Growth effect of foreign direct investment: The role of labor market flexibility

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Abstract

This paper deals with the role of the labor market in moderating the growth-effect of foreign direct investment (FDI) in developing countries. FDI has developed rapidly and become the main source of economic growth in developing countries. The purpose of this paper is to examine the role of labor market flexibility in mediating the impact of FDI on economic growth in developing countries. Panel threshold regression analysis proposed by Hansen (1999) is employed to assess the hypothesis of the study. Findings/Originality: The results provide the empirical finding of the role labor market in moderating the growth effect of FDI in developed and developing countries and fill this gap by assessing the role of labor market flexibility as an absorptive capacity in FDI-growth link in developing countries.

Introduction

One of the important issues that economists have to address is why some countries grow faster than others. Over the years, they have attempted to find out the reason for this phenomenon and inquired on policies which are necessary for the nations to maintain and promote sustained output growth in the long run. The literature on this issue is filled with a lot of controversies in both theoretical and empirical. Nevertheless, several recent studies reveal that there are more than sixty different variables which are able to improve our understanding of variations in long-term growth performance across countries (Durlauf, Johnson, & Temple, 2005; Sala-i-Martin, 1997).

The growth literature has highlighted that factor accumulation alone cannot adequately explain differences in growth performance across countries. Recently, the economist has recognized that technological progress appears to be the key explanation for differences in output growth and productivity across countries. Countries with a high level of technology and those who specialize in technological progressive activity are expected to enjoy a high rate of productivity growth compared to others (Grossman & Helpman, 1991; Lucas, 1993). In the neo-classical growth models, the long-run rate of growth is exogenously determined by either the savings rate (the Harrod–Domar model) or the rate of technical progress (Solow model). However, the savings rate and rate of technological progress remain unexplained. More specifically, the neo-classical growth model treats productivity improvements as an 'exogenous' variable, they are assumed to be independent of the amount of capital investment. According to these models, the main factor that promotes output growth is an improvement in the capital-labor ratio. However, an increase in capital investment will not have a permanent impact on the output growth rate.
Over the past few decades, the role of the institution in explaining economic performance has been extensively analyzed. North (1990) defines institution rules that structure political, economic and social interactions, which covered formal rules (e.g. constitutions, laws, and property rights sustained through courts, and the police) and informal constraints (e.g. sanctions, taboos, customs, traditions, and codes of conduct). Institutions provide the incentive structure of an economy that shapes the direction of economic change towards growth. A number of empirical studies confirm the important role of institutions for economic performance. Knack and Keefer (1995) indicates positive and significant economic performance with institutional quality (political stability, property rights, and bureaucracy). Meanwhile, Demetriades and Law (2006) stressed that institutional quality is critically important in explaining the growth performance of low-income countries.

Although the role of the institution in economic development has been extensively tested, one aspect of institutional quality which is often neglected in the literature is the role labor market. The Labor market is expected to help foster economic performance in various ways. A country with flexible labor market (i.e. worker can move freely across firms) are expected to not only be able to attract more FDI inflows (Haaland, Wooton & Faggio, 2003; Javorcik & Spatareanu, 2005) but may also play an important role in moderating the impact of FDI on output growth. FDI is widely believed to an important element for the development process in many countries. Generally, one would expect that host countries may reap significant benefits associated with FDI inflows if workers are allowed to move freely across firms. When the labor market is flexible, workers who were trained with the latest technology while they were with MNCs and this may benefit host countries when they join local firms. Thus, countries with a higher index of labor market regulation (i.e. labor market is more flexible) are expected to encourage more inflows of FDI and increase country growth rate.

FDI by MNCs has always been linked to new and superior technologies, extensive R&D activity, new managerial techniques, increased capital, job creation and improvement of working conditions, improvement in the quality of human capital, development of industrial sector, broadening of the tax base and better integration into the world markets (Haddad & Harrison, 1993). Based on these positive expectations, many countries have lifted numbers of restrictions on the free flow of capital across the border, leading to significant inflows of FDI globally. Global FDI inflows increased from $10.1 billion in 1970 to $1,319 billion in 2000 and reached its highest record of $2,985 billion in 2007 before it dropped to $1,561 billion in 2014.

