EMPLOYMENT RELATIONS OCCASIONAL PAPER

Labour Market Flexibility and Foreign Direct Investment

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Executive Summary

Purpose

The purpose of this paper is to examine the interaction between labour market flexibility and foreign direct investment (FDI), both in terms of the importance of the former as a key determinant of inward investment flows, but additionally examining the impact that FDI has upon the development of the domestic labour market, particularly relating to its flexibilisation.

FDI is a key means of attracting inward flows of capital and technology, together with associated innovation in management techniques, the organisation of work and distributional networks. It is associated with the import of capital, work organisation and technological advantages to a host economy, thereby potentially improving aggregate productivity, facilitating the rising skill level of the workforce through the provision of high-skill employment opportunities. FDI provides the UK with a significant proportion of high value-added, manufacturing jobs and is perceived as having potential to improve employment opportunities and promote regional economic development.

There are many determinants of FDI, including demand- and supply-side factors, however this paper concentrates upon one variable identified in the literature, namely the degree of labour market flexibility. This paper examines both FDI and labour market flexibility in terms of their constituent characteristics, and seeks to discover which of these are the more important in terms of attracting inward investment, and the relative degree of importance of each when compared to alternative determinants. The paper

additionally investigates the extent to which FDI reinforces trends towards a flexible labour market.

Survey

The primary data collection pursued by this study seeks to contribute to the literature by extending the evidence relating both to the determinants of FDI and examining the impact that this inward investment has upon the domestic labour market. The study therefore seeks to examine the inter-relationships between these two features.

The study utilises primary data generated through the circulation of a questionnaire to 1800 transnational corporations, with existing production facilities located in the UK economy. An initial set of survey responses were combined with financial data drawn from two financial datasets, FAME and Thomson Research, in order to facilitate comparative analysis with regard to company characteristics. The questionnaire utilised a combination of open and closed questions in order to combine standardised with less easily quantifiable data, in order to provide elucidation and greater emphasis upon those factors considered by the respondent to be particularly significant.

Employer surveys, although considered to be more subjective than data drawn from secondary sources, nevertheless contains information provided by business people who, presumably, are in the ideal position to denote those aspects of labour market flexibility that impact upon the location of FDI.

Results

- Labour market flexibility identified as representing moderate or high degree of importance by 60 per cent of respondents
- Principal significant labour market factors
- Highly trained and skilled labour force
- Numerical flexibility – working time, labour mobility
- Functional flexibility – multi-skilling, reduction in demarcation, loosening of employment protection regulation
- Disaggregating responses by company characteristics
- High-risk technology firms - quality of labour force skills base, physical infrastructure, location near international market
- Moderate risk and/or low cost firms - national factors - product demand, deregulation, taxes, low cost of capital

Policy Recommendations

- Important to identify firm profile prior to determining attractive factors to potential investors
- Labour market flexibility is not a single phenomenon, but agglomeration of multiple characteristics

- Potential for misdirection of policy designed to promote FDI by focusing upon less significant aspects of labour market flexibilisation
- Highly skilled workforce disproportionately benefits high-risk technology and niche strategy firms
- Numerical and functional flexibility benefits more evenly distributed across company clusters
- Many ‘traditional’ factors (labour cost, wage flexibility, incentive pay, trade unions activity) are weak influences upon FDI
- Little evidence of firms utilising indices of international competitiveness between countries
- UK possesses low levels of employment regulation than the EU overall, but…deterioration in degree of labour market flexibility since 1997
- Relatively consistent behaviour of inward investors in terms of initial attractors and policies subsequently pursued
- Policies, ideally, need to be fine tuned to address the specific attractors of firms
- Expectations remain significant determinants of FDI

Introduction

The internationalisation of economic processes has prompted considerable interest in Foreign Direct Investment (FDI) as a key means of attracting inward flows of capital and technology, together with associated innovation in management techniques, the organisation of work and distributional networks. Trans-National Corporations (TNCs) are estimated to account for more than one-fifth of global employment in the non-agricultural sectors, with global sales of $19 trillion, double the value of world exports (Dunning, 1993:15; Scholte, 2000:130; UNCTAD, 2002). Thus, FDI has become an increasingly significant factor in influencing the level of economic activity in developed, in addition to developing, nations.

In the literature, FDI is associated with the import of capital, work organisation and technological advantages to a host economy, thereby potentially improving aggregate productivity, facilitating the rising skill level of the workforce through the provision of high-skill employment opportunities (OECD, 1991; De Mello, 1999). Accordingly, FDI should improve allocative efficiency, as resources are transferred towards the most efficient new entrants to the host market (Dunning, 1988). FDI may additionally produce beneficial externalities for domestic producers, through spillovers in the areas of technology and work organisation, together with a positive association with an increase in investment by national investors (Borensztein et al, 1998; Aitken and Harrison, 1999; Bosworth and Collins, 1999; McMillan, 1999; Driffeld and Munday, 2000). Furthermore, in so far as regional regeneration is facilitated through the infusion of new capital, technology and creation of skilled employment opportunities, FDI would appear to have significant potential in this regard (Young et al, 1988, 1994; Neven and Siotis, 1993).

Balance of payment effects are indeterminate because the initial inward capital transfer may be offset by a reluctance to permit inter-subsidiary competition and/or the reduction in competition arising from the takeover of an existing producer (Bairoch, 1993:183-4). Thus, the beneficial impact associated with FDI may be partially or wholly negated by deadweight effects if FDI occurred through the takeover of a export-orientated domestic firm, and through the long-term repatriation of profits to the home economy (OECD, 1998). Evidence on this point indicates that only 14 per cent of FDI flows were associated with the establishment of new businesses (Fallows 1994: 481). Consequently, it is not surprising that the capability to induce rising FDI flows into its economy has become an important policy objective of many different governments, in diverse nation states.

In terms of the UK, the importance of FDI inward flows during the past two decades is illustrated by the fact that, as early as 1989, TNCs employed 40 per cent of the manufacturing sector (Ladipo and Wilkinson, 2002:12-13), whilst FDI may account for 30 per cent of the productivity growth in UK manufacturing industry (Barrell and Pain, 1997). Moreover, it is suggested that attracting inward investment has become 'the chief instrument of industrial policy in the UK over the past 20 years' (Driffield and Taylor, 2000:93; Wren and Taylor, 1999). Furthermore, the importance given to

continued attraction of FDI by the UK government is reflected in the fact that it features prominently as one of the Chancellor's "Five Tests" established to ascertain the potential impact of participation in Economic and Monetary Union (EMU) upon key aspects of the UK economy (HM Treasury, 1997).

The ability to attract FDI depends upon many different factors, including the relative development of physical and informational infrastructure, wealth and growth rates of national (and/or regional) markets, factor endowments, skill levels and quality of training, political stability and possession of raw materials, in addition to policy measures favouring business development. Such policy factors include relative tax rates, levels of regulation, provision of location incentives and the existence of labour market rigidities.

It is, however, upon the latter factor that this paper concentrates, due in large part to the identification of labour market flexibility as facilitating superior financial performance and higher levels of productivity at firm level (Kling, 1995; Ichniowski *et al*, 1996; Becker and Huselid, 1998), together with favourable macroeconomic benefits including lower levels of unemployment and reducing inflationary bottlenecks in the labour market, thereby reducing the economy's Non-Accelerating Inflation Rate of Unemployment (NAIRU) (Layard *et al*, 1991; OECD 1994a and 1994b; Nickell, 1997; Siebert, 1997; Elzmeskov *et al*, 1998; Nickell and Layard, 1999). These conclusions are not, however, universally shared as other studies have found no significant impact arising from labour market deregulation (Nickell, 1998; OECD, 1999:88; Blanchard and Wolfers, 2000; Solow, 2000; Baker *et al*, 2002; Schettkat, 2003; Arestis and Sawyer, 2004:93).[1] Nevertheless, the UK government's position is that 'flexible and dynamic markets' are considered to be 'a precondition for economic strength' (HM Treasury, 2003:239).

This paper seeks to investigate the interaction between FDI and labour market flexibility, both in terms of the importance of the latter as a key determinant of inward investment flows, but additionally examining the impact that the arrival of TNCs have upon the development of a flexible labour market. The paper utilises primary data, generated from a questionnaire distributed to 1800 trans-national companies, all of whom possess existing production facilities in the UK economy.

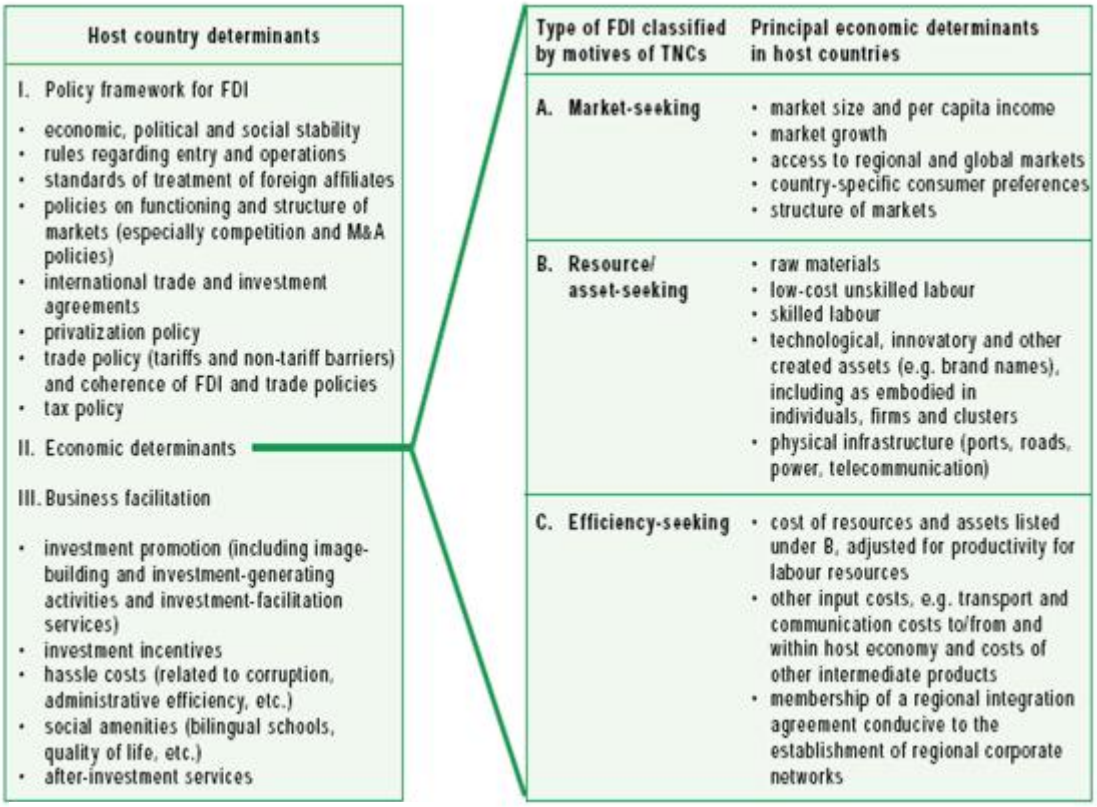
Determinants of FDI

Foreign Direct Investment (FDI) may be defined as capital invested for the purpose of acquiring a lasting interest in an enterprise, whilst simultaneously exerting a degree of influence on its operations. It is this combination of ownership and control that distinguishes FDI from other

[1] One reason for this might derive from a tendency to downplay the importance of demand-side factors influencing unemployment, together with the fact that characteristics of labour market flexibility can themselves be influenced by the impact of aggregate demand upon investment, capacity utilisation and indirect effects upon the viability of regulatory and institutional arrangements (Palley, 2001:3; Alexiou and Pitelis, 2003; Schettkat, 2003; Stockhammer, 2004; Arestis and Sawyer, 2004:93).

forms of trans-national investment and/or production, such as portfolio investment (i.e. ownership of financial assets without the same degree of direct control) and franchising (i.e. control over production technology and process but without ownership) (Dunning, 1979).

