role on a case-by-case basis. Business surveys have tended to focus on the role of labour costs in average investment, but within industry, there is variation by sector. For example, in a European Commission study of the sensitivity of European industry to the 1992 programme, taking into account all labour costs (including social protection expenses), it was noted that the range of labour costs was greater in the automobile than the textiles industry (CEC, 1990). Moreover, the level of costs in sectors differed in relation to the manufacturing average in each country. In the UK, labour costs as a share of total production expenditure in the automobile sectors were higher than the average for all manufacturing, but lower in Italy, Portugal and Spain, reflecting the higher labour-intensity of manufacturing as a whole in the latter countries. Similarly, when comparing labour costs in manufacturing and service sectors, the cost differentials between Member States are greater in manufacturing than services - a factor of 5.0 as against 2.5, according to Eurostat data (Sysdem, 1995b).

Calculations of the cost of using labour in different Member States can establish that certain countries have a comparative advantage in labour costs. However, given the methodological problems of providing robust comparative figures, the volatility of productivity rates over time and their variation by sector (if not individual company), the direct impact of such differences on foreign investment decisions may be muted. What may have a greater effect on companies is the *perception* of a trade-off between labour cost and productivity and trends over time. As it is easier to compare labour costs than productivity between countries, multinationals may be more sensitive to changes in the former.

This is particularly evident in the recent 'competitiveness' debate in Germany, where rising labour costs are not seen as having been matched by increasing productivity (Tüselmann, 1995; EIRR, 1994b). The period following national unification was initially marked by excessive wage settlements in western Germany and dramatic increases in wage levels in eastern Germany that outstripped any productivity growth. Internal disparities have been created, as wages in eastern Germany are now over two-thirds the level of the western Länder, but productivity is less than sixty percent. It has been argued that this is reflected in the country's low levels of FDI and increasing outward investment by German companies.

3.2.2 Wage Costs and Social Dumping

In the past, it has been difficult to associate wide disparities in labour costs directly with foreign investment patterns. While labour costs have had an influence on the location imperatives of particular sectors, countries with high unit labour costs did not appear unduly penalized in terms of foreign investment (Erickson and Kuruvilla, 1994). However, when considering recent changes in the EU, as noted in the previous chapter, one effect of the completion of the Single Market should be to reduce the importance of national commercial markets in determining foreign investment. Production cost factors are expected to not only influence the direction of new investment flows but lead existing investors to reconsider the distribution of their investments between countries.

With regards to labour costs, European integration is unlikely to lower the differentials existing in the EU. In the US, labour cost differentials are relatively low compared to

the EU. Migration has largely been the principal mechanism for labour market adjustments in the US, as workers at comparable skill levels have moved from low-wage to high-wage areas, rather than through production relocations or job creation (Adnett, 1995). In the EU, labour mobility has historically been low because of national-level barriers to employment. Although many restrictions are being removed in the Single Market, cultural and social differences continue to fragment the European labour market (CEC, 1995c).

The persistence of labour cost differentials has largely been the impetus for a debate about the danger of social dumping within the EU. As an explanatory term, 'social dumping' has been widely used but generally defined as the likely investment response of multinationals to the emergence of the Single Market. Leaving aside the debate over how differences in labour standards relate to FDI to the next chapter, it has been argued that capital mobility will react directly to differences in the unit costs of labour as market factors diminish. Mosley (1990) identified three ways in which this could take place:

- through the increased competitiveness of low-cost producers based in countries with low labour costs at the expense of high-cost producers;
- through the relocation of the activities of high-cost producers to countries with low labour costs; and
- through pressure on high-cost countries to reduce the overall level of wages and indirect labour costs.

Evidence for each of these three versions of social dumping is patchy. On the first point, it is difficult to assess whether cost advantages have made producers in low-cost Member States more competitive. Neven (1990) has estimated that the comparative advantage in Greece, Portugal and Spain in labour-intensive industries (such as clothing and footwear) should increase as a result of the Single Market, to a large extent at the expense of regions in the northern European countries specializing in these industries. However, further empirical research is needed to test Neven's and others' predictions and on the role of European integration in increasing the significance of cost advantages in general.

With regards to the relocation of high-cost producers to low-cost countries in the EU, anecdotal evidence is plentiful. For example, the UK packaging multinational, Bowater, relocated production in Italy and France back to the UK while the Taiwanese computer company, Mitac International, established its European headquarters in the UK rather than Germany, in large part because of employment cost considerations (*The Times*, 1995; UNCTAD, 1994). Similarly, Sabena Airlines developed plans to place its Belgian aircraft and pilots under Luxembourg status in order to reduce labour costs (*L'Echo*, 1995).

On the last form of social dumping - governments attempting to reduce their cost structures in order to become more competitive - there has been a widespread movement within the EU to reduce indirect labour costs (as described in more detail in a later section). For example, companies in Belgium are entitled to some exemptions from social security contributions in internationally-competitive industries (Sysdem, 1995a). In Germany, the level of costs has been closely linked to the crisis in the country's international competitive position (EIRR, 1994b).

Work on social dumping has largely been based on theoretical research or anecdotal evidence rather than empirical testing. Full research should focus on case studies because of the statistical problems in isolating relocation investment within existing data sources. Nevertheless, an indication of the potential scale of social dumping in manufacturing as a result of labour cost differentials can be provided by identifying sectors where they constitute a relatively large share of costs in the production process and where markets are fragmented along national lines and characterized by a high level of price competition. These features tend to be more prevalent in mature industries, where product differentiation is less critical and consequently, the quality of labour may be less significant. As Ramsay (1995) has suggested, these sectors tend to be classified as those in which labour costs can be an important determinant in investment decisions, though in few cases are they a sole or over-riding factor.

Such traditional industries include a wide variety of sectors, among which the European Commission has identified the following (CEC, 1990):

- cotton industry;
- footwear;
- clothing;
- household textiles; and
- toys and sports goods.

Combined, the sectors represented less than eight percent of value added in Community industry, though their concentration in particular areas would heighten the opportunity for new investment and potential damage of relocation.

Vaughan-Whitehead (1992) constructed a parallel list of industries that had higher-than-average risks of relocations on the basis of labour cost differentials. With 1985 data, two sets of filters were used to identify sectors in which:

- the dispersion of manual and white-collar salary wages were higher than the average for EU industry as a whole; and
- the share of earnings in both turnover and value added in a particular sector was greater than the EU average.

Drawing together his results from the filters, the sectors most vulnerable to investment shifts were the following:

- structural metal products;
- mechanical engineering;
- motor vehicles;
- shipbuilding;
- timber and wooden furniture; and
- rubber products.

To examine whether there have been changes in the role of labour costs in foreign investment trends, FDI data should be examined in these sectors over the period of the 1992 programme. Although this approach does not rule out the operation of other factors, it can indicate an association between labour costs and investment patterns. Ideally, it would be best to isolate investment flows in the sectors for high- and low-labour cost countries. Unfortunately, statistics are not available at this level of aggregation, though it is possible for most countries to study sectoral and geographical trends in inward and outward flows.

Two approaches were used for identifying the role of labour costs in FDI. First, changes in the flows into and out of the vulnerable sectors were considered for both high- and low-cost countries (Table 3.3). Because of problems in the definitions used in national datasets, only Germany and Spain were chosen as extremes examples of the importance of FDI (as Germany is characterized by low and Spain by relatively high inward investment levels). The following sectors were chosen: textiles/clothing/footwear; metal products; mechanical engineering; and automobile manufacture (other industries were not considered because of difficulties in disaggregating the sectoral data). Two two-year

periods were used in the case of Germany in order to even out the yearly variations in flows; as detailed sectoral information was not provided in Spain prior to 1991, only one period has been used here.

<i>Sector</i>	O u t w a r d			I n w a r d		
	Germany		Spain	Germany		Spain
	<i>1986-87</i>	<i>1992-93</i>	<i>1992-93</i>	<i>1986-87</i>	<i>1992-93</i>	<i>1992-93</i>
Textiles/etc.	1.1	2.0	3.6	1.0	2.1	2.7
Metal products	5.7	5.2	2.9	6.5	8.0	5.0
Mechanical	9.9	12.2	1.4	7.1	8.1	2.6
Motor vehicles	18.8	17.2	0.6	8.3	8.4	8.8
TOTAL	35.5	36.6	8.5	22.9	26.6	19.1

Source: OECD (1995b).

The pattern of flows gives a mixed picture. For Germany, outward flows exceeded inward investment in these sectors, both as a share of total manufacturing investment and in volume terms (as German investment abroad was considerably larger than FDI in Germany). The situation was reversed in Spain, as the net flow of investment was into the vulnerable sectors. The interpretation of these results depends on the measurement of labour costs used, as either country can be seen as having particularly high or low labour costs. For example, in terms of total *nominal* labour costs, Germany had the highest in the EU in 1992, while Spain had the third lowest. When taking productivity into consideration though, Germany had the second lowest *unit* labour costs and Spain the second highest in the EU (Table 3.2). From this table, it appears that there may be a relationship between labour costs and investment flows - most notably in the motor vehicles sector where the differences between shares in inward and outward flows appear greatest in both countries - but only for nominal rather than real labour costs. In other words, firms may be responding to gross wage costs rather than the actual costs of units produced.

In addition, the role of European integration in promoting these trends is not clear from the table. Although overall German outward investment from labour-intensive sectors increased between 1986-87 and 1992-93, as a share of total manufacturing investment abroad, its importance has not changed much. Similarly, though there has been a net outflow of investment from labour-intensive sectors in Germany, the levels of FDI in these industries still increased between both periods from 22.9 percent to 26.6 percent of total manufacturing inward investment.

The second approach to examining labour cost factors in recent FDI trends is to trace changes in outward investment flows from high- to low-cost countries (Table 3.4). Using the nominal labour cost ranking from Table 3.2, the highest cost countries in the EU are Belgium, Germany and the Netherlands and the lowest are Portugal, Spain and Ireland (Ireland - traditionally regarded as a low-cost location for investors - has been used instead of Greece as its FDI flows have consistently been more significant, making it easier to distinguish between longer-term changes in flows and one-off single investments). As before, two two-year periods are used to assess changes over time.

	Belgium		Germany		The Netherlands	
<i>Country</i>	<i>1986-87</i>	<i>1992-93</i>	<i>1986-87</i>	<i>1992-93</i>	<i>1986-87</i>	<i>1992-93</i>
Ireland	0.3	2.4	0.2	4.0	*	1.7
Portugal	*	0.4	0.5	1.2	*	0.9
Spain	0.3	10.7	4.8	3.8	*	8.3

* - Negligible amounts.

Source: OECD, 1995b.