According to the World Bank, global FDI flows into developing countries have surpassed the amount of FDI received by the developed countries. As in 2012, developing countries received $629 billion as compared to $516 billion received by developed countries and in 2013 FDI flows into developing countries was $778 billion and only $565 billion FDI flows to developed countries. However, due to global economic uncertainty, the flows of FDI dropped in 2014 where developed and developing countries received $753 billion and $499 billion of FDI inflows, respectively. Thus, FDI appears to be an important channel for international knowledge transmission and it, therefore, becomes a central element of the development strategy for many developing countries.

However, empirical evidence suggests that not all countries have benefited from FDI inflows. In fact, the literature reveals that the growth-effect of FDI is ambiguous (Gorg & Greenaway, 2004; Alguacil, Cuadros & Orts, 2011). In some cases, FDI appears to exert positive impacts on the growth of host countries but in some other cases, there were no impacts or even negative impacts. This study argues that the ambiguous findings for the growth effect of FDI are due to the failure to account the contingency effect in the FDI and growth relationship. Several factors have been highlighted in the literature such as financial markets (King & Levine, 1993; Beck, Levine & Loayza, 2000; Hermes & Lensink, 2003; Alfaroo, Chanda, Kalemli-Ozcan, & Sayek, 2004; Durham, 2004; Azman-Saini, Baharumshah, & Law, 2010), trade regime (Balasubramanyam,
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The present study argues that the growth-effect of FDI is possibly influenced by the flexibility of the labor market in the host country. This factor is expected to affect FDI spillovers because when the market is flexible, managers and workers who were employed and trained by MNCs can easily join local firms and bring along all the knowledge and technology they have acquired while working with MNCs. MNCs is known to be the most technologically advanced firms as they invest substantially in R&D activity. In this way, new technology, skills, managerial and organization best practices may be transferred from MNCs to local firms. This process is expected to enhance the productivity of local firms which eventually lead to the expansion of the local economy. The objective of this study is to examine the role of the labor market in moderating the FDI-growth effect.

This study provides important contributions to the existing literature in several aspects. First, it provides empirical evidence of the potential role of labor market flexibility in moderating the growth effect of FDI. This issue has not been examined in the past. So, the literature has focused mainly on the role played by other factors such as human capital, institutional quality, economic freedom, trade policy, and financial market. Therefore, this study examines how labor market flexibility will make a difference in the ways FDI affects output growth. The finding is expected to reveal new insights on the intricate link between FDI and output growth for developing countries.

One of the main factors that have an important impact on economic performance is foreign direct investment (FDI). FDI is a form of international investment that is most likely to drive international technology diffusion (Balasubramanyam et al., 1996; Caved, 1996). It increases capital stock and employment, encourages technological change through the adoption of foreign technology and technological spillovers via the introduction of new process and product by foreign firms, employee training, licensing agreement and imitation. Since MNCs are among the most technologically advanced firms, domestic firms may be able to adopt and internalize advanced technology by interacting with MNCs which leads to the expansion of the economy in the long run.

One of the earliest theories developed for FDI spillovers was by Findlay (1978). According to the model, FDI is one of the important channels for the transfer of technology, where spillover effects from advanced countries to the host country is expected to increase the rate of technological progress. The model also predicts that technological gap will influence the degree of FDI spillovers. Domestic firms are able to have more FDI spillovers when the technological gap is small but if the gap is big, domestic firms are not able to gain the technological advantage of foreign firms. Meanwhile, the model by Wang and Blomström (1992) stresses the importance of market structure on FDI spillovers, where stronger competition in the host country reduce the technology gap between domestic and foreign firms which forces foreign firms to transfer more technology to host countries.

The impact of FDI on economic growth may also be explained by endogenous growth model through the diffusion of technology (Barro, 1999). Romer (1990) and Grossman & Helpman (1991) emphasize the potential role of FDI in the growth process as a diffuser of technology and its relationship to economic growth. Romer (1986) introduced the theory of technological change into the production process, where he specified technological progress as a function of R&D investment in knowledge that generates positive externalities. According to Romer (1990), FDI accelerates economic growth through strengthening human capital, which is the most essential factor in R&D effort. As stated by Grossman and Helpman (1991), the long run economic growth was a result of an increase in competition and innovation that influenced technological progress and increased country productivity.