Figure 1: Host Country Determinants of FDI



Source: UNCTAD (1998:91)

The international business literature proposes that firms tend to consider FDI once they have developed certain competitive advantages that they feel they can more effectively exploit by engaging in a strategic location of production abroad, rather than export goods and services, but maintain their direct control over the process to minimise transaction costs, retain control over technological and other elements of the production process together with organisation knowledge (Morgan, 1997). Assuming rational action, firms must be responding to, firstly, incentives to locate production abroad, rather than export from their existing home base, and secondly, a separate set of incentives to internalise the production process. The latter may centre upon the perceived risk inherent within the principal-agent problem, whereby the reliance upon an agent to fulfil objectives established by the principal might lead to sub-optimal solutions, due to differences in self-interest, and may require costly solutions, involving the provision of additional incentives for the agent or otherwise intensive monitoring of their activities. Risk of this nature may include the threat of theft of technological knowledge, or, less dramatically, the provision of greater opportunities for the diffusion of technological knowledge, and hence

erosion of competitive advantage, together with possible loss of reputation and goodwill due to the operations of low quality franchise operations.

The United Nations World Investment Report (UNCTAD, 1998) argued that FDI arises due to a combination of, firstly, host country (or locational) determinants, based upon the social and economic factors together with the attractiveness of government policy framework for the attraction of FDI, and secondly, the strategic motives of TNCs. This is illustrated in FIG 1. An alternative representation of the determinants of FDI, grouped by risk, cost and demand, is illustrated in FIG 2.

Minimising Risk

TNCs prefer to minimise the risk associated with their investments, and therefore they prefer the combination of a stable political climate together with a dependable macroeconomic framework (Wheeler and Mody, 1992). Indicators of the latter include low rates of inflation, budget deficits and government debt, together with a relatively stable exchange rate. High rates of any or all of these variables threaten to erode the financial value of the assets purchased or developed by the inward investor, and thereby increase the risk premium of FDI in that particular nation. Interestingly, given the relevance to the issue for the membership of the Euro, this does not necessarily imply a preference for a fixed exchange rate, but does indicate a general dislike of excessive exchange rate variability. Inward investors additionally minimise risk through their preferences for operating within a secure and transparent legal framework, designed to protect their property and security of their business contracts. Additional attractive policy-related factors include the maintenance of a reasonable rate of economic growth, low costs of borrowing (via a low rate of interest), low levels of taxation and/or the provision of specific investment incentives intended to lower the cost of inward investment. Furthermore, the potential offered by privatisation, through potential undervaluing of former state assets and/or the opportunity provided to purchase strategically valuable assets, has further encouraged increases in FDI throughout the past two decades.

Demand Factors

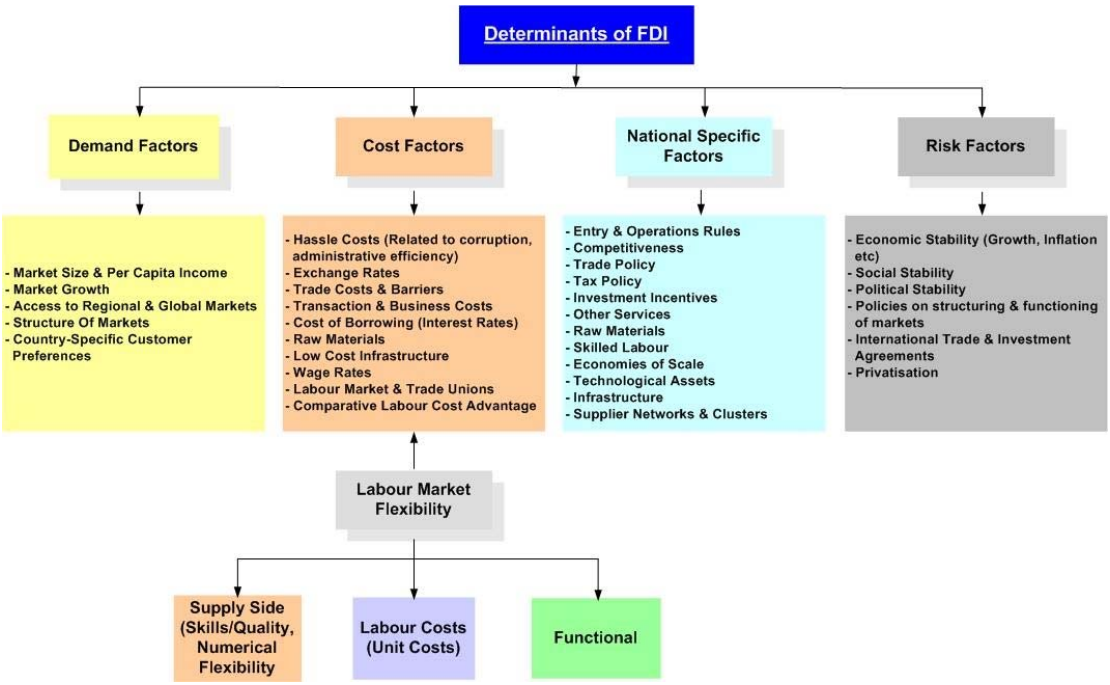
The international business literature suggests that there are many inter-related determinants of FDI, and that the ultimate decision for a TNC to invest in a particular country will depend upon a composite of these various variables (see Appendix One for a partial summary of this literature). Evidence tends to suggest that investors prefer nations with relatively liberal trade regimes, perhaps some type of regional supra-national trade arrangement, such as the European Union single market, NAFTA, ASEAN and so forth. The size of the national and/or regional market is therefore of great significance, since it is primarily to serve this market by localised production, rather than export from the home nation, that FDI occurs (Culem, 1988; Jost, 1997; Pain and Lansbury, 1997). The relative affluence and growth rates enjoyed by the host market are of similar significance for potential entrant firms. Furthermore, in addition to market conditions which will influence the potential demand for the firms' products, there are additional nation-specific factors which may influence location of

FDI. These may relate to the existence of a natural resource, technology or production method protected by legal patent, to which the TNC wishes to gain access (Cantwell, 1989: Caves, 1996: Neven and Siotis, 1996; Dunning, 1988).

Cost Factors

In addition to demand factors, FDI is influenced by the relative cost of production and distribution within potential host nations. This is determined by the quality and reliability of physical and communications infrastructure, relative unit costs, the cost and ease of access to raw materials and the cost of capital. The latter could be eased by monetary policy maintaining a relatively low rate of interest and/or full integration within international financial markets. The existence of capital controls and other types of financial regulations would be perceived as generally unattractive. Furthermore, relative unit costs can be influenced by government policy.

Figure 2: Determinants of FDI



Labour costs can be affected by a number of variables, including the design of institutions and patterns of wage bargaining, labour market policies designed to solve skill shortages and thereby remove inflationary employment bottlenecks, together with the overall macroeconomic stance of the government. The latter may involve a tight monetary and fiscal policy, designed to restrain wages and inflation, which may in the process improve national competitiveness. It may equally pertain to the maintenance of a high level of aggregate demand, intended to sustain high rates of industrial capacity, thereby encouraging future investment in capacity and reducing unit costs as these are borne by a larger volume of output. Finally, it may also involve exchange rate management to attempt to maintain competitive unit costs through currency appreciation or devaluation, as necessary.

Labour costs may be minimised through the degree of labour market flexibility pertaining in the host market, as discussed in the previous section of this paper. This involves consideration of the quality of available labour, the type of production setting in which it will operate (i.e. labour- or capital-intensive) and hence its productivity, in addition to its relative cost. Furthermore, costs can be further minimised through a reduction in regulations imposed upon productive activity, together with the levying of a low rate of taxation upon all aspects of production. It is this aspect of FDI that the paper now examines in greater detail.

Characteristics of Labour Market Flexibility

Labour market flexibility derives from the degree to which labour market outcomes are determined by the operation of market forces free from rigidities and/or restrictions imposed by powerful actors such as monopsony employers, trade unions and government. A perfectly flexible labour market would imply the absence of all hindrances to the free operation of market forces. This not only includes examples of labour market regulation (eg. job protection legislation) and institutional arrangements (eg. systems of sectoral wage bargaining), but also unorganised forms of market imperfection (eg. resulting from insider-outsider power imbalances and/or irrational employment practices arising from labour market segmentation or discrimination). Furthermore, there is a sizeable literature pointing to the existence of labour market inflexibility due to various factors, including implicit contracts, efficiency wages, transaction costs in the renegotiation of contracts and incentives provided due to the principle-agent problem (Bosworth *et al*, 1996). Clearly, certain types of labour market inflexibility are more easily subject to corrective government policy reforms, whilst others appear more intractable.