On the basis of these results, it appears that European integration may have influenced the direction of investment flows, though again it should be stressed that such research can only be indicative at best. In all cases (apart from German FDI in Spain in 1992-93), the share of the three low-cost countries of the total outward investment of the high-cost countries has increased. However, while this may suggest some 'social dumping' is occurring, it remains relatively minor compared with other investment flows. For example, Germany and the Netherlands have received significantly larger shares of Belgian investment than the three low-cost countries here, probably because of their close proximity (OECD, 1995b). Caution is required in interpreting the statistics because of the effects of single, large investments on the data on flows, a factor explaining the notable jump in Spain's share of Belgian investment between 1986-87 and 1992-93.

These figures should be understood in the context of research on industrial closures. Although high labour costs may be dissuading new investors and prompting existing investors and domestic companies to expand foreign operations, there is little evidence that multinationals will close plants on the basis of production costs alone. For example, Fothergill and Guy (1990), in reviewing relevant studies and carrying out their own research in the UK, have found that relative losses of productivity or labour cost differentials alone cannot explain closure decisions, though as noted in the previous chapter, this phenomenon may increase if business functions within multinationals (such as production, administration and distribution) are located separately. Where the influence of labour cost factors may be more clearly felt is on new investment strategies rather than through disinvestment or closures. In other words, shifts in the relative balance of investment between locations through expansions and low investment upgrading may take place rather than closures.

Nevertheless, considering Tables 3.3 and 3.4 together, a case could be made for social dumping taking place, at least in terms of the direction of new investment. While to date it has not occurred on a large scale, as companies draw clear of the recession and the impact of the Single Market is experienced more widely, these trends may become more apparent. Yet if the social dumping argument is correct in any of its manifestations, it could be argued that the impact of labour costs on foreign investment decisions in the EU is likely to be overtaken by the effects of labour cost differentials *outside* the EU. Competition in labour-intensive sectors such as textiles and clothing has been increasing from Asian countries where labour costs are considerably below the lowest levels in the EU (*Financial Times*, 1995b). When the Multi-Fibre Agreement

protecting EU producers is finally removed, the price competition facing EU companies in these sectors may lead to more severe industrial restructuring than merely redistributing production investment within the EU (Neven, 1990).

Potentially more far-reaching has been the restructuring of economies in Central and Eastern Europe. Although these economies are disadvantaged by the problems associated with the transition to market economies - particularly the lack of macroeconomic and financial stability, the extensive changes to industry as part of the privatization programmes, and the poor quality of local business, transport and telecommunications infrastructure - the cost benefits of location have increasingly proved attractive to investors. For example, Coats Viyella, a textile and engineering company, recently cited labour cost differentials as the main reason for its plans to shift production from Western European locations to Central and Eastern Europe, as has the German tyre company, Continental, the French textile producer, Vestra, and the Dutch cement manufacturer, Mulder Boskoop (*Financial Times*, 1996; *Le Figaro*, 1995; *De Volkskrant*, 1995). Not only are general labour costs significantly lower in these countries (below the lowest levels in the EU), but skilled labour is widely available, especially in the more advanced economies such as the Czech Republic, Hungary and Poland (Raines and Bachtler, 1995). The EU already accounts for over 60 percent of the FDI stocks in the Visegrad countries, with the highest European shares coming from neighbouring countries, Germany and Austria. Consequently, the danger of investment relocation is particularly great for these latter countries, as production is increasingly shifted across the border and products are exported back into the EU (Halpern, 1995).

3.3 Social Protection Costs

When firms are comparing labour costs between potential investment locations, they consider overall labour compensation costs. These not only consist of direct wages, but also the sum of indirect social protection costs for which employers are liable, such as employer contributions for statutory social benefits programmes (normally a mixture of health insurance, unemployment support and pensions). The addition of these charges can alter the cost advantages of different locations within the EU. When examining a table of labour costs for 1992, the ranking by total labour costs is changed when indirect wage costs are removed (Table 3.5). As a result, some countries which have a limited comparative advantage on wage levels improve their cost ranking because of the relatively low share of additional indirect costs - particularly Denmark, Ireland and the UK.

Country	Wage-only labour costs (UK=100)	Ranking (highest=1)	Total labour costs (UK=100)	Ranking (highest=1)	Indirect costs as % of total costs °
Germany (1992)	153.1	1	169.0	1	22.5
Belgium (1991)	138.3	4	151.6	2	22.0
The Netherlands (1992)	141.5	3	141.6	3	14.5
Denmark (1991)	149.1	2	133.5	4	4.5
Luxembourg (1990)	112.4	5	113.1	5	15.0
France (1988)	94.9	8	112.8	6	28.0
Italy (1988)	87.2	9	105.2	7	29.0
UK (1992)	100.0	7	100.0	8	14.5
Ireland (1992)	100.9	6	95.9	9	10.0

Spain (1988)	84.5	10	95.7	10	24.5
Greece (1991)	34.2	12	39.5	11	26.0
Portugal (1992)	36.2	11	35.8	12	13.6

Source: Sysdem, 1995b; ° - CEC, 1995a.

It has been argued that differences in social protection costs do not affect the overall level of labour costs to employers over time (Adnett, 1995). Where a relatively high share of total labour costs are made up of employers contributions for social protection expenditure - as in France, Greece, Italy and Spain - this may mean that employees seek a compensatingly lower wage for any given level of productivity and labour demand. Where indirect labour costs are low - as in Denmark and Ireland - it can be anticipated that social protection costs will have to be met privately by employees, who will consequently demand a sufficient wage to meet their fiscal responsibilities. Effectively, the theory implies that wage growth takes into account the costs to workers of social protection expenditure, so that employers should be indifferent to whether this expenditure is met by their own social security contributions or higher wages for workers. Consequently, while the overall level of social protection expenditure in different Member States will continue to concern employers, they should not react to differences in the shares of non-wage costs of total labour costs.

The evidence for this pattern within the EU is mixed. In the 1980s, social security expenditure expanded (relative to GDP) in several Member States - notably Greece, Italy and Portugal - while it declined in Belgium and Germany (Begg and Nectoux, 1995). However, at the same time, the share of employer contributions to the financing of social protection expenditure fell in *all* EC-12 countries, particularly in the Denmark, Netherlands, Portugal and the UK, as taxation and other forms of financing expenditure have increased (Table 3.6). In general, the use of employers contributions as a means of financing social protection expenditure been increasingly avoided out of sensitivity to the perception of high labour costs in many EU Member States (CEC, 1995a).

Nevertheless, as a share of total labour costs for which they are liable, employers contributions have still grown in the majority of EU countries - the exceptions being Luxembourg, the Netherlands, the UK and Denmark (the only country where indirect costs actually *decreased* between 1981 and 1991). In other words, employers contributions have been generally rising faster than their wage costs. Regardless of whether they are paying more relative to previous payments, employers in most EU countries are likely to be more aware of the fact that larger shares of their labour costs are increasingly being earmarked for social protection contributions.

Country	Average annual growth of direct labour costs	Average annual growth of indirect labour costs	Ratio of indirect to direct labour cost rates
Belgium (1981-91)	6.22	7.73	1.24
Denmark (1981-91)	9.95	- 0.02	0.00
France (1981-88)	7.51	9.33	1.24
Germany (1980-92)	8.87	9.48	1.07
Greece (1981-88)	2.18	6.55	3.00
Ireland (1980-92)	9.25	11.37	1.23

Italy (1981-88)	11.80	14.50	1.23
Luxembourg (1981-90)	6.44	5.17	0.80
The Netherlands (1980-92)	8.04	0.97	0.12
Portugal (1980-92)	8.53	9.41	1.10
Spain (1981-88)	5.59	7.34	1.31
UK (1980-92)	6.58	6.52	0.99

Source: Sysdem, 1995b; CEC, 1995a.

Although employers may perceive that their indirect costs are rising, this may not prove to be a significant factor in influencing foreign investment decisions unless the changes are seen to be widening existing labour cost differentials in the EU - in other words, it may not alter the relative attractiveness of competing locations. For example, the ratios of growth rates of employers' indirect costs and total labour costs in the EU appear to be diverging rather than converging - rising from a factor of 3.0 to 6.4, evidence of the relatively faster growth of indirect to direct labour costs (Table 3.6). However, this does not seem to have had a significant impact on the *overall* labour cost structures of operating in particular countries. The countries which have the highest proportions of indirect costs are not necessarily the same as those with the highest levels of wage costs nor those with where total social protection expenditure has the largest share of GDP. Further, as seen in Table 3.5, indirect costs have not been exacerbating the existing total labour cost differences between countries over time, but seem to be assisting in their convergence.

In spite of the ambivalent impact of changes in indirect costs on total labour costs, anecdotal evidence continues to suggest that investment decisions can be influenced by the comparative changes in social protection expenditure. For example, non-wage labour costs were cited by Hoover Europe in their controversial shift of production in 1993 between French and UK factories (Income Data Services, 1993b). Not only were French indirect costs considerably higher relative to total labour costs than in the UK, but what seems to have mattered to the company was that they had been rising faster during the 1980s (Table 3.6). Similarly, when industrial companies were questioned in a EU business survey about obstacles to employing more workers, insufficient profit margin due to non-wage labour costs was rated as more important than the effect of direct wage costs (CEC, 1994c). Consequently, trends in indirect labour costs can be a determinant of foreign investment where wage costs between countries are otherwise equivalent.

Moreover, from the perspective of policy-makers, awareness of the potential impact of employer contribution levels has prompted several Member States to make temporary and limited suspensions of charges wherever possible (CEC, 1995b). As noted before, the Belgian government has reduced indirect labour costs on sectors with high exposure to international competition. Similar targeted reductions have been introduced in France, Ireland, Italy, the Netherlands and Spain in order to encourage the hiring of more unemployed people by firms (Sysdem, 1995c).

3.4 Summary

Foreign investment decisions are sensitive to international differences in labour costs. Over the last decade, labour cost differentials within the EU have persisted, apparently unaffected by the trend towards greater economic integration. Although it has been argued that labour costs are less important once productivity differences are taken into consideration and evidence suggests that productivity variations do bring about some cost convergence and an alteration in the national cost rankings, significant gaps between countries remains. In addition, it appears from an examination of investment flows in high- and low-cost countries that not only do flows appear to be broadly responsive to labour cost differences, but companies seem to react to nominal rather than real labour cost differentials. Nevertheless, more work should be undertaken to establish the links between national changes in productivity and wage levels - particularly at a sectoral level - as well as examining questions relating to the extent to which companies are aware of and incorporate these changes into their future investment plans.