The ambiguous effects of FDI-growth link were explained by researchers as the "absorptive capacity". Narula and Marin (2003) defined absorptive capacity as the ability to internalize knowledge created by others and modifying it for their specific objectives. Meanwhile, Cohen and Levinthal (1989) defined absorptive capacity as the ability to recognize the value of new, external information and apply it to commercial ends. Aitken and Harrison (1999) and Girma and Wakelin (2000) recognized absorptive capacity as the technological capability that can help host countries to benefit from MNCs. Based on Blomstrom and Kokko (2003), the level of absorptive capacity is important for a host country to gain positive spillover effects from FDI. This finding supported Kokko (1994), in which the role of absorptive capacity stressed as a determinant of inward investment. In this study, absorptive capacity serves as a moderating factor that encourages FDI in recipient countries, to gain the benefits of technology diffusion and spillovers. In previous studies, several factors identified as absorptive capacity factors, such as financial market, human capital, trade policy, regulation, and institution. A financial market is one of the important factors in mediating the impact of FDI on growth.

Labor market showed to be an important element in the development strategy. For instance, the reform of the labor market played an important role in attracting the FDI inflows especially for FDI flows with resource seeking motive, asset seeking and export-oriented. Ismail (2009) studied on ASEAN countries, location advantage available in ASEAN region like cheaper input factors, particularly labor costs and natural material costs and complemented with preferential investment policies encourage more inflows of FDI. However, the availability of labour may not benefit the host countries, because the link between FDI inflow and labor abundance may be negative (Borio, Kharroubi, Upper, & Zampolli, 2016), study the importance of labor reallocation on productivity and they find that this factor tend to contribute less to productivity growth.

Moreover, policies implemented in the labor market (rigidity and flexibility) may also influence FDI inflows. Labor market flexibility is the ability of labor markets respond to changing economic conditions. The importance of labor market flexibility as a determinant of FDI inflows was discussed in Whyman and Baimbridge (2006). This factor was considered vital to the choice of FDI decision because an entire production process was entrusted in the hands of the host country labor force. According to Whyman and Baimbridge (2006), the measurement of labor market flexibility is based on three categories; supply side; labor cost; and functional. The supply-side flexibility can be divided by two elements; skills and qualification, and numerical flexibility (i.e. quality comprise fiscal policy and regulation). The second category of flexibility is labor cost that includes minimum wage, aggregate wage flexibility, institution and patterns of wage bargains, incentive pay, workplace, and wage flexibility. The third category is the functional flexibility that includes job diversification, multi-skills, teamwork, employee participation, subcontracting and human resource management initiative.

The precise relationship between labor market flexibility and FDI inflows was harder to predict because the impact depends on the indicator used to measure labor market flexibility. For instance, by using labor market standard and regulation as an indicator for labor market flexibility, there are different impacts on FDI. On the one hand, labor market standards and regulations increase costs and diminish the power of a firm to react to market changes, which deters FDI. On
the other hand, labor market standards and regulations enhance labor productivity, which attracts FDI. Other studies that suggested flexible labor markets were significant attractors for FDI are Cooke (1997), Cooke and Noble (1998), Gorg (2002), and Haaland et al. (2003). Haaland et al. (2003) demonstrated a trade-off between FDI incentives and labor market flexibility and showed that a nation with a more flexible labor market may find it easier to attract FDI. Javorcik and Spatareanu (2004) stated that the higher the flexibility of the labor market in the host country would encourage higher inflows of investment with a bigger volume. A study by Gunnigle and McGuire (2001) stated that the location decision of MNCs was highly related to labor flexibility and was supported by Storey, Quintas, Taylor, and Fowl (2002), labor market flexibility became a central requirement for investment decision by MNCs.

In addition to the impact on FDI inflows, the labor market may also correlate with economic growth. A few studies examined this issue. Nickell and Layard (1999) established that countries with more flexible labor markets were expected to generate higher productivity and faster growth. Meanwhile, Calderon and Chong (2005) examined the influence of a flexible labor market on economic growth in a sample of 76 developing countries for the period 1970 to 2000. Using the GMM method, they confirmed that less regulated labor markets could foster productivity growth. Betcherman (2015) examined the impact of labor market regulation indicators, namely the minimum wage and the employment protection legislation, in developing countries. The author concluded that the minimum wage has a positive impact on productivity growth and this finding is parallel to Bassanini and Venn (2007), who examined 18 OECD countries for the period 1979 to 2003. Meanwhile, the finding of Bercherman (2015) was similar to Basanini and Venn (2009), where the impact of employment protection legislation was negative with productivity growth. Generally, the empirical literature suggested that labor market flexibility was among the important determinants of FDI inflows, productivity and output growth.