The literature on labour market flexibility denotes a range of different factors that, in aggregate, determine the extent to which the labour market is comparatively more or less flexible. At any one moment, it is possible that a number of these characteristics of flexibility are moving towards greater flexibilisation whereas others are indicating increasing rigidities. This can explain why labour markets that are generally considered as exhibiting a high degree of flexibility nevertheless contain features that depart quite significantly from this norm. For example, the fact that US and UK labour markets have a relatively low incidence of temporary workers as a proportion of the total workforce does not necessarily imply labour market rigidity, but rather reflects the fact that employers are relatively unencumbered by labour market regulation and are therefore more able to hire and fire core workers without having to resort to other forms of non-standard employment contract to avoid regulation and pursue the flexibility agenda through a core-periphery split (Robinson, 2000:36).

Additionally, there are a number of different typologies that run throughout the literature. One emphasises the fact that labour market flexibility is concerned with both *micro* and *macro* issues. For example, whereas the pay structure for an individual firm would have considerable significance for

micro-flexibility, it would have little influence upon the macro-flexibility of the economy as a whole; the latter would be more concerned with matters such as national wage bargaining institutions and the resultant real wage flexibility. Similarly, micro-flexibility would focus upon the impact of increasing self-employment and growth in temporary employment at firm level, whereas macro-flexibility would be concerned with deregulation of the regulation of working time, together with various labour market programmes (Beatson, 1995).

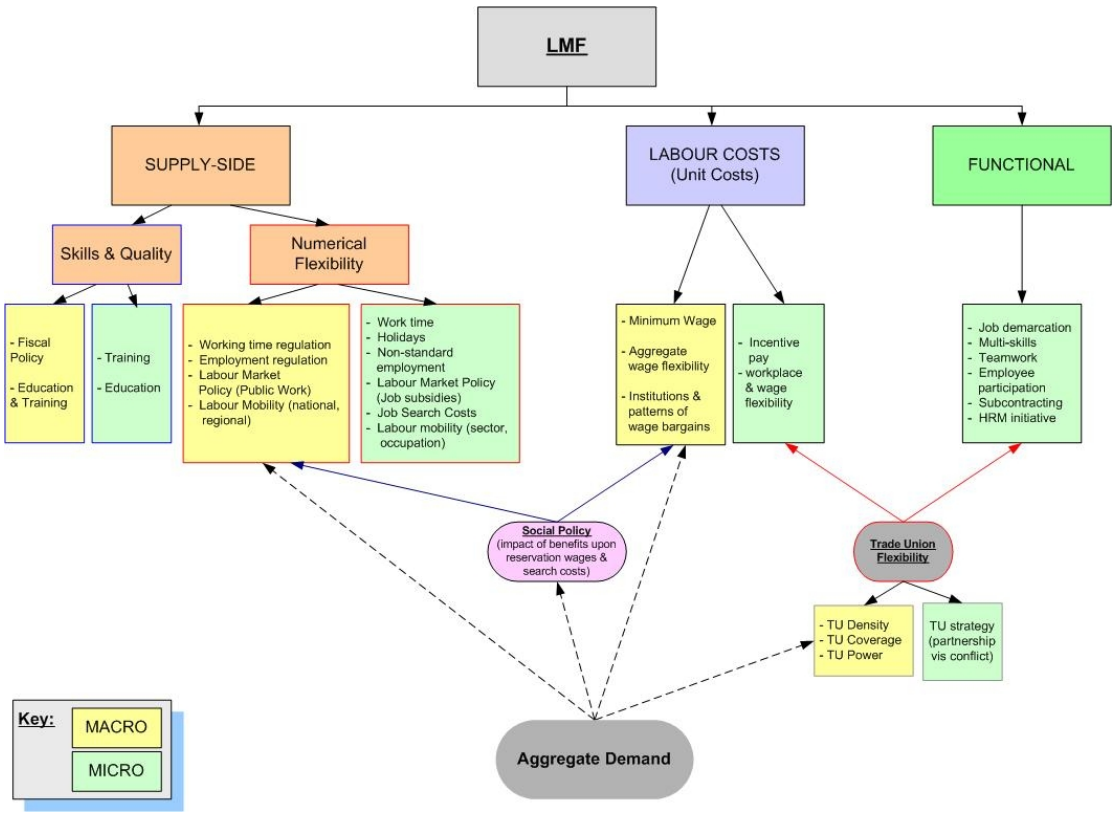
Flexibility characteristics can be further identified with the concepts of numerical and functional flexibility (Burchell *et al*, 1999; Weiss 2001). The former concerns the capacity to adapt the quantity of labour inputs to changing demand patterns. This could relate to a shift in the numbers of potential workers willing to work at the going wage rate (perhaps due to a reduction in reservation wages), changes in the value or duration of social benefit entitlements, active labour market policies, a shift in relative trade union bargaining power, and/or changing employment regulations which impinge upon the cost of hiring and firing workers (and hence firm demand for new labour). It might similarly involve temporal flexibility, namely the capacity to introduce variability in working time, whether through changes in holidays, the length of the working week, shift working patterns and overtime working. Alternatively, numerical flexibility might be enhanced through shifts towards non-standard employment, through an increase in part-time working, temporary employment contracts, sub-contracting job tasks outside the core organisation, home-working, and consultancy.

Functional flexibility, by contrast, embraces work reorganisation initiatives in the attempt to increase efficiency and/or adapt to changing patterns of product demand. Examples include the introduction of multi-skilling (or multi-tasking) and reduction in job demarcation, the enhancement of employee participation within the workplace, and measures to sub-contract elements of production to external actors. Inspired by the philosophies of 'lean production', 'just-in-time-production' and 'total quality management' (Berggren, 1993; Hackman and Wageman, 1995), functional flexibility may encompass initiatives designed to flatten organisational hierarchies and thereby reduce bureaucratic overheads (Hudson, 2002:44). Objectives included both the enhancement of skills and competences of individual employees, together with the advancement of 'teamworking'.

Monastiriotis (2003) extended this basic framework by adding a third category, namely labour costs (i.e. flexibility in pay and non-wage costs). Wage flexibility is perceived to be a central element in achieving labour market flexibility through its adjustment to maintain the balance between demand for, and supply of, labour. Hence the initiative introduced by the UK government to promote regional variations in those areas of the public sector currently utilising national pay bargaining (HM Treasury, 2003:244-7). Moreover, wage flexibility can be affected by the development of industrial relations legislation and government action as employer relating to promotion or restriction of trade union activity (Carruth and Disney, 1988; Visser, 1988; Freeman and Pelletier, 1990).

The synthesis of the literature, illustrated in FIG 3, highlights the multi-faceted nature of labour market flexibility, together with the potential for conflict between the different types of flexibility, thereby potentially partially offsetting reform objectives. For example, deregulating employee training regimes to workplace level might improve firm flexibility, and hence micro-flexibility, but if the result is a decline in aggregate training, as competitive pressures squeeze individual training budgets, then aggregate macro-flexibility may be reduced over time (ILO, 2004:191-220). Similarly, the decentralisation of wage formation may facilitate pay structures best suited to the incentive structures sought by individual managers, yet the rise in pay diversity in the labour market as a whole, together with the removal of the moderating effect of peak level bargaining partners, might provoke increased industrial unrest and hence damage macro-flexibility.

Figure 3: Labour Market Flexibility



A second concern relates to the *means* by which flexibilisation is pursued, since research indicates that the erosion of traditional job demarcations, work intensification, downsizing, flattening hierarchies and giving employees greater responsibility, are all associated with heightened feelings of anxiety and stress, which, in turn, may result in demoralisation and demotivation of concerned employees, thereby impairing productivity (Wichert, 2002). Similarly, the OCED acknowledged potential costs associated with an expansion in 'non-regular' forms of employment, including potential conflict between certain forms of greater flexibility of working hours and family life responsibilities (OECD, 2004:12-13). Thus, the extraction of functional, numerical and labour-cost flexibility may be

secured at the expense of attitudinal and/or behavioural inflexibility, thereby reducing the net value of potential gains (Mankelow, 2002:137).

A third, distinctive feature of this synthesis concerns the theoretical limitations demonstrated by much of the existing literature relating to the assumption that employment is determined by supply-side factors in the labour market and is not therefore influenced by aggregate demand. This is an error, because it is well established that the level of demand impacts upon many of the other variables outlined in this paper. For example, the literature indicates that the level of aggregate demand has a significant impact upon trade union membership, strike activity and wage bargaining power (Ashenfelter and Pencavel, 1969; Bain and Elsheikh, 1976; Booth, 1983; Carruth and Disney, 1988). Aggregate demand management may similarly impact upon the continued optimality of the wage bargaining institutions and patterns of bargaining (Calmfors and Driffill, 1988; Iversen, 1999).

Aggregate demand is closely related to the degree of capacity pertaining in an economy at any given time, and this, in turn, is associated with encouraging industrial investment, enhancing productivity and acting as a significant determinant of the level of unemployment (Rowthorn, 1995; Arestis and Mariscal, 1997:191 and 2000:487; Dow, 1998:369; Arestis and Sawyer, 2003:11; Baddeley, 2003). Therefore aggregate demand is a major factor influencing the supply curve of available labour, itself affecting numerical flexibility, whilst the buoyancy of the economy may influence the replacement ratio, degree of wage flexibility, willingness of employees to accept certain types of non-standard employment and so forth. Consequently, demand features should feature in a government's calculations when considering the merits of policy reform, to facilitate flexibility in the labour market.

Labour Market Flexibility as a Key Determinant of FDI?

The evidence of the effects of labour costs on FDI is mixed, but tends to indicate a negative association (Schneider and Frey, 1985; Culem, 1988; Friedman *et al*, 1992; Wheeler and Mody, 1992; Karier, 1995; Cooke and Noble, 1998; Head *et al*, 1999; OECD, 2000; Traxler and Woitech, 2000; Floyd, 2003). Nevertheless, it remains the case that four-fifths of the world stock of FDI is located in the high-wage and relatively high-tax nations, primarily the USA, UK, Germany and Canada, where this proportion has *increased* by 12 per cent over two decades (Weiss, 1998:186). Alternative evidence suggests that labour costs are not ranked very highly amongst other determinants of FDI (Traxler and Woitech, 2000), such that a majority of UK-owned TNCs do not even bother to collect data on overall labour costs and labour productivity (Marginson *et al*, 1996), and that sizeable (and growing) differences in unit labour costs, amongst EU nations during the 1980s, failed to result in significant differences in FDI (Erickson and Kuruvilla, 1994). Moreover, absolute figures for labour costs may mis-specify the indicator as a determinant of FDI, due to the higher level of capital (both physical and human) investment in developed nations, resulting in higher rates of productivity, implies that their unit labour costs

may be lower than in low-wage, less developed nations (Garrett, 2000:455). Therefore, unit labour costs may be a more preferable indicator to inward investors than the level of wages and/or non-wage costs per se.