When considering the role of labour costs in affecting foreign investment, it is useful to distinguish between wage costs and social protection costs. It has been argued that it is unnecessary to separate these two types of costs, both in theoretical terms but also in terms of business behaviour, as companies are only interested in bottom-line total compensation cost differences. However, while variation in the share of indirect costs of total labour costs has not greatly reordered the ranking of Community countries by total labour costs, there does seem to be evidence of companies reacting to perceived high levels and increases in indirect labour costs. Future research in this area should include efforts to examine the links between changes in wage demand and the level of social protection costs, and the extent to which companies respond to relative changes in nominal wage costs, real wage costs and indirect labour costs.

The relationship between labour costs differentials and foreign investment has been recently cast in terms of the social dumping debate in the EU. As noted above, there is an apparent correlation between the relative level of labour costs in EU countries and trends in their outward and inward investment flows (particularly in sectors where labour cost differentials are important). Proof of social dumping remains patchy though and it will continue to be a debated issue, especially in the context of potential investment diversion (from both inside and outside the EU) to lower-cost Central and Eastern European countries.

4. FOREIGN INVESTMENT AND LABOUR MARKET FACTORS: LABOUR MARKET REGULATION

4.1 Introduction

When considering labour market factors as determinants of foreign investment, there has been a tendency in the theoretical and empirical literature to focus on the role of labour costs and productivity. However, when assessing competing locations for investment, firms consider a range of labour factors that are not directly related to costs, including the availability of workers with particular skills and the freedom to organize the production system. In particular, companies have been expressing greater interest in the regulatory limits not only on the ways in which they can organize their production when they first establish new investments, but also on restrictions on the speed with which they can later adapt their production and administration structures in response to changing economic conditions.

Several other trends have increased the importance of labour market regulation in investment strategies. The completion of the Single Market has initiated industrial restructuring in several sectors, where companies are exploring ways of increasing their competitiveness through new forms of organization. As part of this process, interest has been increasing in the use of flexible production systems as a means of coping with short-term shifts in demand and longer-term changes in products and production technologies. Many firms are aiming to enhance their ability to adapt their internal productive capacities (through changing the organization of their labour force) and their external network of industrial linkages (such as the use of sub-contractors). Environments that will enable firms to maximize this flexibility are increasingly likely to be favoured by their investment strategies.

Evidence of the rising sensitivity to labour market regulation can be seen in several parallel developments. First, there have been a number of recent cases of investment location that have highlighted differences between national regulatory systems and their influence on corporate strategies. Most famous was the Hoover case in 1993, where the multinational closed down production at its factory in France and expanded production in its Scottish plant, in large part as a result of regulatory issues. The UK workers were able to offer the company provisions that workers in France would have been prevented by existing regulation, notably the exclusion of new employees from the occupational pension scheme for two years after the conclusion of the agreement in the UK (EIRR, 1993). Second, in general business surveys, companies have often cited labour market regulation as a key constraint on their business activities. For example, in a recent UNICE (1995) report, employment law was listed by companies as second to taxation as a factor in reducing their competitiveness.

Lastly, concern about differing levels of labour market regulation has partly prompted the debate on the 'social dimension' of the EU. With the Single Market beginning to emerge, policy interest in recent years in the EU has shifted towards the social and economic cohesion of the Community. As part of the new debate, labour market policy has become a controversial subject in two areas. On the one hand, there has

been concern over the extent that labour market regulation restricts or enhances the creation of jobs and the skills levels of the labour force. In addition, fears have been expressed that the Single Market may accelerate a levelling-down of employment conditions, giving rise to arguments over the scale of 'social dumping' in labour market standards as well as labour costs within the EU. Consequently, one of the objectives of the so-called Social Chapter measures introduced at EU level has been to provide a floor of employment standards and workers rights throughout the Community while giving attention to the relationship between levels of regulation and employment creation, an issue discussed in the next chapter.

The following chapter is structured as three sections. In the next section, labour market regulation is defined, with emphasis on the different aspects of regulation. Consideration is given to the role of industrial relations and collective bargaining, though these will be considered in greater detail in a later stage of the project. Regulation's impact is most closely associated with production flexibility in individual companies. Different types of flexibility have been noted in recent years and these are linked to different sets of regulations and types of investment in the second section of this chapter, with examples drawn from the case study and company interviews. In the third section, national differences in flexibility - with potential implications for investment strategies - are discussed. The key questions here are: can significant differences be detected at national level in these forms of flexibility; and, do these differences affect foreign investment patterns?

4.2 Definition of Labour Market Regulation

Before proceeding, it is important to provide the definition of labour market regulation to be used in this report. I shall start with the definition given by Grubb and Wells (1993):

regulation exists when an individual employer cannot, even by agreement with his or her own employees, use particular working arrangements or forms of employment contract, without risking legal sanctions or the invalidity of the relevant provisions in the contract.

For this report, I will widen their definition of "working arrangements" to include a range of issues associated with working conditions and the scope for employees to negotiate - or be informed of - any alteration to either those conditions or the provisions of employment contracts. The subject of working conditions introduces the complex issue of health and safety regulations. In recent years, there has been a tendency for employment rights and health and safety issues to overlap at EU level, most famously in the introduction of EU employment condition policies as health and safety measures. Nevertheless, health and safety issues will not be covered in this report, mainly because sectoral differences in the type and importance of specific regulations are too large to discuss in this study.

Labour market regulation can be considered under a series of five headings, relating to different aspects of employment and pay conditions: recruitment and dismissal;

atypical work; working time; employee consultation; and bargaining arrangements.

(i) *Recruitment and dismissal*

A key part of national labour market regulation is employment protection legislation. Restrictions have existed on the ability of companies to *recruit*, as some countries oblige employers to use public employment offices which can have a strong influence on workers that can be hired. More importantly, limits have been placed on the freedom, timing and scale of *dismissals*, the levels of redundancy payments and the mechanisms for ruling on unfair dismissals. In some countries, prior authorization is required before dismissals can be made, which has led companies to take the costs of dismissals into consideration when setting wage rates. Regulations of *mass dismissals* are especially important, as they can not only involve statutory protection but also collective agreements between management and unions. Many countries insist on *consultation with workers representatives* before company action, sometimes requiring firms to present a 'social plan' showing how laid-off workers can be found other jobs.

(ii) *Atypical work*

Increasingly, non-standard employment contracts are becoming popular in certain countries and for certain types of work. In 1991, *temporary employment* though fixed-term contracts affected approximately one in eleven workers in the EU, an increase in absolute numbers of 34 percent over the previous four years (inforMISEP, 1994). Similarly, *part-time employment* is particularly important in many service sectors, such as retailing. Regulation can determine not only the extent to which employers can make use of these different contractual forms (eg. in avoiding claims of unfair dismissals), but also the costs of their use, mainly through employer liabilities for social security contributions. Statutory or collective agreement limits have been placed on the number of renewals of fixed-term contracts as well as the maximum duration of all atypical employment for individual workers. Some countries require companies to consult with unions before introducing atypical work.

(iii) *Working time*

Working time issues consist of several areas where national regulation has been influential: length of working week, holiday and leave entitlements, and night shifts. With respect to working week regulations, restrictions on the maximum *length of working week* can have a restrictive impact on employment in certain sectors and economic activities. Regulations also often govern the entitlements to employees of *paid holiday time* as well as *parental leave*. Where regulations affect the pay and conditions of workers on *night shifts*, these can affect the business costs of maximizing plant capacity for production.

(iv) *Employee consultation*

In many companies, *workers councils* exist to provide employees with a channel for information on important changes in corporate strategies and in some cases, allowing workers to take part in strategy-making (though usually in a limited capacity). National regulations have differed over the requirement for employee representation, and the powers and responsibilities of workers councils.

(v) *Bargaining arrangements*

Industrial relations institutions place important limits on the ability of companies to alter unilaterally pay and employment conditions. The institutional backgrounds of EU countries can differ considerably, both in terms of the extent of unionization in the national labour force as well as in the degree of centralization and coordination in negotiations over pay and employment conditions. In this context, what is important to businesses is the level at which wage and employment issues are decided and the resulting autonomy for individual companies to negotiate plant-specific agreements.

* * *

These different areas of labour market regulation can be categorized in different ways. From the perspective of companies (and the importance of these issues in determining investment decisions), a useful means of examining the impact of these areas is to consider the nature of the cost added to companies by higher regulation, as it is cost differentials between countries that determine investment decisions in large part. First, there are the aspects of labour market regulation that are made up of quantifiable, or *fixed* costs. These include working time and atypical work areas, where the cost effects of regulation can be calculated for any given size of workforce. As they govern the use of labour over time and its direct costs (in terms of the entitlements of different contractual forms), in principle, firms can assess the overall cost consequences (and compare the costs of different countries' regulations) for a given size of workforce on different contracts.

Second, labour market regulation involves a degree of uncertainty that is reflected in *unfixed* costs. For this category, costs are more difficult to calculate for several reasons. The direct cost of regulation may depend on specific and unpredictable circumstances, such as whether the company will face compensation penalties in cases of unfair dismissals or the extent to which negotiations on pay and employment conditions at industry or national levels will affect individual companies and plants. In addition, some aspects of labour market regulation can potentially have extensive indirect effects. For example, severe and protracted differences between management and employee representatives, such as workers councils, may delay key business decisions and consequently have extensive knock-on effects on company investment strategies. As such costs influence arise from constraints on the ability of a company to adapt to changing business conditions, stringent regulation in this area can loom as an important investment disincentive to firms where it significantly increases business uncertainty.

The two sets of costs can be expected to have different effects on foreign investment decisions. In the case of fixed costs, the costs of locating in different sites can be calculated, making it easier for investment decisions to be formed (and for inward

investment agencies to work out the comparative advantages and disadvantages of the regions and countries which they represent). Unfixed costs present a problem to investors, as the element of uncertainty over the long-term costs of particular sites allows for the larger role of perception and attitude to influence investment strategies. Through such costs, some investment locations can acquire unfavourable reputations that often lag behind any changes to the regulatory environment producing the business uncertainty.

4.3 Labour Flexibility and Foreign Investment

In recent years, the debate over the appropriate levels of employment regulation in an economy has been linked to the issue of labour market flexibility. To understand the importance of this debate on foreign investment trends, it is first necessary to define labour market flexibility. In general, it can be viewed as the ability of firms to adapt the organization of production to existing and anticipated changes in markets, products and production processes (CEC, 1995d). Labour market regulation has a central role in the development of flexibility, both in limiting it where flexibility is seen as unacceptably damaging to the welfare and rights of employees as well as in encouraging it where flexibility can assist in overall job creation (Deakin and Mückenberger, 1992).