Research Method

Model Specification

The objective of this study is to examine the role that labor market plays in moderating the impact of FDI on output growth. Specifically, this study intends to test whether labor market makes a difference in the way FDI affects output growth. Our hypothesis is countries that promote labor market flexibility are able to benefit more from FDI inflows.

This paper uses a panel threshold regression modeling proposed by Hansen (1999) to assess the hypothesis that labor market flexibility plays an important role in moderating the impact of FDI on growth. The threshold estimation analysis is employed because this methodology is more flexible to accommodate the possible contingency effect of LMF in the FDI-growth link. This procedure allows the data to endogenously determine the numbers and locations of the threshold points. We argue that a model particularly well suited to capture the presence of contingency effects and to offer a rich way of modeling the influence of labor market flexibility on the link between FDI and output growth is the following threshold specification:

\[
\text{GROWTH}_{it} = \alpha X_{it} + \begin{cases} 
\beta_1 \text{FDI}_{it} + \varepsilon_{it} & \text{LMF} \leq \gamma \\
\beta_2 \text{FDI}_{it} + \varepsilon_{it} & \text{LMF} > \gamma 
\end{cases}
\]

where \( \text{GROWTH} \) is a growth rate of real GDP, \( \text{FDI} \) is the foreign direct investment, and \( X \) is a vector of variables hypothesized to affect output growth which includes population growth rate, physical capital, human capital, and government expenditure. In this model, labor market flexibility (LMF) acts as sample splitting (or threshold) variable. The above specification allows the effects of FDI on growth to take two different values depending on whether the level of labor market
flexibility is smaller or larger than a threshold level $\gamma$. The impact of FDI on growth will be $\beta_1 (\beta_2)$ for countries in the low (high) regime.

**Data Descriptions**

The data set consists of observations for 80 selected developing countries over the 2000-2012 periods. The dependent variable of the growth was defined as the per capita real GDP in US$ at time $t$. This definition was used in Ranis, Stewart, and Ramirez (2000), and Butkiewicz and Yanikkaya (2006). FDI data is expressed as a ratio of net inflows of foreign direct investment to GDP. As explained in endogenous growth theory, FDI is a factor that tends to contribute to the growth rate. However researchers stated the mixed finding of FDI-growth link, where positive relationship found by Bengoa and Sanchez (2003), negative relationship stated by Aitken and Harrison (1999) and Djankov and Hoekman (2000) and finally ambiguous effect due to absorptive factors discovered by Gorg and Greenaway (2004) and Alguacil et al. (2011). Although there are the mixed finding of FDI-growth relationship, the expected results for this study is the positive impact of FDI flows on economic growth in developing countries.

The relationship between physical capital and human capital on economic growth are discussed in the endogenous growth theory. In this study, physical capital is measured as a ratio of gross fixed capital formations to GDP. Human capital is measured based on life expectancy at birth and this measurement was used in Davies and Quinlivan (2006). The data were extracted from the World Development Indicators database (WDI).

The other independent variable used in the model is government expenditure. The data on final government expenditure is expressed as a ratio to GDP. The importance of government expenditure on economic growth was proved by Kolluri, Panik, and Wahab (2000) and Akitoby and Cinyabuguma (2004). The expected results are positive with government expenditure and economic growth when there is an increase in government expenditure the country economic growth is expected to increase also. The data were extracted from the World Development Indicators database (WDI).

The population growth is computed as the growth rate of the number of population. The relationship between population growth and economic growth indicated a mixed finding. According to Darrat and Al-Yousif (1999), countries with high population growth rate tend to be economically poor and Tsen and Furuoka (2005) found no relationship between population and economic growth. The expected results for this study is negative between population and economic growth, which means that the increasing number of population growth in developing countries is expected to decrease the economic growth rate. The data were extracted from the World Development Indicators database (WDI).