Rigid regulation of the labour market is generally perceived to be a disadvantage for a nation seeking to attract FDI, and particularly so for those industries subject to a greater than average risk of failure, whereby exit costs from a particular market become increasingly important. Thus, many studies indicate that flexible labour markets characterised by low closure costs are significant attractors for FDI (Bentolila and Bertola, 1990; Cooke, 1997; Cooke and Noble, 1998; Görg, 2002; Haaland *et al*, 2003). Similarly, Dewit *et al* (2003) found that differences in employment protection between nation states is a significant determinant of FDI location, and that this effect increases the higher the cost associated with FDI; although this is partially tempered by the fact that domestic levels of employment protection discourages outward flows of FDI.

Not all studies, however, have discovered a statistically significant link between labour market regulation and job creation (Leonard and Schettkat, 1991). It is a stylistic fact that FDI tends to be higher in countries with stronger employment rights; Kucera (2002:63) suggests that this contradiction with the 'conventional wisdom' might derive from the fact that the non-wage advantages associated with these nations outweigh the dissuasive impact of higher labour costs. An alternative rationalisation focuses upon the differential risk of failure facing 'traditional' and 'innovative' firms, with the former more interested in entry costs and structural features of potential markets, whereas the latter may be more interested in exit costs due to their higher exposure to the risk of failure. Moreover, fact that the theoretical predictions that labour market rigidities impose resource costs is based upon the assumption of competitive markets, and therefore the recognition of the existence of market imperfections implies that certain forms of labour market regulation may have beneficial effects upon human capital investment and productivity (Addison and Teixeira, 2001:2-3).

Employment protection measures may, under certain circumstances, reinforce commitment and loyalty to the employing firm, and the subsequent reduction in labour turnover costs, together with the maintenance of a trained workforce, may offset the perceived disadvantages related to labour market rigidities. Indeed, whilst labour market flexibility is an advantage in attracting FDI in markets with no strategic interaction between firms, this is not necessarily the case where strategic interaction occurs (Dewit *et al*, cited in Haaland and Wooton, 2003).

In terms of industrial relations factors, the presence of trade unions tends to have an inconclusive impact, even though the relative weakness in trade union power is claimed to be amongst the UK's attractive features when seeking to attract FDI (Floyd, 2003). Similarly, the literature indicates that the institutional framework relating to wage formation significantly influences a nation's ability to attract FDI. Firm- or workplace-level wage

determination enables remuneration packages to be tailored to the specific characteristics of the firm and its competitive environment, such that a high-risk TNC would pay correspondingly lower wages due to this risk factor. This would suggest that decentralisation facilitates labour market flexibility and would enhance the attractiveness of a host economy to potential inward investors. However, the literature is not so clear cut in its conclusions.

Haaland and Wooton (2003:19), for example, argue that a similar effect could be secured through an increase in labour market flexibility, and particularly through a reduction in employment protection, thereby lowering potential redundancy costs for the high-risk firm. Consequently, employment regulation and wage formation may be perceived as substitutes, as well as complements, and therefore the existence of firm-level wage determination implies that the relative flexibility of the national labour market no longer remains a significant determinant for inward investment.

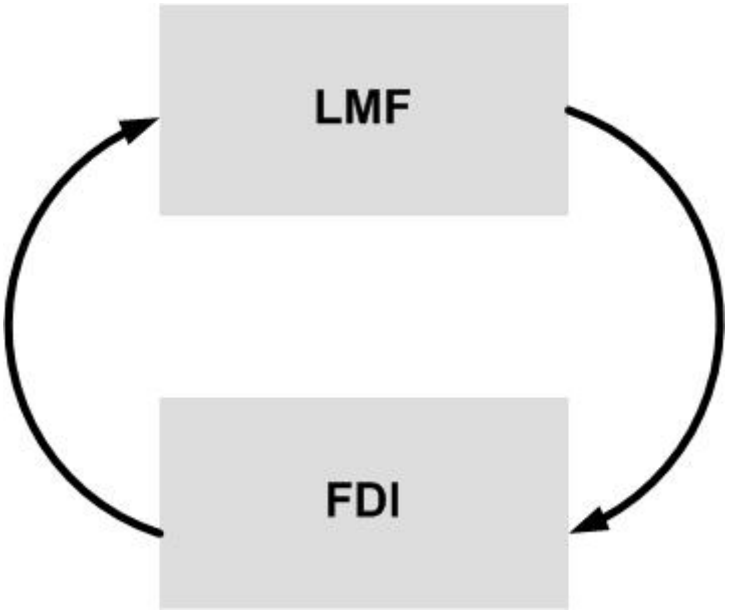
In addition, the sizeable corporatist literature demonstrates that *macro*, as opposed to *micro*, flexibility can be secured through co-ordinated, centralised wage bargaining, and has the potential to secure a slower rate of growth in aggregate real wages, reduce labour turnover (with associated reduction in recruitment costs and possible productivity impact) and industrial conflict (Cameron, 1984; Bruno and Sachs, 1985; Calmfors and Driffill 1988; Rowthorn and Glyn, 1990; Amoroso and Jespersen 1992,79-80). Furthermore, through negotiation of wages independently of productivity in individual workplaces, centralised wage bargaining may promote structural change, as high productivity plants are able to create jobs due to a lower wage rate than the marginal productivity of labour, whilst a low productivity plant will shed labour for the opposite reason (Salvanes, 1997).

The Impact of FDI upon the Labour Market

The introduction of long term inward investment into the host economy is likely to have a significant impact in a number of different areas. This includes the labour market. Thus, the degree labour market flexibility is likely over time to be influenced by FDI, in addition to it being one of the various determinants of its selection of a favourable location in which to cite its production facilities (see FIG 4). Thus, the technological and other competitive advantages inherent within FDI are likely to increase the productivity of skilled workers in the domestic sector, and in the process to increase the demand for skilled workers (and hence their wages) at the expense of unskilled workers (Barrell and Pain, 1997; Blomström, 1989; Driffield, 1999; Driffield and Taylor, 2000). For example, estimates suggest that the TNC-wage premium in the UK ranges between 3.4 per cent and 7 per cent (Driffield, 1996; Girma *et al*, 2001), whilst the productivity advantage over domestic companies approximates to 20 per cent (Davies and Lyons, 1991). This is likely to increase the industry-level skilled wage share (Figini and Görg, 1999; Taylor and Driffield, 2000). The literature

additionally suggests that the full effects of FDI are only experienced after approximately two years (Barrell and Pain, 1997; Figini and Görg, 1999).

Figure 4: Inter-relationship between labour market flexibility and FDI



Although FDI is associated with an increase in the skill intensity in host markets, approximately half of this relationship is considered to be due to the 'composition effect', whereby the distribution of TNCs is disproportionately skewed towards higher-skill industries (Davis and Lyons, 1991). Moreover, studies suggest that TNCs are unlikely to engage in training skilled workers, and prefer to recruit them from existing firms or rely upon ex-patriots (Driffield and Taylor, 2000). Consequently, it is unlikely that FDI, in and of itself, can solve problems of long term unemployment amongst unskilled workers.

TNCs can, additionally, directly influence government policy through utilising their influence as large employers and providers of inward investment, to lobby for a more favourable policy mix, whether this be in the area of reducing environmental regulations, reducing taxation and/or facilitating a greater degree of flexibility in the domestic labour market. One of the most notable examples of this overt lobbying behaviour in the UK, in recent years, relates to Toyota's vocal support for UK participation in the European single currency, whilst in Sweden a group of the largest companies threatened disinvestment in the domestic economy if the nation voted to reject EU membership and persisted with its high-spending, high-taxation fiscal policy (Whyman, 2003:158). Moreover, TNCs may use the possibility of disinvestment as a means to bargain with its workforce, trade unions and/or government, in order to obtain wage and other concessions (Streeck, 1992).

The policy relevance of this literature arises from the fact that FDI and labour market flexibility are inter-related, and therefore it is important for policy effectiveness to understand the nature of the effect that initiatives

made in one area of policy will have upon the other. It is insufficient to assume that all characteristics associated with FDI and labour market flexibility will have a positive association. It is perfectly possible that certain, low-risk types of FDI may prefer the combination of a less flexible labour market in terms of greater job security regulation and centralised wage formation. However, where higher exit costs, of which low risk firms are less interested, co-exist with lower aggregate real wage growth and reduced labour turnover, these may facilitate workplace training, leading to productivity gains. Similarly, there is significant disagreement amongst the literature over the degree to which labour costs are more important to potential FDI than more expensive, but higher quality labour.

The Study – Project Outline, Methodology, etc

The primary data collection pursued by this study seeks to contribute to the literature by extending the evidence relating both to the determinants of FDI and examining the impact that this inward investment has upon the domestic labour market. The study therefore seeks to examine the inter-relationships between these two features.

The study utilises a questionnaire which was circulated to 1,800 trans-national corporations, with existing production operations located in the UK. Due to time constraints involved in the collection and analysis of the data, this paper relies upon preliminary results based upon the initial tranche of responses to the questionnaire, rather than a complete and final data set. Survey responses were combined with financial data drawn from two financial datasets, FAME and Thomson Research, in order to facilitate comparative analysis with regard to company characteristics. The questionnaire utilised a combination of open and closed questions in order to combine standardised with less easily quantifiable data, in order to provide elucidation and greater emphasis upon those factors considered by the respondent to be particularly significant.

Employer surveys, although considered to be more subjective than data drawn from secondary sources, nevertheless contains information provided by business people who, presumably, are in the ideal position to denote those aspects of labour market flexibility that impact upon the location of FDI. Previous studies have tended to reply upon indexes derived from comparative surveys of employer attitudes relating to a variety of issues, including, for example, estimates of business competitiveness incorporated within annual *Global Competitiveness Report* (Porter et al, 2004).

Results

From the 1,800 questionnaires submitted, an error rate of 80 occurred associated with data imperfections in the database, together with a number of companies stating their policy to refrain from responding to any format requesting information, limited the effective sample. Given that the only data available for non-respondents is the financial data from the FAME and Thomson databases we do not consider this to be directly relevant to the

resulting survey data. Furthermore, given that our selection of companies was based on the magnitude of their financial statistics, non-respondents would, in all likelihood, been of a similar nature to respondents. Hence, overall we believe that any bias is unlikely, whilst the general findings described later in this report are similar to those found from previous studies. Consequently, the 60 companies comprising the initial tranche of respondents represent a response rate of 7.78 per cent. This has implications for the analysis and interpretation of this first tranche of data, together with the potential policy recommendations. However, given that the study was an exercise in primary data collection, together with the wide ranging nature of the survey which explored determinants of investment within the UK and associated labour market factors, the information gathered provides a unique insight into the underlying thought and decision-making process of large UK- and foreign-owned companies currently operating within the UK. Moreover, this weakness will be eliminated once the full respondent data set is analysed, and the results contrasted with this initial data set to determine the extent of any potential bias arising due to the incomplete nature of the analysis.