The pressure to enhance and the opportunities to achieve greater flexibility within firms has arisen because of several processes (Beatson, 1995). Greater competition within many product and services markets - particularly with the increasing internationalization of sectors within the EU following the 1992 programme - has given companies incentives to become more responsive to market changes, both in terms of volume as well as of product developments. In several manufacturing industries, production systems have adapted to the need for faster market response through just-in-time working practices in order to cut down inventories and delivery times. For some service sectors, notably retailing, increasing competition has led to more firms making more use of longer working hours in their businesses.

At the same time as these changes in the demand for labour, the supply of labour has been altering in recent years as well. The participation of women in the workforce has increased, particularly in atypical employment. As many women have to balance child-rearing responsibilities with the desire for employment (and indeed the need for income), there has been greater demand for more widespread use of flexible contractual forms, such as part-time work.

Government policy has also had a key role in determining the type and extent of flexibility in a national economy. In this context, labour market regulation has been shaped by two sets of objectives which have frequently been perceived to have contradictory effects. Regulation has primarily been inspired by welfare goals, especially the need to provide a guarantee for the rights and conditions of employees. However, through its role of institutionalizing social protection, certain aspects of regulation - notably those relating to pay and employment conditions - have been criticized for creating labour market rigidities at a time when persistent unemployment

within Western Europe has been identified as one of the key concerns of public policy. As a result, there has been significant deregulation of labour markets in many EU Member States, usually as part of wider and longer-term national debates on job creation policies (System, 1995a).

In addition to preserving minimum standards of employment welfare, regulation has also tried to address areas of labour market failure. For example, concerns about long-term unemployment have been expressed through policies to promote an increased employment intensity of firms, so that businesses are more willing to vary the size of their workforce rather than the hours worked by their employees (by taking on more staff instead of extending working time during growth periods). Consequently, regulations (and selective deregulation) can be used by national governments to promote particular types of flexibility. The opposite can also hold true - that a set of regulations in one aspect of labour market flexibility can have unwanted consequences in another. The severe restrictions in Spain on employment dismissal have led to the extensive use of temporary employment, so that Spain has the highest share of fixed-term contract workers in its labour force of all EU countries (System, 1995a).

Hence, when examining flexibility, it is important to note that the term has been used to cover a wide variety of areas relating to the adaptability of businesses - and ultimately, regional and national labour markets - to changing economic conditions. The most important types of flexibility which have been identified are the following: numerical, temporal, pay and functional (Treu, 1992). Each of these are discussed below with examples drawn from case studies in the pilot interviews for this project.

4.3.1 Numerical Flexibility

Numerical flexibility can be defined as the employers' ability to alter the size of the workforce. From the perspective of firms, expansions and reductions in the workforce tend to be made in response to significant changes in output (resulting from market trends) and changes in the relative cost of capital and labour (because of relative variations in these costs and developments in production technology). Flexibility can take place within the 'core' (usually full-time) workforce through the latitude and costs of firms in taking on and shedding labour. It can also influence the cost of maintaining a 'peripheral' labour force, which includes the use of 'atypical' (temporary and part-time) employment on non-core business activities or tasks in which there is relatively low transaction costs involved in high personnel turnover. The use of atypical employment by employers is often viewed as less costly than using full-time employment because of the reduced exposure to employers contributions for social protection. Extending the argument further, many companies have decentralized their production by sub-contracting more of their business activities to external firms, consequently shifting out the burden of adapting to market changes.

The ability to alter the core workforce of a firm (within the limits laid down by recruitment and dismissal legislation) and its 'peripheral' labour (such as part-time and fixed-term workers) depends on the relative importance of several strategic issues to the firm. One that has often attributed to firms needing to vary the size of their workforce is the need to accommodate substantial fluctuations in output. These changes can be sudden (as when there are unanticipated changes in market demand and reductions in the supply of essential components or raw materials) or regular and expected (such as seasonal demand for a product or service). The most-cited example of a business where these changes are very relevant is the retail sector where staff have to be taken on and disposed in line with shopping demand - consequently, some international retail companies will be considering this kind of flexibility as a location factor in addition to market proximity and property cost issues. However, it has been notable in sectors such as electronics and office equipment, where the use of fixed-term contracts can be widespread, though differences in how this type of flexibility occurs in practice depends on the country. For example, the high share of sub-contracting in the Italian footwear industry compensates for the lack of internal flexibility that companies in the same sector in France and the UK possess (Courault, 1992).

Atypical employment is also common in the service activities of multinationals. For example, it is important in the customer service functions of large computer firms, call centres for airline companies, and the data-processing and administrative units of financial service firms because of the mundane nature of the work and the need for long manning hours. Where these activities are being established on a pan-European basis, regulations on the use of this kind of labour could be a significant restraint on their operations.

Evidence for greater numerical flexibility in the EU demonstrates that it has been increasing in some areas of the labour market. Between 1987 and 1993, part-time employment as a share of the total labour force rose in all EC-12 countries apart from Denmark, Greece and Italy (Sysdem, 1995a). Similarly, using data for the UK for the mid-1980s, businesses were found generally to be making greater use of sub-contractors, particularly in manufacturing and transportation sectors (Beatson, 1995). For temporary

employment however, the picture is more mixed: the number of temporary contracts as a percentage of employees in the labour force only grew in France, Ireland, Italy, the Netherlands and Spain in the 1987-1993 period.

In the pilot interviews, this type of flexibility was one of the most evident forms of flexibility among multinational investors. For example, in manufacturing, companies tended to make use of numerical flexibility in industries where seasonality or other regular variations in demand are prominent features of production. One company - the UK subsidiary of a medium-sized, German producer of consumer electronics - faced a demand profile where approximately 60 percent of annual production took place in the second half of the year, mainly due to the heavier use of its product during the winter and the nature of Christmas shopping patterns. To cope with a 'bottom-heavy' production year, the firm used both fixed-term and part-time labour contracts during the busy period, amounting to a third of its workforce in terms of full-time equivalents - usually for terms of up to ten weeks, working six-hour days.

4.3.2 Temporal Flexibility

Working time has become a more important aspect of flexibility for several reasons. Partly there is a direct cost element to the issue, as longer hours worked by employees can theoretically reduce the costs of training new people to take over the tasks. However, to a large extent it is a response to the increasing need for firms either to maximize production output through continuous plant operation or to reduce and expand output in markets characterized by significant variation (such as the retail sector, where shopping demand changes at different times of year). Temporal flexibility includes not only the number of hours worked in a certain period of time (where adjustment can take place through overtime or shorter working weeks) but also the arrangements for working time within a period, such as shift work and flexitime (Beatson, 1995).

With regards to investment strategies, working time has become an increasingly important issue for firms in capital-intensive sectors within the EU. Where sectors face increasing international competition and shortening product life-cycles (which can lead to relatively frequent replacement of production equipment), firms have incentives to utilize their plant capacity fully and maximize machine running times (Mueller and Purcell, 1992). The ability to organize the workforce for maintaining round-the-clock production - either through extending working time of existing staff or taking on new staff and being able to deploy them in night-time and irregular shifts - is dependent in part on regulatory legislation and national bargaining structures. Other factors being equal, systems that allow firms greater autonomy to set working time in order to reduce capital unit costs are more likely to receive internationally-mobile investment.

While temporal flexibility is a concern for a range of businesses, firms in capital-intensive sectors are more likely to be subject to its effects, especially those characterized by mass production of homogeneous goods - examples of these sectors include paper, automobiles, consumer appliances and electronics. While FDI in these sectors are influenced by other, often more powerful determinants, investor firms will aim to maximize this type of flexibility in their location decisions.

Examining trends within the EU, temporal flexibility appears to be occurring at the same time as overall working time is declining. EC labour force surveys have shown that in all Member States, the average working week was reduced during the 1980s (CEC, 1994a). Nevertheless, the share of employees working longer than 48 hour weeks has gone up in the same period, suggesting that there is greater variation in the number of

hours worked within Member State labour forces.

In the interviews, as with numerical flexibility, temporal flexibility was often a function of market seasonality. Many companies were reported to use a concept of 'annualized' hours in setting contracts with their workforce. In one example, at certain times of the year, one manufacturing company altered their production schedule so that operation of key equipment would move from round-the-clock five days a week to seven days. In order to maintain full utilization of the machinery at the heavier times of year, the workforce on that part of the production process would change to different shift patterns, involving an increase in their average hours from approximately 40 hours a week to 42 hours. In another case, an American computer manufacturer based in Scotland adopted a similar, though less formal approach to 'annualized hours', as production surges tended to take place at the ends of each quarter rather than for a single period in the year.

At those points, the workforce tended to work longer than 'usual' hours in order to meet production demand.

4.3.3 Pay Flexibility

Firms can adapt to changes in labour market conditions by altering their pay and award systems. Where firms have greater freedom to set wage levels and employment conditions, it is argued that they can respond more quickly to market fluctuations. In practice, this type of flexibility is normally important in periods of market contraction where labour costs may be targeted for savings. In this context, rigidities in the pay bargaining structures within the company (and often the industry as a whole) are important, so that pay flexibility can be directly related to the level at which collective bargaining takes place and how binding agreements made at national and industry level are on individual companies.

Pay flexibility can also be a significant issue during business growth when firms may want to be able to offer financial awards and incentives to certain workers to the exclusion of others sharing the same initial pay and employment conditions as a way of encouraging productivity. The removal of automatic job pay grades and the increasing use of performance-related pay (at least as a share of total wages) reflects this trend towards using pay flexibility as an award system. This was a key aspect of the pay framework of one of the computer companies in the pilot studies. Productivity improvements were rewarded with special annual bonuses as a way of creating greater incentives among the workforce.

Most firms would value freedom to set pay and award rates in line with changing business conditions and consequently, would be attracted to location environments where minimum wage legislation and bargaining structures favour the ability to negotiate at plant level. Wages in the EU tend to be determined mainly through collective agreements, though in recent years flexibility has been increasing in the Member States (Treu, 1992). Automatic indexation of wages to price growth has been declining and the determination of pay has been increasingly decentralized. With regards to minimum wage legislation, research suggests that pay minima have not had a negative impact on job creation at national level, suggesting that it has not greatly affected foreign investment decisions (CEC, 1995d). If national differences do have an influence though, it would be expected to be most significant in sectors where wages account for a relatively large share of production costs, notably labour-intensive industries such as clothing, footwear and textiles.

4.3.4 Functional Flexibility

Within the production process, some employers have found that the ability to reassign workers to different tasks can increase productivity. It may be important to have a labour force that can adapt to changes in the production system, particularly when short-term bottlenecks occur. Moreover, functional flexibility is necessary where part of the workforce is organized into teams allocated particular problems to solve where employees may have to carry out a range of different tasks. Attempts to deregulate job definitions - through the removal of closed shops and task demarcation as well as by decreasing the number of job pay grades within companies - have aimed to increase the mobility of workers between tasks in the production process.