Corporate characteristics

The dataset derived from the responses to the questionnaire resulted in a sample of corporations with an average annual UK turnover of in excess of £603m and £1478m globally [QU5]. From this, reported mean profits were £88m (UK) and £317m (worldwide) [QU6]. The profit-turnover ratio favoured non-UK operations by a small margin (0.21 to 0.15), whilst the profit per employee was again remarkably close with only a £10,000 difference between the UK (£0.02m) and worldwide (£0.03m) figures. However, the global workforce employed by the respondent companies differed substantially with the mean UK labourforce of 4,432 dwarfed by the worldwide average figure of 11,752 [QU7]. Hence, in relation to worldwide operations, the UK accounted for some 40.8 per cent of turnover, 27.8 per cent of profits and 37.7 percent of employees.

Of the responding companies, approximately 73.2 per cent describe their corporate strategy as primarily based upon differentiation and/or high cost-high quality focus, rather than 21.4 per cent who indicate pursuit of a low cost strategy [QU12]. In relation to market focus, 75 per cent have adopted a primarily domestic production orientation, with only a quarter primarily producing for export [QU15]. In terms of technology, a mere 5.3 per cent identify their activities as involving the assembly of imported materials, whereas 31.5 per cent state that their UK activities involve a fully integrated production process, and 63.2 per cent claim that their activities in the UK involve all aspects of production, including research and development [QU14]. Finally, 15.5 per cent of the dataset identify their activities as involving high risk, cutting edge technology, with 60.3 per cent utilising moderate risk, established technology and 24.1 per cent lower risk, older established technology [QU13].

In relation to key issue of FDI, we sought to examine its intertemporal dimension in the medium-term of 5 years through seeking information regarding both the amount (£m) invested in the last 5 years [QU9] and

whether their investment programme is likely to rise or fall over the forthcoming 5 years [QU10]. From the sample as a whole, for the former question, the mean was £348m with a range as diverse from £0.5m to £11,900m. With regard to the future, opinion was evenly distributed at 51.9 per cent (rise) and 48.1 per cent (fall).

However, a somewhat different picture emerges once the sample is broken down by the three principal categories selected (sector, cost strategy and level of technological risk) as Table One illustrates.

Table 1: Trends in FDI by company characteristics

	Sector of economy		Cost strategy		Technological risk		
	Manufacturing	Service	Low	High	High / niche	Moderate	Low
% firms predicting FDI to rise	37.5	72.7	58.3	52.5	55.6	50.0	53.8
Average annual FDI (£m), 1999-04	169.7	651.4	172.5	407.6	1345.5	101.1	265.6

Table 1 indicates that the responses to both future intensions and past levels of FDI fluctuate with company characteristics. For this table as with those following, we do not show the 'net balance'. Given the two-option choice of answer to the question set, this can be simply calculated. A general degree of optimism is evident and relatively stable across both the cost strategy and technological risk classifications, with the potentially crucial exception of manufacturing. In contrast, the level of previous FDI displays considerable volatility. A clear dichotomy emerges within the sectoral break down with service sector firms having almost a four-fold high level of past FDI and being more optimistic regarding future FDI. A similar discrepancy occurs within the cost strategy classification, whilst the technological risk variable illustrates both expected and unexpected outcomes. The highest medium-term historical FDI is evident for high/niche technology firms, which may indicate the higher cost associated with this type of new technology. Alternatively, it may indicate the increased levels of replacement investment necessarily undertaken by those firms utilising older established technology, and/or that lower risk technology may be more embedded in the UK economy having been introduced in a previous time period. Irrespective of causation, the fact remains that higher risk firms report that they account for a disproportionate quantity of recent FDI flows into the UK.

Determinants of FDI

In order to estimate the relative significance of potential determinants of FDI, as identified in the literature, the questionnaire requested respondents to both rank and, using a five-point Likert scale, indicate the relative importance of a list of eighteen factors. Following UNCTAD (1998:91),

these sought to test the relative attractors assigned to the following groups of variables:

- ***market-seeking*** - i.e. size and growth rate of national market, part of large regional market
- ***resource-seeking*** – i.e. gaining access to natural resources, technology, and/or the quality of infrastructure (transport, communications, IT)
- ***asset-seeking*** – i.e. low-cost unskilled labour and/or highly skilled labour
- ***efficiency-seeking*** – i.e. related to the cost of resources such as access to borrowing facilities, labour resources, together with infrastructure factors
- ***business facilitation*** – provision of tax incentives (local, regional, national) and/or investment subsidies
- ***policy framework*** – stability of political and macroeconomic framework (low inflation), levels of taxation (general, corporate), degree of regulation (general, labour, environmental, etc) and the degree of flexibility in the labour market.

The questionnaire utilises three main questions to discover the relative importance of each of the eighteen variables, by, firstly, requesting respondents to place a weighting onto each of the eighteen variables, where a value of '5' represented high importance and '1' low importance (Table Two) [QU16]. Secondly, to identify the three most important attractors according to the respondent [QU17], and thirdly, to rank all eighteen factors in terms of their significance in attracting inward investment (Table Three) [QU18]. Additionally, there are a number of interesting features that arise when considering the *relative* rankings and/or weightings respondents gave to individual factors when the overall sample is disaggregated by the selected group of company characteristics (technological risk, cost strategy and sector) to which the firm is exposed. Thus, complimentary factors emerge as important in addition to the general presence of the key overall drivers.

To discuss this breakdown of the analysis in the following discussion, we describe the prime factor as being the 'first-level' determinant and those ranked 2nd-5th and 'second-level' variables when examining the outcome for the sample as a whole. The decision to use such classifications followed our preliminary review of the findings, where it quickly became obvious that, for example, market demand factors consistently possessed a strong relationship with investment etc. Hence we wished to separate these from the following and often more varied series of determining factors, which we labelled as second-level variables. Indeed, the sub-samples based on company characteristics frequently reveal 'third-level' features, of which some will score more highly than either the overall first- and second-level determinants. Where this occurs these are highlighted in 'bold' within the tables. These third-level drivers are identified as the subsequent five factors for each category of the sub-sample of company characteristics. Although these will vary between categories, in practice we find a significant degree of overlap. These illustrate the important nuances when company characteristics are considered in greater depth, which are vital to develop a

comprehensive understanding of the trigger mechanisms of inward investment.

Table 2: Top 5 determinants of investment in the UK

	Frequency (%)						
	1	2	3	4	5	Mean	SD
Size of national market	1.8	7.0	8.8	15.8	66.7	4.39	1.03
Flexible labour market	12.3	8.8	19.3	40.4	19.3	3.46	1.25
Growth rate of national market	10.5	17.5	29.8	24.6	17.5	3.21	1.24
Stable & favourable political climate	12.3	19.3	29.8	26.3	12.3	3.07	1.21
Quality of infrastructure	10.5	21.1	33.3	24.6	10.5	3.04	1.15

The responses given to all three questions identify the size of national market-demand to be the most significant factor. It received an average score of 4.39 with 66.7 per cent of respondents ascribing the value of '5' to this factor [QU16]. Moreover, this factor was chosen by fully 72.7 per cent of respondents to be the primary determinant of FDI from an open question format [QU17], and ranked 1st in terms of all eighteen labour market variables by 62.5 per cent of all respondents (Table Three) [QU18].

Table 3: Top 5 ranked determinants of investment in the UK

	Mean	SD
Size of national market	2.75	3.63
Growth rate of national market	6.10	4.78
Flexible labour market	6.68	4.39
Highly educated & skilled labour force	6.98	4.21
Quality of infrastructure	7.19	4.18

Second-level factors included other market-seeking factors, related to the growth rate of the national market and location geographically near to a large international market, together with resource-seeking factors relating to the quality of infrastructure and asset-seeking labour market variables relating to the degree of flexibility in the labour market, with particular respect to the level of regulation and job protection, and the relative degree of highly educated and skilled labour force [QUs16,17]. Indeed, labour market flexibility was identified as representing moderate or high degrees of importance when considering the allocation of FDI by 59.7 per cent of respondents [QU16].

Table 4: Determinants of investment in the UK (risk in technology)

		Level of risk in technology		
	Total sample	High	Moderate	Low
First-level				
Size of national market	4.39	4.44	4.50	4.07
Second-level				
Flexible labour market	3.46	3.33	3.56	3.29
Growth rate of national market	3.21	3.22	3.24	3.14
Stable & favourable political climate	3.07	2.78	3.15	3.07
Quality of infrastructure	3.04	3.22	2.97	3.07
Third-level				
Highly educated & skilled labour force	3.02	3.89	3.00	2.50
Location near large international market	2.21	3.00		
Prefer deregulated market	2.89	2.67	2.91	3.00
Low levels of corporate taxation	2.95	2.44	3.00	3.14
Low cost of borrowing	2.61	2.33	2.71	2.57
Few environmental regulations	2.16	2.33		
Low levels of general taxation	2.60		2.71	2.64

Other third-level (less significant) elements included tax incentives to attract inward investment, access to raw materials, macroeconomic policy (including the nature of the exchange rate regime), regulations (general and environmental), the cost of labour, and, most interestingly, location within the European Union single market, were deemed to be relatively unimportant as attractors for FDI [QUs16,17].

Following this general analysis, we then proceeded to disaggregating these results to ascertain whether respondents prioritise determinants of FDI differently according to various company characteristics, sector, its associated degree of technologically-induced risk, together with its adopted competitive strategy.

Table 5: Ranked determinants of investment in the UK (risk in technology)

		Level of risk in technology		
	Total sample	High	Moderate	Low
First-level				
Size of national market	2.75	4.38	2.79	1.39
Second-level				
Flexible labour market	6.10	7.38	5.75	5.50
Growth rate of national market	6.68	6.63	6.80	5.82
Highly educated & skilled labour force	6.98	6.00	7.18	7.64
Quality of infrastructure	7.19	6.88	7.56	6.64
Third-level				
Location near large international market	8.06	7.88	6.93	
Stable & favourable political climate	7.48	8.14	7.15	8.27
To gain access to a natural resource or national technology	10.11	8.25		
Prefer deregulated market	9.20	9.50		6.91
Low levels of corporate taxation	7.88	9.88	8.07	5.83
Low cost of borrowing	8.44			8.15
Low levels of general taxation	9.36		8.73	
National economy has history of low inflation	9.15		8.92	8.27

When evaluating the weightings ascribed to the eighteen variables by degree of technologically-induced risk (Tables Four and Five), the absolute preferences for national market-demand variables persists. However, there is a noticeable preference for high-risk companies to place greater emphasis upon the quality of national labour force skills base and physical infrastructure, together with the significance of location near a large international market. Companies exposed to moderate degrees of risk are relatively predisposed to primarily national factors, such as size of national market, a stable political and economic policy framework, together with low costs of capital and low rates of taxation. Low risk companies appear to be markedly less concerned about worker skill levels and more about national policy-related issues, including the level of national market-demand, degree of deregulation and rates of corporation tax. Thus, it would appear that firms subject to higher risk rely more heavily upon skilled employees, presumably within a more flexible-specialisation production format, and are less influenced in their location decisions by national market and government policy factors. Lower risk enterprises, by contrast, are more interested in national market-demand and policy-related factors.

Examining the significance of corporate competitive cost strategies, a similar pattern emerges, whereby low-cost firms were disproportionately concerned about national market-demand (level and growth rates), the quality of infrastructure, corporate taxation and the low cost of labour (Table Six).

Table 6: Determinants of investment in the UK (cost strategy

	Total sample	Base of competitive strategy Low	Niche/high
First-level			
Size of national market	4.39	4.42	4.35
Second-level			
Growth rate of national market	3.21	3.50	3.09
Flexible labour market	3.46	3.25	3.49
Highly educated & skilled labour force	3.02	2.50	3.12
Quality of infrastructure	3.04	3.33	2.91
Third-level			
Low levels of corporate taxation	2.95	3.42	2.77
Stable & favourable political climate	3.07	3.08	2.98
Low cost of labour	2.39	2.75	
Low levels of general taxation	2.60	2.67	2.56
Prefer deregulated market	2.89	2.64	2.88
Low cost of borrowing	2.61		2.56

However, firms pursuing a differentiation-niche strategy were particularly interested in a highly educated and skilled labour force, together with an environment characterised by the political climate, low levels of regulation and corporate tax [strategy + QUs16,18].

Table 7: Determinants of investment in the UK (sector)

	Sector of economy Manufacturing	Service
First-level		
Size of national market	4.46	4.27
Second-level		
Flexible labour market	3.66	3.14
Growth rate of national market		3.41
Highly educated & skilled labour force	3.26	
Quality of infrastructure		3.18
Low levels of corporate taxation	3.14	
Prefer deregulated market		2.67
Stable & favourable political climate	3.11	

In relation to the sectoral division between manufacturing and service companies the predominant determinants of investment are similarly size of means for the national market (4.46 and 4.27), labour market flexibility (3.66 and 3.14). However, several other factors, albeit to a slightly lesser extent, emerge as import drivers of FDI. For manufacturing firms these include a highly educated and skilled labour force (3.26) and low levels of corporate taxation (3.14) and a stable and favourable political climate (3.11), whilst for service sector companies they include the quality of infrastructure (3.18) and the preferment of a deregulated market (2.67) [QUs8,16] (Table Seven).

Table 8: Ranked determinants of investment in the UK (sector)

	Sector of economy	
	Manufacturing	Service
First-level		
Size of national market	2.45	3.29
Second-level		
Flexible labour market	5.77	8.44
Highly educated & skilled labour force	6.10	
Growth rate of national market	6.58	
Quality of infrastructure	6.74	8.06
Low costs of borrowing		8.22
Location near large international market		8.38

When examining the ranking of investment determinants, three similarities emerge in relation to the size of national markets, labour market flexibility and the quality of infrastructure. However, differences are also apparent with the importance of labour being highly skilled and educated perhaps unsurprisingly being a key driver for manufacturing [QU18] (Table Eight).

Chi-squared tests are utilised to measure the strength of association between the eighteen potential determinants of inward investment [QU16] into the UK and various forms of company characteristics (Table Nine). In relation to deviation from the expected equal distribution of responses, significant variation is demonstrated across the three disaggregated classification of characteristics of competitive strategy base, level of technological risk and sector. For the overall sample fifteen of the eighteen determinants are found to deviate statistically significantly from an equal distribution of responses, which is only surpassed by niche/high costs firms. The other categories demonstrating statistically significant results for at least half of the determinants are moderate level of technology (twelve), manufacturing (twelve) and services (nine). In contrast, a very rate of statistical deviation is evident for companies exhibiting either a low (five) or high (one) level of technology.

Viewing Table Nine horizontally reveals several noticeable patterns emerging from these tests. Firstly, that the size of the national market (product demand) is highly significant across all categories, with the exception of high cost base firms. This reinforces the findings in the other illustrated tables whereby this determinate of FDI is consistently the dominant 'first-level' driver. Secondly, in contrast, two hypothesised FDI determinants (growth rate of national market and low costs of borrowing) are statistically insignificant across all company characteristics. This, however, does not indicate that they play no part in contributing in the FDI decision-making process, rather given our sample there is no significant deviation away from a near even distribution of of responses. Thirdly, in a number of cases three significant factors are found with two being consistent in all instances (total sample and niche/high costs), whilst the third factor varies between moderate level of technology and manufacturing. Fourthly, there appears to be a strong association between six of the eighteen FDI determinants and either the statistical insignificance or weak significance (i.e. 10%) of three company classifications (low cost

strategy, together with high and low levels of technology). Finally, the issue of exchange rate regime, the of preference for either fixed or floating systems reveals a considerable change in the level of significance for several company types (low cost strategy, moderate level of technology) and from insignificance to strong significance for manufacturing.

Table Nine – Chi-squared tests

		Base of competitive strategy		Level of risk in technology			Sector of economy	
	Total	Niche/high	Low	High	Moderate	Low	Manufacturing	Services
Product Demand	80.456***	33.744***	16.000***	4.667*	34.471***	17.429***	36.429***	27.091***
Location near large international market	20.429***	16.095***	7.333*	3.000	13.647***	4.769*	10.000**	15.381***
Growth rate of national market	6.246	5.953	1.333	0.444	7.176	1.714	5.143	3.909
National economy has history of low inflation	16.246***	12.233**	2.667	2.111	13.941***	6.000	6.571	5.273
Low costs of borrowing	6.070	5.953	2.167	3.778	5.118	3.857	3.429	4.818
Quality of infrastructure	10.807**	13.628***	1.333	2.111	7.765	2.429	12.571**	4.364
Stable & favourable political climate	7.298	9.907**	.500	3.778	6.294	3.857	5.429	3.909
Low levels of general taxation	19.754***	13.628***	2.000	1.222	11.000**	4.857	12.571**	9.364*
Low levels of corporate taxation	14.316***	18.047***	2.167	1.222	9.529**	6.000	15.714***	6.182
Local (regional) tax incentives to encourage FDI	43.107***	36.810***	11.333**	2.111	25.118***	10.077**	27.714***	16.381***
To gain access to a natural resource or national technology	50.364***	41.317***	1.500	0.000	41.882***	7.333*	30.857***	14.800***
Prefer deregulated market	13.963***	12.049**	5.818	2.111	2.063	2.923	14.424***	3.048
Few environmental regulations	23.821***	18.000***	6.000	.333	15.333***	4.857	11.882**	12.545**
Low cost of Labour	12.852**	13.250***	1.333	3.778	6.750	2.692	6.848	3.571
Highly educated & skilled labour force	13.439***	14.558***	0.000	.667	11.000**	0.286	20.286***	8.000*
Flexible labour market	17.123***	17.814***	3.000	1.556	11.882**	8.857*	16.857***	3.909
Prefer fixed exchange rate	21.434***	14.250***	8.545*	3.000	9.563**	8.000**	5.187	14.238***
Prefer floating exchange rate	39.170***	20.829***	9.800***	3.000	20.188***	9.500***	24.250***	14.952***

Where: *** = $p < 0.01$ ** = $p < 0.05$ * = $p < 0.1$

In conclusion, this section indicates that national market-demand factors are therefore viewed by respondents to be the most significant factors in attracting FDI, whilst labour market flexibility, the skill profile of the labour force, the quality of the national infrastructure together with the degree of political stability, are all second-level attractors. However, there are important divergences in emphasis, at the margin, between companies exposed to different degrees of risk, adopting diffuse corporate strategies and even in so far as the probability whereby they are likely to increase investment in the UK in the next five years. High risk, differentiation companies are less likely to be overwhelmingly reliant upon the UK market. Thus though national market-demand remains the predominant factor for this group as elsewhere in the sample, it is the quality of infrastructure, access to international market-demand and, in particular, the education and skill level of the labour force that disproportionately influence FDI decisions. Low risk, low cost, firms, by contrast, are more interested in national market-demand and policy-related factors.

Evaluation of labour market factors

Focusing specifically upon labour market factors, 61.4 per cent of all respondents identified labour market flexibility as a “very important” or “vitally important” determinant of FDI, although responses followed the earlier pattern of identifying this as a second-level factor, with twice as many individuals preferring the lesser characterisation of importance [QU22]. Nevertheless, 30.5 per cent of respondents stated that labour market regulation imposed a large cost upon their business, with 62.7 per cent indicating a more moderate impact [QU29]. Attempting to quantify the reduction in costs that could be secured via a more flexible labour market, respondents suggested an average of 15.4 per cent of variable, and 12.7 per cent of total, costs [QU23]. Consequently, irrespective of whether labour market issues are second-level in terms of relative importance, their *perceived* potential absolute benefit to the companies concerned is most significant.

Disaggregating the constituent elements related to labour market flexibility, respondents assigned the greatest weight towards the availability of a highly skilled and educated labour force, functional flexibility, numerical flexibility (in terms of both time and non-standard employment) and low levels of employment regulation [QU21]. This is illustrated in Table Ten. Wage-cost and industrial relations factors were considered to be less significant factors, whether relating to wage flexibility, the ease of introduction of pay incentives, form of wage formation, ease of operating HRM policies, the balance of labour relations laws benefiting employees and the potential to develop a favourable relationship with trade unions.