The approach requires companies to emphasize the skill levels of the workforce, either through offering sufficient pay and benefits to attract employees with the necessary skills or providing training at work. Either way, there is frequently give and take in the costs of functional flexibility (in the investment in human capital) and other types of flexibility which may aim to reduce direct employment costs. Without stability of employment and sufficient pay incentives, skilled workers are unlikely to be retained by companies. The costs of re-training staff where high personnel turnover occurs may also become prohibitive for firms where a skilled labour force is crucial.

It also suggests that different forms of flexibility are appropriate for different types of firms: skills-intensive companies (where the *level of skills* is pre-eminent) will value functional flexibility, whereas companies utilizing unskilled labour (in which the *costs of labour* are key) are more likely to favour these other types of flexibility. For example, Bosch (1995) noted that an increasing number of firms were reporting problems in finding skilled workers for non-standard working hours and were forced to offer higher rates of wage compensation.

Similarly, from the perspective of regulating governments, an increasingly unregulated labour market has also been viewed as leading to a potential trade-off between different forms of flexibility. Although it is difficult to provide internationally-comparative data on this issue, it has been noted that while the UK has a relatively high degree of numerical and temporal flexibility, it may have less functional flexibility than countries such as Germany (Beatson, 1995; Mueller and Purcell, 1992). The process of increasing the ability of companies to adapt the size of their workforce (particularly through the use of part-time labour) as well as their wage levels can hinder - if not damage - their ability to increase the skill levels of their workforce (CEC, 1995d).

Functional flexibility is perhaps the form of flexibility least affected by regulation - especially as task demarcation constraints has declined in many EU countries - but it does appear to be more prevalent in certain economies. In terms of sector, this type of flexibility is likely to be important in industries characterized by heterogeneous and specialist products and services (Ramsay, 1995). In many cases, the companies serve one or a series of niche markets in which labour has to be able to change product specifications to suit customer needs. Certain consumer product industries are affected by these considerations, as well as skilled labour-intensive industries such as industrial and electrical machinery. The R&D functions of multinational manufacturing companies will also be responsive to location environments where this type of flexibility is encouraged as innovation often needs teams of highly-skilled workers.

Such flexibility was particularly important among the interviewed companies in the pilot study in which design and production modifications - if not actual R&D - were carried out at the manufacturing plant, requiring a workforce with a significant degree of multi-skilling. The firms - particularly in mass consumer electrical products - also tended to organize their production as work-teams, requiring workers to develop a range of labour skills within their part of the production process (enabling them to become interchangeable in particular tasks where required).

* * *

Overall, different types of flexibility act on similar sectors, though there are likely to be significant industrial differences in the interaction of labour market regulation and investment strategies. However, a distinction may exist in industries that favour *external* flexibility - which includes numerical, temporal and pay - and *internal* flexibility, especially as it relates to functional flexibility. Further research is needed to identify the types of effects these forms of flexibilities will have and which types of industries they will affect.

Where there is some variation appears to be in the effects of different forms of flexibility on the type of investment that is being made. In *greenfield* investments, flexibility can be a factor, but it tends to be part of a package of a location's advantages. For example, in its recent huge investment in North East England, Samsung cited the flexibility of the UK workforce, but other factors - including the financial incentives it received - will have been very influential as well (*The Times*, 1995). In terms of *investment redistribution* strategies, the influence of the scope for different labour flexibility on investment decisions is more apparent. Ample evidence exists of the sensitivity of multinationals to these labour market differences in terms of how they invest in different plants across the EU and how they bargain with their labour forces. Increasingly, multinationals have been using their investment strategies to extract concessions from workforces in different plants to increase productivity (Ferner, 1994). Specific examples can be cited (UNCTAD, 1994).

- Recio (1992) noted that some multinational investors in Spain were using the threat of firing temporary workers and withholding investment plans in their collective bargaining to secure greater numerical flexibility, such as Saturday working.
- Mercedes-Benz decided to make a significant production investment in its Untertürkheim plant in Germany rather than in neighbouring Alsace in France (where labour costs were lower) because of the willingness of the German workforce in agreeing to more flexible working time arrangements to maximize machinery operating hours and the introduction of more performance-related pay (EIRR, 1994a).
- General Motors Europe used differences in productivity in its European plants - resulting from the introduction of more flexible working practices - to put pressure on lesser-performing plants to make concessions on working time arrangements, team-working, use of temporary employment and dispute procedures (Mueller and Purcell, 1992).

It should be pointed out that the negotiations between companies and workforces over more flexible organization of labour is not necessarily conducted in hostile circumstances. Often, both sides can make concessions to improve productivity, as when Opel in Germany secured a more flexible arrangement of working time to ensure continuous production without increasing the average number of hours worked by employees (*Financial Times*, 1995c). Furthermore, as demonstrated by one of the companies interviewed for the pilot study, the use of investment strategies as a bargaining counter in negotiations over working conditions tends to be limited to certain types of sectors. In some industries, manufacturing investment is linked to particular markets or R&D specialisms that preclude potential investment shifts. Some multinational companies have been organized so that different plants have specialized in their product lines, giving the company very limited scope for moving investment between plants.

Nonetheless, as the previously cited Hoover case demonstrates, investment - and consequently employment - is being influenced by national differences in labour market regulation. While a case for social dumping in labour costs has yet to be proven, stronger evidence appears that national differences in working practices have resulted in a 'levelling-down' as workforces are making concessions to guarantee future investment.

4.4 National Variation in Labour Flexibility

In addition to identifying the sectors whose investment decisions are most likely to be affected by different types of flexibility, it is useful to consider the differences in flexibility across the EU. In particular, the question arises as to whether it is possible to link national differences in flexibility to existing (or potential) FDI patterns.

As discussed earlier, certain forms of flexibility are closely associated with specific types of labour market regulation, so it should be possible to assess the overall environment for these forms of flexibility through a table measuring the 'severity' of the regulatory systems. This approach to considering the impact of the regulatory system on inward investment relies heavily on author judgments in comparing the 'strictness' of different regulations. Further, it gives a generalized indication of the importance of regulations without the benefit of witnessing how the regulations are operated at the company level nor how different set of regulations may interact. In order to minimize these drawbacks, attitudinal surveys of employers have been used where available.

4.4.1 Numerical Flexibility

In order to measure numerical flexibility in different Member States, a range of indicators have been used. First, recruitment and dismissal legislation is ranked according to severity (highest figure equates with the most restrictive system). This is determined by the European Commission's labour force surveys measuring the share of companies listing these regulations as barriers to increasing employment (CEC, 1995c). Use is also made of the work by Grubb and Wells (1993) which assesses regular

procedural inconveniences, notice and severance pay for no-fault individual dismissals, and the difficulty of dismissal (Table 4.1).

The table produces mixed results. Both sources are in agreement that the UK (and possibly Denmark, though data for companies located there was not available in the EU labour force survey) has significantly low regulation on hiring and firing. However, Grubb and Wells concluded that Ireland should be included in the list of 'flexible' countries, whereas employers in Ireland perceive the existing legislation to restrict their ability to employ more people. Italy and Spain emerge more clearly as the two countries with the most restrictive dismissal legislation, though Spain is viewed very favourably for its regulations governing recruitment and Italian companies do not perceive their dismissal legislation as a key barrier to employment growth. Belgium and the Netherlands are also seen as having liberal recruitment laws (though Belgian companies note that they remain restrictive) while France and Luxembourg appear to be relatively stringent.

<i>Country</i>	Recruitment		Dismissal	
	<i>CEC</i>	<i>CEC</i>	<i>CEC</i>	<i>Grubb & Wells</i>
Belgium	3	8	4	
Denmark	*	*	2	
France	10	7	5	
Germany	5	8	7	
Greece	7	4	8	
Ireland	8	10	3	
Italy	5	3	9	
Luxembourg	11	1	*	
The Netherlands	8	6	5	
Portugal	8	5	10	
Spain	1	11	10	
UK	3	2	3	

*- Not included in ranking.

The ease of using atypical work in different Member States can be measured using the relative shares of part-time and fixed-term employment in national labour forces for 1993 (drawn from work by Sysdem (1995c)) as well as an assessment by Grubb and Wells of the eligibility of different forms of work, number of contract renewals and maximum accumulated employment duration for part-time and temporary work (Table 4.2).

<i>Country</i>	<i>% of workforce in part-time employment</i>	<i>Grubb & Wells: part-time employment</i>	<i>% of workforce in temporary employment</i>	<i>Grubb & Wells: temporary employment</i>
Belgium	13	8	5	11
Denmark	23	5	11	1
France	14	3	11	8
Germany	15	6	10	9
Greece	4	9	10	7
Ireland	11	1	9	1
Italy	5	9	6	10
Luxembourg	6	*	2	*
The Netherlands	35	4	10	4
Portugal	8	7	10	6
Spain	6	9	32	4
UK	24	1	7	1

*- Not included in ranking.

For part-time employment, there appears to be significant correspondence between its incidence and the relative lack of regulation on its use. Denmark, the Netherlands and the UK demonstrate the most flexibility, whereas Greece, Italy and Spain have more severe regulatory systems. The case of Ireland is unusual in that it has very low restrictions on part-time employment but evidence of its limited use.

The ranking by fixed-term employment has a few commonalities. The UK again emerges as having a low level and Italy, a high level of regulation. Among the more deregulated countries can be included Denmark, Ireland and Spain while Belgium has relatively intensive regulations on temporary employment. However, Spain appears to be the only country where the incidence of temporary employment in the labour force is broadly in line with perceptions of its regulations, in large part because of the severity of its dismissals legislation, encouraging the use of fixed-term contracts (Blyton and Martinez Lucio, 1995).

Overall, numerical flexibility characterizes Denmark, Ireland and the UK. In contrast, Italy and Spain (apart from fixed-term employment) are the most restrictive countries in the EU.

4.4.2 Temporal Flexibility

Several measures have been used to indicate the extent of temporal flexibility allowed by different national regulatory systems. First, the length of the working week is considered from a number of perspectives (Table 4.3). Sysdem (1995c) has collected 1992 information from the EC-12 on the average hours worked per week and the percentage of the labour force regularly working over 48 hours a week. In addition, Grubb and Wells (1993) have ranked countries by the restrictions on the normal weekly hours.

<i>Country</i>	<i>Average hours per week</i>	<i>% of workforce with 48+ hours</i>	<i>Grubb & Wells</i>
Belgium	38.0	4.0	10
Denmark	35.4	9.6	11
France	38.8	8.6	7
Germany	38.2	6.8	8
Greece	44.0	8.5	4
Ireland	41.9	12.9	2
Italy	39.6	4.8	6
Luxembourg	39.8	4.6	*
The Netherlands	33.1	1.6	8
Portugal	42.6	9.4	3
Spain	40.9	6.6	5
UK	38.1	27.8	1

*- Not included in ranking.