Table 10: Top 5 features of labour market flexibility for FDI

	Frequency (%)						
	1	2	3	4	5	Mean	SD
Availability of highly skilled / educated workforce	1.8	16.1	17.9	26.8	37.5	3.82	1.16
Flexibility in work context	1.8	5.5	23.6	49.1	20.0	3.80	0.89
Flexible use of work time	3.7	5.6	29.6	35.2	25.9	3.74	1.03
Low levels of employment regulation	7.4	7.4	25.9	24.1	35.2	3.72	1.23
Ease of use of non-standard employment	1.9	13.0	29.6	25.9	29.6	3.69	1.10

The weakest elements of a flexible labour market in terms of attracting FDI, relate to the creation of work incentives for the unemployed, whether through 'pull' factors such as provided through intensified job search services, improved pay via tax credits and a minimum wage, or 'push' factors related to the shortening of the duration of benefits, reduction of the replacement ratio and intensification of requirements placed upon unemployed individuals to actively seek work. This is perhaps not particularly surprising since TNCs place the importance of a skilled labour force at the top of their list of requirements and equate their own production strategy more closely with the type of differentiated-focus strategy, which relies upon skilled, multi-tasking employees, than low cost strategies that may employ traditional 'Fordist' techniques of employing unskilled and semi-skilled operatives. However, this finding tends to raise questions relating to whether the attraction of FDI is particularly appropriate for regional development in so far as directly tackling stubborn, long term unemployment, rather than playing an indirect role through attracting new, highly paid jobs to an area. An influx of FDI may facilitate the rise in regional aggregate demand, pulling additional jobs into the area, many of which may be more suitable for the skills base of the long term unemployed which tends to be lower than in the employed population as a whole.

When asked to prioritise labour market factors in terms of their significance in attracting FDI, respondent selections reinforced the earlier results [QU32]. The importance of a highly trained, skilled labour force emerged as the most significant factor, which reinforced the findings from a number of supplementary questions in the survey [QUs24,37]. Indeed, fully 42 per cent of respondents selected this factor as their prime labour market attractor for FDI [QU32]. One aspect of numerical flexibility, namely the flexible use of working time, was ranked the second most significant determinants of FDI, and yet, intriguingly, other aspects of numerical flexibility, including labour mobility and the ease of use of non-standard employment, were considered to be of relatively little importance. Third ranked elements of labour market flexibility were identified as functional flexibility, via facilitation of multi-skilling and reduction of demarcation in the workplace, together with a greater flexibility in terms of employment protection regulation. In terms of the remaining factors, wage flexibility is ascribed more significance in this question in the survey to elsewhere, but this is pretty consistently in terms of individual respondents ranking it outside of their top three

selections. Consequently, there does appear to be a consistent pattern arising from responses to the survey, where a more functionally and numerically flexible, highly skilled labour force is deemed to be more significant for a majority of inward investors than the degree of wage flexibility, state of industrial relations, form of wage formation, use of incentive pay and other aspects of wage-cost flexibility. Once again, government policy to provide incentives for the unemployed to seek work might be considered to be significant in terms of creating overall labour market flexibility, but it has little value as an attractor for FDI.

Table 11: Features of labour market flexibility for FDI (risk in technology)

		Level of risk in technology		
	Total sample	High	Moderate	Low
First-level				
Availability of highly skilled / educated workforce	3.82	4.89	3.73	3.38
Second-level				
Flexibility in work context	3.80	3.88	3.79	3.85
Flexible use of work time	3.74	3.38	3.88	3.67
Low levels of employment regulation	3.72	3.63	3.79	3.75
Ease of use of non-standard employment	3.69	3.88	3.76	3.50
Third-level				
High degree of labour mobility		3.50	3.00	
Relatively easy to operate HRM policies		3.50	3.00	2.91
Wage flexibility		3.25	3.33	3.17
Relatively easy to introduce incentive pay		3.25	3.21	3.23
Low non-wage costs		3.00	3.45	3.25
Favourable relationship with trade unions			3.00	
Balance of industrial relations laws beneficial to employers				3.42

A further disaggregating is undertaken in accordance to the level / type of technology utilised by companies [QU 13], which is classified as being: (a) high risk, cutting edge technology, (b) moderate risk, established technology and (c) low risk, older (very established) technology. We assume, *a priori*, that each of these different types of technology require differing levels of FDI and will be triggered by different factors. In relation to the level of risk in technology, high-risk firms appear to be disproportionately favourable towards the availability of a skilled workforce, together with a high degree of labour mobility. They additionally display a greater preference for decentralised or individual wage bargaining than other company types, favour the ease of operations of HRM policies, numerical flexibility through the utilisation of non-standard employment, and flexible allocation of working time (Table Eleven).

Medium risk firms tend to favour labour market deregulation, numerical flexibility through the use of work time, low non-wage costs and the establishment of a favourable relationship with trade unions. Low risk companies have little enthusiasm for skills although they do profess an atypical interest in functional flexibility through the introduction of multiskilling in the workplace, but prefer the deregulation of the labour

market, the establishment of industrial relations laws that favour employers together with wage flexibility [QUs13,21,32].

Adding consideration of company strategies, low-cost firms tended to prefer labour market deregulation, numerical (working time) and functional flexibility, together with registering an interest in working with 'partnership' forms of trade unionism (Table Twelve). Differentiation-niche firms, by contrast, tend to prioritise the quality of a skilled labour market above all other factors, although they are predisposed towards preferring numerical flexible through labour mobility and the exercising the potential for individual pay setting.

Table 12: Features of labour market flexibility for FDI (cost strategy)

		Base of competitive strategy	
	Total sample	Low	Niche/high
First-level			
Highly trained labour force	4.34	5.91	3.73
Second-level			
Flexible use of working time	4.59	3.91	4.64
Flexible employment protection regulation	5.88	5.64	5.97
Ease of introducing multi-skilling in the workplace	5.88	4.73	6.00
Wage flexibility	6.46	6.50	6.29
Third-level			
Flexible dismissal protection regulation		6.45	6.69
Ease of use of incentive pay		7.40	
Ease of use of non-standard employment		8.00	
Low non-wage costs		8.36	7.78
'Partnership' forms of trade unionism		8.63	
Ability to set individual pay – without bargaining with a trade union			6.08
Decentralised wage bargaining – at firm or workplace level			7.11
Labour mobility – within the economy			7.54

Disaggregating the data by company characteristics of operating sector, however, reveals little difference from the overall prioritising in relation to labour market factors. For manufacturing companies there is only a marginal reordering of the relative degree of importance, with no single factor emerging with greater strength than the sample as a whole. In contrast, for service sector firms the presence of flexible dismissal protection regulation was ranked within their top 5 factors regarding labour market flexibility, whilst the issue of introducing multi-skilling in the workplace was outside their top 5 drivers.

Furthermore, 72 per cent respondents identify the level of entry costs to be more important as a determinant of FDI than exit costs [QU25], however, no correlation is apparent between the probability of expressing this preference and the self-identified level of technological risk inherent within the company concerned.

Interaction between FDI and labour market flexibility

To examine the issue of human resource practices within their own companies, respondents were asked to identify significant areas of non-standard employment. Table Thirteen illustrates the proportion of firms and the average percentage of employees within various categories. This combined analysis permits the examination of numerical flexibility, whereby it is possible to identify both the breadth and depth of the adoption of non-standard contracts.

Table 13: Human resource practices

		% of employees	
	% of firms	Mean	SD
Part-time	68	8.01	13.07
Temporary contracts	47	4.28	4.59
Agency workers	48	4.97	4.88
Short, fixed-term contracts	35	3.76	5.26
Franchising	10	0.33	0.82
Variable (or zero) hours contracts	15	11.11	19.45
Sub-contracting	22	8.19	13.25
Consultants	22	2.30	2.84
Freelance	13	2.38	2.56
Outworkers, Home workers	15	3.56	4.13
Teleworking	12	1.50	2.40
Seasonal working	22	4.81	6.08

Firstly, in terms of the utilisation by companies of non-standard employment practices, the more established formats of part-time, agency workers, temporary contracts and short/fixed-term contracts are predominate with at least one-third of respondents citing them. However, the two largest types of non-standard employment are variable hours contacts and sub-contracting, although these are only adopted by 15 per cent and 22 per cent of firms respectively [QU33].

A second point arising from Table Thirteen relates to the relatively low levels of part-time working and other forms of non-standard contracts declared by respondents relative to the higher rates found in the Labour Force Survey. One reason for this result may relate to the fact that, typically, TNCs demonstrate less interest than domestic UK firms in utilising non-standard working arrangements to deliver internal labour force flexibility (Morley et al, 1995).

Respondents were relatively split over their categorisation of utilising the 'flexible firm' model to describe their companies' organisation. According to this approach, a firm is characterised as 'flexible' if the workforce is split into 'core' and 'peripheral' employees, with the former receiving permanent contracts and being treated as almost fixed costs, whereas the latter tend to receive non-standard contracts (i.e. part-time, casual, zero-hours, agency employees, consultants) and who provide most of the flexibility required in terms of the labour time, cost and length of employment. Thus, 44.6 per cent of respondents identified their companies with the 'flexible firm' model [QU34]. However, when asked to

identify the proportions of 'core' and 'peripheral' workers, respondents suggested an 82.3 per cent against 18.6 per cent split [QU35]. This evidence, together with the data generated elsewhere in the survey [i.e. QU33], implies that, whilst numerical flexibility is deemed to be important for half of the respondent companies, the potential gains are concentrated to a relatively small number of employees.

Fully 90.9 per cent of respondents claimed to utilise incentive pay in their organisation, with these companies split two-to-one in favour of all employees receiving an element of incentive award, rather than restricting such schemes to management grades [QU27]. In terms of its significance, 56 per cent of companies claimed that incentive payments accounted for in excess of 5 per cent of total wages, with 22.8 per cent stating that such schemes represented more than 10 per cent of their total wage bill [QU28]. These results are interesting since the relative ease of introducing incentive schemes for employees was identified as being of only moderate or average importance [QU21].

In terms of wage formation, 68.5 per cent of respondents stated that their firm preferred to establish a reward structure according to internal requirements to incentivise employees and support HRM strategy, rather than setting pay according to national labour market objectives to pay the 'going rate', secure sectoral industrial peace, promote national competitiveness and macroeconomic goals including low inflation [QU26]. Moreover, 48.2 per cent of respondents stated that their firm preferred setting wages based upon task or position irrespective of the country in which the employee found themselves, as opposed to 33.9 per cent who accounted for national variations in the cost of living and paid according to the "rate for the job", whilst the remaining 17.9 per cent preferred to prioritise the minimisation of wage costs [QU36].

The micro-flexibility created by decentralised (firm or plant-level) wage bargaining is preferred by an overwhelming proportion (93 per cent) of respondents to more co-ordinated wage bargaining, even if the latter delivered more moderate wage growth [QU39]. This answer is perhaps not surprising, but due to the disagreement in the literature relating to whether co-ordinated or decentralised wage formation delivers superior macroeconomic outcomes, this warrants further investigation to discern whether this may be a case where micro-flexibility conflicts in some manner with macro-flexibility.

The relative insignificance of wage flexibility as a human resource policy pursued by respondent companies is demonstrated by 42.4 per cent prioritising utilising quality training programmes to increase productivity and thereby lower unit costs, with 26.3 per cent and 23.7 per cent preferring numerical and functional flexibility respectively, to lower unit costs, and only a residual 8.8 per cent advocating the reduction of unit costs through lowering of labour costs directly, either through downsizing or reductions in remunerations [QU37]. Indeed, when asked to make a straight choice between lowering labour costs and lowering unit costs through raising productivity, 96.6 per cent of respondents selected the latter option as identifying the current practice of their firm [QU38].

Conclusion and Policy Recommendations

This paper has generated primary data, direct from senior executives of TNCs that have invested in the UK, which indicates that the primary determinants of FDI flows relate more strongly to market-seeking factors, followed by resource- and asset-seeking labour market variables. Although not the most important attractor for inward investment, labour market flexibility was nevertheless identified as representing moderate or high degrees of importance by 59.7 per cent of respondents.

Disaggregating the data and testing for association with various company characteristics identifies a number of interesting features of the data. Firstly, small but notable differences in emphasis appear to exist between companies utilising high risk technology upon the quality of national labour force skills base and physical infrastructure, together with the significance of location near a large international market, compared to moderate and lower cost firms who tend to demonstrate a relative predisposition towards primarily national factors, such as size of national market, policy-related variables, including deregulation, tax rates, and the maintenance of a low cost of capital. The similarity between high risk firms and those companies utilising a differentiated-niche strategy is close, although incomplete, as most respondents identified their enterprises having a moderate level of risk whilst the majority also adopted differentiation-niche strategies, therefore necessitating a substantial over-lap between categories. Thus, it would appear useful for government policy to seek to identify the preferred profile for those firms considering investing in the UK, before determining which factor will prove the most attractive to the potential investor.

Examining those characteristics that form the basis for labour market flexibility, this paper has found that respondents identified the existence of a highly trained, skilled labour force as the primary labour market attractor for FDI, followed by elements of numerical flexibility, namely the flexible use of working time and labour mobility, functional flexibility, via the facilitation of multi-skilling and reduction of demarcation in the workplace, together with employment protection regulation and wage flexibility. Thus, these are the elements of labour market flexibility that governments should concentrate their resources upon to maximise the inward flow of FDI. The promotion of a high skilled workforce benefits all companies, but disproportionately favours high risk, differentiation-niche firms, whereas the benefits arising from numerical and functional flexibility are more evenly spread throughout the various clusters of companies analysed in this paper.

A number of features arise from the analysis, however, relating to government policy. Firstly, it is important for policymakers to keep in mind the fact that labour market flexibility is not a single phenomenon, but rather is an agglomeration of multiple individual characteristics, many of which have the potential to conflict with each other in practice. Moreover, respondents have indicated that it is only with certain of these

characteristics that they are primarily concerned. Thus, there exists a clear potential for a degree of misdirection inherent within policy reforms intended to promote FDI by strengthening the less significant aspects of labour market flexibilisation. For example, whilst the introduction of 'push' and 'pull' initiatives to incentivise the unemployed to seek work may be justified on the grounds that this may facilitate a reduction in unemployment and thereby is warranted as part of an overall flexible labour market strategy, it is of little significance in terms of attracting FDI. Similarly, factors including the cost of labour, wage flexibility, utilisation of incentive pay, industrial relations restrictions upon trade union activity and the decentralisation of wage bargaining act as relatively weak attractors for FDI.

This conclusion is reinforced by the data concerning how the investing companies treat labour market issues once they have located in the UK economy, through their overwhelming prioritisation of competition via lowering unit costs through training and productivity gains, rather than forcing down costs and wages per se. Numerical and functional flexibility, according to this analysis, are of intermediate significance [QUs37,38].

In relation to alternative forms of non-standard employment adopted by the firms, our survey indicated that these remain confined to orthodox measures, whilst the average proportion of employees rarely rises above 5 per cent. Hence there appears little evidence of a wide spread utilisation of numerical flexibility beyond established formats.

It would therefore appear that inward investors behave in a relatively consistent manner to their expressed preferences relating to those factors in the UK labour market that first attracted them to locate in the country, and which they themselves pursue in practice. Firms are typically concerned about the quality of their employees, the ability to pursue functional and numerical flexibility, where necessary, and prioritise internal pay setting over national labour market interests.

Two additional points to arise out of the survey that have some utility for policymakers include, firstly, the fact that only 13.3 per cent of the respondents acknowledge use of indexes, produced by the ILO and OECD, comparing the relative competitiveness of national economies and/or the relative flexibility of national labour markets [QU19]. Thus, although the provision of one source of information for policymakers, a movement in the 'league table' will not directly influence FDI flows, but only as a reflection of economic fundamentals and as an *indirect* influence upon the perceptions of leading business executives involved in determining the investment patterns in their company.

Secondly, when asked their perceptions of the UK's labour market, 69.8 per cent of respondents stated that it is characterised by a lower level of employment regulation than other EU economies, however a similar number (67.3 per cent) believe there to have been a deterioration in the degree of labour market flexibility since 1997, with only 21.2 per cent suggesting that circumstances have improved over this period [QUs30,31]. This is clearly not an objective measure, and many other

indexes may suggest that little or no deterioration has in fact occurred. However, the expectations and perceptions of businesspeople are significant determinants of the future development of investment flows and economic success in general. Therefore, policymakers should embrace this as a challenge to focus upon the most productive elements of labour market flexibility to facilitate enhanced future inward investment flows.

Finally, in relation to avenues of further study, this unique primary data questionnaire has provided a number of insights relating to the thought and decision-making process of trans-national corporations, with existing production facilities located within the UK. From both the overall sample and the sub-samples based on company characteristics, it indicates those drivers that act as significant attractors to FDI. In relation to the previous literature, it suggests that there are a relatively small number of central factors that strongly determine investment undertakings, whilst a large number of hypothesised variables appear to possess little influence. Hence, it raises as many questions as it answers and therefore would provide a useful foundation upon which to undertake subsequent research seeking to examine in greater depth the identified key issues. For example, a follow-up study may seek to determine more precisely what type of skill and education firms prefer, namely whether this relates to in-house training, state education and/or government sponsored college-based generic training programmes. Similarly, interest in the quality of infrastructure could be more precisely delineated in terms of physical transport links or communications networks. Corresponding in-depth analysis would be feasible for the other key factors highlighted by this study.

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Appendix 1:

Determinants of FDI – A Summary of the Literature

Variables	Measurement Parameters	Value	Authors
Firm size	Assets	Positive	Kim and Lyn (1987), Ratnayake (1993), Driffield and Munday (2000), Horst (1972), Juhl (1979), Sleuwagen (1985), Grubaugh (1987), Terpstra and Yu (1988), Yu (1990), Blomstrom and Lipsey (1991), Jeon (1992), Li and Guissinger (1992), Breumenhjelm and Svensson (1996), Belderbos and Sleuwagen (1996), Louri et al (2000)
	Sales		
	Employees		
International experience		Positive	Ratnayake (1993), Terpstra and Yu (1988), Yu (1990), Breumenhjelm and Svensson (1996), Pfaffermayer (1996). Louri et al (2000)
Technological advantages	R&D	Positive	Kim and Lyn (1987), Kumar (1990), Ratnayake (1993), Driffield and Munday (2000), Kogut and Chang (1991), Pugel et al (1996), Anand and Kogut (1997), Kuemmerle (1999), Lall (1980), Sleuwagen (1985), Grubaugh (1987), Yu (1990), Blomstrom and Lipsey (1991), Breumenhjelm and Svensson (1996), Belderbos and Sleuwagen (1996), Pfaffermayer (1996),, Rabanal (2001)
	Expenditure/sales		
Marketing and product differentiation advantages	Advertising Expenditure/sales)	Positive	Kim and Lyn (1987), Kumar (1990), Ratnayake (1993), Driffield and Munday (2000), Pugel et al (1996), Anand and Kogut (1997), Lall (1980), Sleuwagen (1985), Yu (1990), Belderbos and Sleuwagen (1996), Rabanal (2001)
Host country size	GDP	Positive	Scarpelanda and Balough (1983), Root and Ahmed (1979), Schneider and Frey (1985), Coughlin et al (1991), Wheeler and Mody (1992), Koechlin (1992), Cheng and Kwan (2000), Veugelers (1986), Culem (1988), Martín and Velázquez (1996), Grosse and Trevino (1996), Liu et al (1997), Kuemmerle (1999), Terpstra and Yu (1988), Yu (1990), Li and Guissinger (1992), Breumenhjelm and Svensson (1996)
Host country wealth	GDP per capita		
Host country dynamism	GDP growth rate		
Labour costs		Negative	Schneider and Frey (1985), Coughlin et al (1991), Koechlin (1992), Yang et al (2000), Cheng and Kwan (2000), Culem (1988), Liu et al (1997)
Geographical or cultural distance		Negative	Koechlin (1992), Veugelers (1986), Grosse and Trevino (1996), Liu et al (1997), Yu (1990), Li and Guissinger (1992), Breumenhjelm and Svensson (1996),
Economic uncertainty	Inflation	Negative	Schneider and Frey (1985), Yang et al (2000)
Country risk		Negative	Root and Ahmed (1979), Schneider and Frey (1985), Yu (1990)
Infrastructure		Positive	Root and Ahmed (1979), Coughlin et al (1991), Wheeler and Mody (1992), Chang and Kwan (2000)
Inward FDI or manufacturing weight in host country		Positive	Coughlin et al (1991), Scaperlanda and Balough (1983), Wheeler and Mody (1992), Cheng and Kwan (2000), Terpstra and Yu (1988), Li and Guissinger (1992)
Assets created	Technological Human capital	Positive	Dunning (1977), Kogut and Chang (1991), Anand and Kogut (1997), Kuemmerle (1999), Li and Guisinguer (1992), Breumenhjelm and Svensson (1996)

Source: Alvarez, 1993.