Using the different measurements, two lists can be drawn up ranking the Member States. In terms of the actual length of working week, the difference between the highest and lowest countries is significant - approximately 11 hours, or one third of the average time of the shortest average working week in the EU. Employees in Greece, Ireland and Portugal on average work the longest weeks, while the shortest weeks are in Belgium,

Denmark and the Netherlands. When considering the share of employment working longer than 48 hours each week, Ireland and Portugal have high shares while Belgium and the Netherlands have low percentages as would be expected from the statistics for the total average. However, although Denmark has one of the shortest average working weeks in the EU, it also has a higher than average share of total employment working longer than 48 hours. While the average working week is not among the longest in the EU, a higher share of employment in the UK also work over 48 hours than anywhere else. This is confirmed by taking into consideration the Grubb and Wells ranking, in which the UK, as well as Ireland and Portugal, appear to have the fewest regulatory restrictions on the length of the working week. As might be expected from their low average working week, Belgium and Denmark are viewed as having the highest level of regulations on the working week in the EU.

A second way of measuring temporal flexibility in the EU is the freedom of companies in arranging working time (Table 4.4). Using 1992 data from *Employment in Europe* on male employees as an indication (CEC, 1994b), it is possible to examine the share of Member State employment that work on Saturdays and Sundays as well as night shifts. Grubb and Wells (1993) provide an assessment of the comparative flexibility of overtime, weekend and night work.

Table 4.4: National differences in the organization of working time				
	% of workforce			
<i>Country</i>	<i>Saturdays</i>	<i>Sundays</i>	<i>Night shifts</i>	<i>Grubb & Wells</i>
Belgium	29	18	17	5
Denmark	48	46	20	2
France	49	23	18	7
Germany	43	23	21	6
Greece	45	26	19	10
Ireland	*	*	*	3
Italy	55	19	15	3
Luxembourg	29	15	12	*
The Netherlands	38	21	8	7
Portugal	26	13	*	11
Spain	35	13	10	9
UK	63	43	27	1

*- No data available.

Compared in this way, the country with the highest share of its employment working Saturdays, Sundays and night shifts is the UK, followed by Denmark with respect to Sunday and night working. Grubb and Wells suggest that the UK's and Denmark's flexibility is reflected by the relative lack of regulation they have. In terms of the most regulated countries, the lowest shares of atypical working hours appears to be in Portugal (weekend work) and Spain (Sundays and night shifts), which is supported by Grubb and Wells estimations of their levels of regulation in these areas. It should be noted though that while Greece also appears to have strict regulation on this kind of work, this is not reflected statistically.

Using both types of measurements, a consistent picture of temporal flexibility does not emerge. On average, the UK appears to have the most temporal flexibility in theory and practice in the EU, followed perhaps by Ireland. Portugal scores well on the average working week but not on the flexibility of working outside normal hours, whereas Denmark has a notably short working week but significant flexibility on how the hours are worked. Belgium, the Netherlands and Spain have low temporal flexibility depending on which measurements are being used.

4.4.3 Pay Flexibility

Pay flexibility can be considered from several different perspectives. From a regulatory point of view, the key constraint on the autonomy of companies in setting their wage rates relates to minimum wages as fixed by legislation or collective agreement. Three types of minimum wage agreements have been identified in the EU (Income Data Services, 1993a):

- *statutory minimum wage systems*: France, Luxembourg, the Netherlands, Portugal and Spain (as well as Belgium and Greece, where it is set through collective agreements that become generally binding);
- *collective agreements within industries*: Denmark, Germany and Italy (as well as Ireland, though binding rates are set for sectors with low union density by statute); and
- *no minimum wage restrictions*: the UK.

A significant factor in the differences in pay flexibility is national differences in the collective bargaining systems, but here the evidence on its impact on FDI is not clear. Differences in how much of the national workforce is covered by collective bargaining do not appear to be directly related to the level of wage costs - for example, Germany has a higher coverage than Portugal, which in turn has a higher coverage than the Netherlands, a ranking that does not mirror labour cost differentials between these countries (Beatson, 1995). Calmfors and Drifill (1988) have shown that centralization of wage bargaining cannot be used as an index for wage growth or macroeconomic performance. Highly-centralized and highly decentralized bargaining structures can equally encourage real wage growth in line with macroeconomic performance.

This does not fully outline the flexibility of wage setting in each country, so use should be made of comparative data on wage flexibility. Beatson (1995) cites several methods of measuring such flexibility. Inter-industrial wage dispersion demonstrates the extent to which wage levels are allowed to vary between industries - a limited study covering the period between 1975 and 1986 showed that there was high dispersion in Belgium, Ireland, Italy and the UK, but there was little variation in Denmark, France, Germany and the Netherlands. In addition, average real wage flexibility can be measured by the trends in wage levels and unemployment over a period of several decades. Recent studies cited by Beatson have produced mixed results, concluding that wages may have responded to macroeconomic changes more flexibly in France, Germany and the UK but notably less so in Denmark, Ireland, Italy and Portugal. Comparing the statistical measures demonstrates the difficulties in determining pay flexibility, as one set of indicators point to flexible systems in Ireland and Italy whereas the other suggests the opposite.

4.4.4 Functional Flexibility

It is difficult to provide cross-national comparative data to examine functional flexibility. Beatson (1995) cites a few studies that have examined a small number of countries and examined the proportion of skilled workers and the definition of job boundaries as indicators of the level of rigidity in this type of flexibility. The evidence of these studies and others suggests that there is a spectrum of countries for functional

flexibility, placing countries like Germany, Italy and the Netherlands (specifically the more industrialized northern regions) at the more flexible end of the range and France, Spain and the UK at the other.

As functional flexibility requires a significant and long-term investment in human resources in order to maximize the adaptability of the workforce, one method of measuring functional flexibility could be the level of training investment by firms. Tüselmann (1995) noted that two-thirds of the West German workforce were qualified to crafts level or higher, as compared to one-third in the UK, suggesting that there may be a trade-off between different forms of flexibility and their impact on investment strategies in different international sectors. In general, more research is needed to examine the extent to which this takes place.

4.4.5 Industrial Relations

Although industrial relations enter into all the different forms of flexibility discussed above, it is worthwhile drawing attention to how the quality of industrial relations can influence foreign investment. For example, one of the major claims that have been made about the German investment climate is that its consensus-based industrial relations has guaranteed a low level of strikes and wage settlements in western Germany, at least until recently as far as wages are concerned (Tüselmann, 1995). Germany had the fewest number of working days lost between 1983 and 1992 in the EU apart from Luxembourg and the Netherlands, in contrast with Greece and Spain, which lost *twenty* times as many days as Germany (Sysdem, 1994).

However, the gains at macro-economic level can be lost at company level where it prevents individual firms to negotiate deals in line with their specific circumstances. EU labour force surveys have shown that companies were more concerned by the restrictions of collective agreements on weekly operating hours in Germany and Portugal than other Member State (CEC, 1995c). It does not always follow that highly-centralized systems can restrict negotiation at company level. In the case of Mercedes-Benz's negotiation on production flexibility at its Untertürkheim plant, the role of the union, IG Metall, was crucial in securing worker cooperation (EIRR, 1994a). However, collective agreement restrictions prevented French workers in Dijon negotiating employment concessions with Hoover Europe that might have prevented the shift in production to the company's Scottish plant (EIRR, 1993). Clearly, there is an interaction between the benefits of centralized and decentralized systems of industrial relations, where the scope for negotiating maneuverability tends to be influenced more by the specific circumstances of individual cases.

* * *

From the analysis conducted above, national variation in labour market regulation - and consequently, labour flexibility - is extensive in the EU. With some exceptions, external flexibility in its different forms (numerical, temporal and pay) is broadly apparent in some countries more than others. Ireland and the UK have the most flexible labour environments in these terms, whereas Belgium and Spain may be characterized by having the regulations that make this kind of flexibility more difficult to achieve. Germany, frequently held up as an example of an 'over-regulated' country does not appear among the most restrictive EU countries by this analysis.

With regards to functional flexibility, more research is needed to ascertain the extent to which different Member States can be classified as more flexible than others. While

Germany has long been regarded as leading the EU in this area, categorization of the other countries cannot be undertaken without a better definition of the type of indicators that can be used to measure this form of flexibility. Further, unlike the various forms of external flexibility, functional flexibility is more sector-dependent and company-specific.

Shifts in investment on the basis of these differences cannot be established statistically. Unlike labour costs, no direct correlation can be shown between outflows from highly-regulated countries and inflows into less-regulated countries, nor would it be expected. For new investors, case study work will be necessary to demonstrate the importance of this factor. In the interviews for the pilot studies, the evidence supporting such shifts is mixed. For one American company, a shift took place, though only indirectly. The firm closed down its single European plant in Germany in the late-1980s, in part because of labour costs and difficulties in achieving 'flexible' American production methods in the German labour regulation system. A few years later, the company established a new European plant in the UK, again in part because of labour market cost and regulation factors. In contrast, a German-based electronics company argued that no production was being shifted out of different countries as a result of labour issues (indeed few relocations were taking place within the firm). Where labour market factors partially influenced investment strategies was in the location decisions for new types of business - especially new product lines - rather than the *consolidation* of existing investments.

In general, shifts arising from relocation investment are more likely to surface as investment expansions rather than closures, as work by McDermott (1989) and Fothergill and Guy (1990) have emphasized that closures and significant disinvestments are normally the result of long-term market and product changes. However, the course of industrial restructuring may be influenced by regulatory differences, as suggested by the evidence of companies using threats of investing abroad to gain concessions on the organization of labour in the production process. In this sense, the threat of diverting investment by multinationals - a change in relative investment patterns than actual disinvestment - could be the main effect of the persistence of regulatory differences in the EU.

4.5 Summary

Labour market regulation should be considered as a series of discrete areas covered by statutory legislation or collective agreement, whose combined effect can be witnessed in different types of labour flexibility. The importance of labour flexibility has been seen in a growing recognition that industrial competitiveness is linked to the ability of individual firms to adapt to changes in markets, products and production technologies, both short- and long-term.

Key to this process is the freedom allowed to the firm in reorganizing its production in line with market and industry changes. With regards to labour, this freedom can be considered as several different types of flexibility: *numerical* (such as dismissal legislation and the use of atypical employment), *temporal* (such as working time), *pay* (such as minimal wage legislation) and *functional*. The first three refer to external flexibility, while the latter can be considered as the ability to reassign workers to different tasks within the production process. Labour market regulation has an impact on all four areas, though there is concern that there may be a trade-off between external and functional flexibility. In addition, the nature of industrial relations at national level can be an important factor, depending on the extent to which it facilitates or restricts the ability of the firm to alter pay and employment conditions to

match its individual circumstances.

Evidence has been cited on the extent to which companies can use the threat of diverting investment to extract concessions on employment conditions. In all four areas of flexibility, national differences in labour market regulation can be found, with Ireland and the UK emerging as the most liberal countries overall, and the Belgium and Spain as the most restrictive. However, the evidence with regards to functional flexibility needs to be supplemented by additional research. The research here has provided a base for more in-depth research on the links between regulatory environments and labour markets in the EU countries.

The scope for multinationals to use national differences to increase competitiveness remains to be examined. As Goodhart (1994) has noted, firms can change their productivity more easily than their labour costs, particularly where they can extend their plant operating hours. As labour market regulation affects how far firms can reorganize their workforces to increase productivity, greater work will be needed on examining the inter-relationship of investment strategies, labour market regulation, productivity and labour costs.

5. FOREIGN INVESTMENT AND THE SOCIAL DIMENSION OF THE EUROPEAN UNION

5.1 Introduction

As differences in national labour market regulation are influencing foreign investment patterns, changes to those differences are likely to have a knock-on effect on FDI. The EU's 'social dimension' is increasingly influencing the range of differences at national level in various areas of employment law. Just as the Community's 1992 programme of deregulation has encouraged industrial restructuring, the regulatory changes of its social policy agenda should have a similar - though likely less extensive - impact. Indeed, in many respects, the social dimension of the EU has been designed to contain some of the shifts in foreign investment that have been made possible by the completion of the Single Market.

The following chapter considers aspects of this issue. It is intended to be supplemented by interviews with companies for the final report, which will be revised appropriately. At present, the sections here provide a background to the EU's social dimension, before examining the potential investment effects of specific measures.

5.2 The Social Dimension of the European Union

Although there has theoretically been a 'social dimension' to the Community from its inception - the Treaty of Rome included broad commitments by the Member States to improve working and living conditions - social measures at the EU level have been increasing in importance in recent years. This new prominence of EU social policy should be seen in the context of other policy developments within the Union. As part of the Single European Act - which legitimized the Single Market programme - special emphasis was given to harmonizing health and safety standards out of concern that increasing competition among European firms should not lead to worsening employment conditions. As extensive deregulation of trade barriers was occurring through the Single Market programme, it was increasingly felt necessary within the Community to prevent deregulation taking place in social and environmental standards. As a result, a statement of objectives relating to the European social dimension was made with the Social Charter in 1989 (McDonald and Dearden, 1992).

Among the commitments listed in the document (signed by all the Community Member States apart from the UK) were the following areas:

- improvements in living and working conditions, such as employment contracts and the organization of working time;
- fair remuneration of workers not subject to 'normal' employment contracts;
- rights to social security or a minimum wage; and
- rights to information, consultation and worker participation.

The Social Charter formed the basis for the discussions of the social and employment aspects of the Treaty of Union in 1991. New articles in the treaty included employment and social protection, dialogue between management and labour, the development of human resources and reducing social exclusion. Under the Treaty, the Council was allowed to act by qualified majority voting on health and safety issues, working conditions, sexual equality in the workplace and the integration of the socially-excluded into the labour market. Issues requiring unanimous support included social security, protection of redundant workers, representation of workers' and employers' interests, and financing measures for employment and job creation. Pay and the rights of association and striking were specifically excluded. As a result of the UK Government's opposition to EU action in many of these areas, the other eleven Member States agreed to these issues in a protocol attached to the main body of the Treaty.

5.3 Specific Measures and Foreign Investment

The impact of the so-called 'Social Chapter' on foreign investment relates mainly to the extent to which its implementation will change differences in national labour market regulations sufficiently to influence the investment decisions of multinational companies. The chief ways in which such differences will be altered are twofold: *removing* existing differences as a result of harmonization and by *exacerbating* differences between participants and non-participants of the agreement (ie. the UK and the rest of the EU). Since 1991, several social policy measures have been suggested and drafted. To date, few have been introduced and made fully operational through the Social Chapter (EIRR, 1996). Moreover, when interviewing companies in the pilot study, current perceptions of the EU 'social dimension' appear to be very limited, in that the firms have little awareness of its business implications and are not changing their investment strategies in response to it.

As a result, in discussing the effects of the emerging EU social dimension on foreign investment trends, attention needs to be given to the potential impact of specific measures. The measures considered in the following sections consist of those areas where EU action has already been taken and areas where action may well occur in the near-future: employees consultation, working time, atypical employment and other, less-significant measures.

5.3.1 Employees Consultation

The most controversial of the recent EU social policy measures has been the European Works Council Directive, which was given full approval by the Council in September 1994. The directive requires multinational enterprises on a 'Community scale' (ie. those with at least 1,000 employees within the European Economic Area group of 17 countries (EEA), including at least 150 in each of two or more of those countries) to establish an information and consultation procedure, usually taking the form of a workers council. The council would meet at least once a year with management to be informed of current cross-border developments within the company and where significant business changes

are being planned. The costs of maintaining this system will be met by the company.

The aim of the directive is not to dictate the precise procedure adopted by companies, but to ensure that some form of consultation is introduced. Companies have considerable freedom to adapt the directive to their organization. Similarly, the issues that are to be covered are to be negotiated between management and workforce. Although the directive refers to a process of 'consultation', this does not suggest the power of veto by employee representation of management decisions. Further, the company is not required to provide the workers councils with sensitive information whose publicity might seriously damage the business activities of the firm.

Nevertheless, the directive is viewed as constraining the flexibility of firms in taking international business decisions. Two sets of criticisms have been levelled against the directive. First, it has been argued that the directive will impose direct costs on companies as they have to pay for the consultation meetings. Second and more importantly, establishing the procedure could increase several indirect and uncertain costs for the company, as noted in the previous chapter. By the directive, workers councils are entitled to be informed of any corporate reorganization that will involve changes in employment levels through cross-border shifts of production and the introduction of new production methods. While the councils will not be able to prevent management taking any decisions that will reduce the workforce or their pay conditions, the process of informing and consulting could delay decisions that may be important to implement quickly. For example, planned closures or plant reductions cannot be prevented, but widespread dissemination of company plans could allow local (and national) resistance to the business decisions making their implementation more costly (if not jeopardizing them altogether). Even over less adversarial issues, the directive could make it difficult for companies to make major business decisions where speed is important.

In assessing whether the directive is likely to affect foreign investment patterns, two questions need to be answered: will the directive significantly change the existing practices of companies and will this be different across the EU? In terms of the change required by the directive, it has been estimated that there are 458 companies with their headquarters in the EEA that can be affected by the directive (Hall *et al*, 1995). However, it has been estimated that 41 companies have already established workers councils and their experience has not only been characterized by diversity of forms of workers councils but also by being largely positive. In particular, the evidence suggests that rather than providing a focal point for opposition to management business decisions, it has often given companies the opportunity to build up general consensus for decisions as well as review their value.

More pertinent than the cases for and against the directive are the impact of the directive applying in all EEA countries apart from the UK. In principle, where companies become unhappy with their experience of the directive, the option of locating outside its remit is possible. However, the directive's criteria already applies to a number of multinational companies based in the UK as they have subsidiaries and plants based in elsewhere in the EEA. Although UK workers will not formally be subject to the directive, many companies have decided to set up workers councils that include their British workforce. Consequently, the UK's opt-out is not necessarily a location factor in this case.

The UK may benefit from new investment coming into the EU, where companies are only intending to locate investment in one country. If the UK maintains its opt-out (which will depend on the results of its next election as the Labour party has committed itself to removing the opt-out), it could reinforce the UK's existing location attractiveness.

5.3.2 Working Time

On the issue of working time, EU social measures are currently concentrating on the number of hours worked in different Member States. The Working Time Directive requires Member States to adopt a number of provisions:

- a maximum length of working week of 48 hours (including overtime) on average;
- rest breaks after six hours of consecutive work;
- rest periods of 11 hours daily and 35 hours weekly (including Sunday in principle);
- an average eight-hour shift for night workers; and
- a minimum four weeks' annual paid leave.

The directive has several exemptions, including job (such as managers and family workers) and tasks (such as work necessitating permanent staff presence or accident emergency responsibilities).

Although working time statistics do not provide sectoral breakdowns in which the extent to which the directive will apply can be estimated, it can be assumed that in principle, the directive is likely to have a greater impact on countries where a significant proportion of labour work over 48 hours a week. Statutory limits of 48 hours or less have already been introduced in all EC-12 countries apart from Denmark, Ireland and the UK. In any case, only the UK and Ireland are countries where over ten percent of employment work 48+ hours. In Ireland, a 39-hour week has been secured for most manual workers but the situation in the UK has yet to be decided. The application of the directive to the UK could lead to a substantial reorganization of working time. The directive's adoption as a health and safety measure - which should include the UK as this area is not covered by the opt-out - has been confirmed by the European Court of Justice following a challenge by the UK Government. However, it is not clear what the UK Government's response will be and consequently, the extent to which the UK may lose part of its temporal flexibility.

Consequently, the impact of the regulation on changing FDI location factors in the EU may not be great. The effects may be more substantial in new Member States and EEA countries. For example, a business survey of attitudes to the effects of EU social policy on working hours and shifts showed that the highest shares of companies anticipating changes were in Switzerland, Norway and Sweden. Potential investment shifts are more likely between these countries and the EU rather than within the EU (Brewster, Hegewisch and Mayne, 1994).

5.3.3 Atypical Work

To date, EU measures on atypical employment have not been fully agreed, but specific areas have been identified for action. Proposals that are currently under discussion include providing some part-time and temporary employees treatment equivalent to full-time workers with regards to vocational training, social security rights, holiday and leave allowances, and dismissal protection (Addison and Siebert, 1992). Although the effects on companies will depend greatly on the final measures agreed, EU action in these areas could potentially influence numerical and temporal flexibility in many countries.

By increasing the cost of using atypical employment for many firms, it has been argued that it could reduce the competitiveness of firms that rely heavily on this type of employment. For example, measures to protect part-time employment could lead to significant restructuring in the UK (assuming any final measures are applicable there), the Netherlands, France and Ireland, given the high share of part-time employment in their workforces and the relatively lack of restrictive regulations (Table 4.2). For fixed-term contracts, the impact on Spain, where this form of atypical employment accounts for a large share of labour, could be particularly widespread. In a survey of company attitudes to potential EU social policy measures, the countries where the highest share of businesses anticipated changes to their use of atypical employment as a result of new measures were Spain, France and Italy (Brewster, Hegewisch and Mayne, 1994).

The response of foreign investors to these changes is difficult to estimate without empirical work. Unlike other current EU social policy measures, the effects of changes in this type of employment flexibility will not be restricted to signatory countries of the social dimension protocol of the Treaty of Union and the UK, but could influence the locational attractiveness of several Continental countries. Moreover, the knock-on effects of changes in atypical employment regulation need to be considered, particularly in countries like Spain where the use of fixed-term contracts should be seen in the context of the restrictions on employee dismissals.

5.3.4 Other Measures

A range of other measures have been implemented or are under consideration by the EU which could alter the comparative levels of employment regulation. The most important of these at present are the following.

- *Parental leave.* The proposed extension of parental leave rights to men as well as women could add costs to companies which will be required to acquire extra staff or reorganize working time to compensate. However, the cost implications for businesses are unlikely to be significant enough to shift investment patterns. In any case, for the economy as a whole, the economic effects of which parent are able to take leave should be neutral, as all equal opportunities legislation aims to be.
- *Posted workers.* The current proposed directive on the posting of workers outside of their country of first employment affects the pay and employment conditions of workers who are subcontracted to another enterprise or a subsidiary located in a second Member State. The company is obliged to ensure that the originally agreed conditions are maintained during the period of the posting. Work by Gold (1994) on UK companies and Italian and French subsidiaries based in the UK has shown that the directive is unlikely to affect many of the postings made by companies. Consequently, the cost effects of the directive are not anticipated to be significant at present.
- *National-level information and consultation.* Discussions are taking place at the EU level on the possibility of introducing measures to ensure that worker information and consultation procedures, similar to those operating in the European Works Council Directive, are implemented at national level (EIRR, 1996). Depending how any proposed directive is framed, the effects of such a measure could be more extensive than the existing directive for international information and consultation, as more companies might be affected by the new legislation. The nature of the effects can be expected to be similar, though again, the crucial question is likely to be to which countries will the policy measure be applied.

5.4 Summary

Although more research has yet to be done on this issue, it appears that the effects of EU social dimension measures on foreign investment are limited to date. Few measures have been implemented as yet and in most cases, they only affect a small proportion of mobile investment. More concern has been expressed about potential areas of future EU action - such as atypical employment or the introduction of national level information and consultation - but the effect of these will mainly depend on the framing of any proposed legislation.

The UK opt-out has not altered FDI patterns greatly. It either does not prevent directives applying to potential and existing investors in the UK or it has only enhanced an established location advantage in the UK.

Overall, it seems that differences in national regulatory frameworks have either not been significantly changed by current EU measures or firms are more interested in these differences than the application of EU policies. Given that the objective of the EU policies have been to create a floor for employment rights and conditions rather than to level national regulations, the measures have been working as they were intended. Questions remain though about the extent to which social dimension regulation at the EU level is preventing 'social dumping' occurring in labour standards at the individual plant and company level.

6. FUTURE RESEARCH

6.1 Introduction

The aim of this paper has been to clarify research issues as part of a longer-term project on the relationship of labour market regulation to foreign direct investment. The preceding chapters have provided a theoretical and statistical overview of these issues, taking in existing literature, the current debates in the field and problems in obtaining useful data. It remains to define the research questions for future stages of the programme and to suggest several methodologies for advancing the research work: essentially, a research agenda.

For this final chapter, the key research questions arising from the pilot study will be outlined. The issues are grouped according to the inter-relationships of three sets of factors:

- European economic integration, shifts in investment and changes in the relative importance of FDI location factors;
- productivity, direct labour costs and social protection costs; and
- labour market regulation, productivity and investment strategies.

6.2 European Integration, Redistribution of Investment and Location Factors

Until recently, it has been difficult to examine the extent to which economic integration in Europe has influenced foreign investment patterns. Although broad effects can be identified - notably the dramatic increases in new investment from the US, Japan and other non-EU investors witnessed during the 1980s - problems remain with separating the influence of different factors and with data. On the first issue, it is not clear to what extent new investment is a response to changing market conditions in Western Europe or more global trends such as new ways of organizing international production, the greater use of enabling IT and communication technologies as well as the negative effects of the worldwide recession on investment strategies. Further, there are clearly several different processes in economic integration in Europe, including enlargement (eg. the rise in investment flows in Spain can partially be attributed to joining the Community), liberalization at the national level (as seen in the increasing privatization of state industries in different Member States) and the opening up of Central and Eastern European markets and economies. To isolate the deregulatory programme of the Single Market from these different processes cannot be achieved easily.

With regards to data problems, as noted in previous chapters, it is difficult to identify the type of investment effects of economic integration because of the way that investment statistics are collected. As one of the main objectives of the 1992 programme was to promote industrial restructuring within the Community, research needs to focus on the redistribution of investment within companies and between plants, which tends not to be

reflected in official statistics. While greenfields and closures may be easily identified from current statistical sources, problems are encountered in tracing expansions or disinvestments of existing sites. Over time, the completion of the Single Market could lead to shifts in the relative balance of investment between the different plants and subsidiaries of multinationals, but these have to be understood within the context of individual corporate strategies and the ways in which these have been influenced by different aspects of economic integration.

At present, research is being undertaken to examine some of these effects as part of the European Commission's wider assessment of progress in achieving the Single Markets. It remains to be seen what will be covered as part of the research's remit, but attention should be given to the following questions in future work.

- *Investment redistribution.* Has a process of 'Europeanization' been taking place among EU-based multinationals as they adjust to operating in the completed Single Market, particularly in the sectors that have been identified as vulnerable to restructuring? Has this process affected the levels of investment between different plants and subsidiaries, through expansions, disinvestments, greenfields or closures? To what extent can these changes be attributed to specific features of the Single Market programme or to other aspects of European economic integration (such as the prospect of European monetary union)?
- *Location factors.* It has been suggested that greater economic integration in the EU should increase the relative importance of production cost factors in investment decisions. Is it possible to identify any significant changes, in particular, greater sensitivity to different labour market factors? To what extent are these changes prevalent in certain sectors? Can longer-term employment effects in different regions be attached to these trends?
- *Types of investment.* Are companies giving greater consideration to the placement of specific corporate functions (such as production, R&D, administration and distribution) in different locations? If so, what kind of labour market factors are taken into account when locating each type of investment? Further, are local labour markets affected by longer-term shifts in the type of investment that regions are attracting, such as through increasing demand for certain labour skills or 'peripheral' workers?

6.3 Productivity, Wage Levels and Social Protection Costs

As concluded in an earlier chapter, foreign investment decisions can be sensitive to international differences in labour costs and productivity. While not necessarily always directly proportional to each other, labour costs - which consist of direct (wage) costs and indirect (social protection) costs - and productivity are linked, particularly when long-term changes in the latter ultimately influence the former. What is not clear is *how* these different elements affect each and over what time periods. Is there a form of self-adjustment in total labour costs - at sectoral or national levels - by which prolonged and substantial changes in social protection costs are reflected in compensating changes in

wage demand? Similarly, to what extent do companies adjust wage costs in line with changes in individual plant productivity? Questions also arise regarding the ability of companies to affect costs, both wage levels (through pay flexibility) and indirect costs (through the use of temporary workers, for whom employer contributions on social security may be avoided).

Comparative international research on these questions has been undertaken, but there are gaps with regards to how corporate investment strategies respond to relative changes in these three factors (productivity, wages, indirect labour costs). Other work on industrial closures has concluded that these factors are rarely the main reasons for closing down plants, but there remains considerable scope for examining how relative differences in these factors between subsidiaries can shape longer-term shifts in investment. In particular, evidence already exists for how multinationals have used these differences to extract concessions from their workforces in wage bargaining and increased productivity of individual plants through threats of redirected investment.

6.4 Labour Market Regulation, Productivity and Investment

It is one of the conclusions of this pilot study that investment strategies are not only influenced by labour cost considerations, but potentially by their regulatory environment. In facing increased competition within the unified European market, companies can increase their competitiveness by reducing key production costs - such as labour costs - and increasing productivity. For many multinationals, there may be less scope in altering overall labour cost levels along the lines discussed in the previous section, than changing plant productivity. This has frequently been achieved through upgrading capital investments by obtaining more technologically-advanced equipment and by increasing its efficiency through new ways of organizing the production process and the workforce. As companies will be interested in maximizing returns on their capital equipment and being able to adapt quickly the size of their workforces or introduce new working patterns and times, labour market regulations are closely associated with productivity (and consequently, with labour costs).

In this report, existing comparative literature on labour market regulation has been reviewed, but descriptive analyses of regulations as laid down by statute or collective agreement are not sufficient in revealing how they influence business behaviour and working practices. What is required is more research on the operation of these regulations at company level with a view to establishing the nature of their restrictions and how firms try to supvene them without significant additional costs to the firm. In terms of our research programme, the key issue is how the regulatory systems in different countries affect the ability of companies in different sectors to re-organize their production and whether persistent national differences in these regulations are influencing investment strategies. An illustration of the linkages in these issues is provided in Figure 6.1.

Figure 6.1: Regulations, production and investment strategy

**NATIONAL
REGULATORY
FRAMEWORK**

**NATIONAL
REGULATORY
FRAMEWORK**

**NATIONAL
REGULATORY
FRAMEWORK**

**NATIONAL
REGULATORY
FRAMEWORK**

**ORGANIZATION
OF PRODUCTION
AT PLANT LEVEL**

MULTINATIONAL INVESTMENT STRATEGY

The employment implications of these developments need to be better understood. It is important to examine how these differences may be leading to changes in plant-level working practices as workforces make concessions on their employment conditions to secure future investments. This overlaps with questions as to the extent that foreign investor working practices are being adopted more widely by other local firms, especially through supplier linkages. It raises issues on the impact multinational companies may have in influencing local working practices, often in different directions from the intentions of national regulatory frameworks, as well as the autonomy of local subsidiaries in acting independently of parent organizations in setting their own production systems.

Lastly, the difficult issue of the relationship of different types of flexibility must be addressed. The types of flexibility discussed in this report - numerical, temporal, pay and functional - are associated with specific regulations and labour market outcomes, but work is needed to understand how far these different outcomes may be incompatible. For example, an environment that promotes adjustments in the labour market through labour costs, working time and the use of atypical employment may be less effective in promoting functional flexibility - particularly in the formation of a highly-skilled workforce - than one guaranteeing stability in pay and employment conditions and incentives for more productive work. Moreover, variables influencing the type of flexibility valued most by companies - such as sector, corporate organization and investment strategy - should be considered in detail. Although studies have been undertaken at national level on these issues, there is room for comparative work to better understand how certain types of companies react in different regulatory environments, not least as a guide for policy-makers to shape their labour market policies.

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