<table>
<thead>
<tr>
<th>Table 1. Summary of Data</th>
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<tbody>
<tr>
<td>Variable</td>
</tr>
<tr>
<td>Growth</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>Labour Market Flexibility</td>
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<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td>Population Growth</td>
</tr>
<tr>
<td>Physical Capital</td>
</tr>
<tr>
<td>Human Capital</td>
</tr>
<tr>
<td>Government Expenditure</td>
</tr>
</tbody>
</table>
Finally, labor market flexibility is defined as the labor market is free from rigidities and restriction that measure by three indicators, labor market regulation as used in Whyman and Baimbridge (2006), minimum wages used in Reed and Economics (2010) and hiring and firing used in Gorg (2005). The data of these three indexes were obtained from Economic Freedom report published by the Fraser Institute. The Index is scaled from 0 to 10 with higher value indicates a higher level of labor market flexibility. The relationship of labor market flexibility is positively toward economic growth as proved by Kharroubi (2006). The expected results are positive between the labor market flexibility and economic growth, that means with a flexible labor market, obey and follow the role of minimum wage and existence of a contract for hiring and firing is expected to influence the country economic growth. Table 1 provides a summary of all data.

Results and Discussion

This section discusses estimation results which examine the role labor market plays in moderating the impact of FDI on economic growth. The analysis is based on 80 selected developing countries over the 2000-2016 periods. Most of the studies that have examined the role of absorptive capacity in the FDI-growth link have relied on the use of a linear interaction model. One major limitation of this type of modeling strategy is that they impose a priori restrictions on the effect of FDI on growth such that the effect of FDI on growth to increase (or decrease) monotonically with absorptive capacity. Therefore, this study uses an alternative method that allows some flexibility in modeling the conditional impact of FDI on output growth. The main goal of our study is to determine whether there is a threshold effect in the FDI-growth link. Specifically, we would like to determine whether the impact of FDI on growth can be characterized as a nonlinear process where the impact of FDI on growth could be positive, negative or neutral depending on some unknown critical level of labor market flexibility.

Figure 1 shows the plot of the concentrated likelihood ratio function of threshold estimate LR(γ) with 90 percent confidence intervals. The point estimates are the value of γ at which the likelihood ratio hits the zero axes as is in figure 1. The results for threshold regression analysis are reported in table 2. As shown in table 2 and figure 1, the threshold estimate is 1.9052 and the test of no threshold effect yields a p-value of 0.0168. Thus, we can split the sample into two groups according to the degree of labor market flexibility, which is high and low flexibility. Countries with the value of labor market flexibility over 1.9052 are classified as highly flexible labor market while the ones with the value below than 1.9052 are characterized as less flexible labor market (i.e. rigid market).
The coefficient on FDI for the high regime is 0.0821 while the one for the low regime is -0.0152. However, only the coefficient for the high regime is found to be significant at the usual level. This suggests that FDI will have a positive and significant impact on economic growth only when labor market has achieved a certain level of market flexibility. Before that, the impact is non-existence. Therefore, we can conclude that labor market flexibility is important in moderating the impact of FDI on economic growth in developing countries.

### Table 2. Threshold Regression

<table>
<thead>
<tr>
<th>Regressor</th>
<th>Coefficient estimate</th>
<th>s.e</th>
<th>t-stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>PG</td>
<td>-0.0312</td>
<td>0.0288</td>
<td>-1.5273</td>
</tr>
<tr>
<td>PC</td>
<td>0.0983</td>
<td>0.0329</td>
<td>1.7867</td>
</tr>
<tr>
<td>GE</td>
<td>0.2139</td>
<td>0.0852</td>
<td>1.5695</td>
</tr>
<tr>
<td>HC</td>
<td>0.0395</td>
<td>0.0286</td>
<td>3.0989</td>
</tr>
<tr>
<td>FDI Low LMF - (LMF ≤ 1.9052)</td>
<td>-0.0152</td>
<td>0.0433</td>
<td>-1.0570</td>
</tr>
<tr>
<td>FDI High LMF - (LMF &gt; 1.9052)</td>
<td>0.0821</td>
<td>0.0525</td>
<td>2.0289</td>
</tr>
<tr>
<td>Threshold estimate</td>
<td>1.9052</td>
<td></td>
<td></td>
</tr>
<tr>
<td>LR Threshold estimate</td>
<td>7.1622</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bootstrap p-value</td>
<td>0.0168</td>
<td></td>
<td></td>
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</tbody>
</table>

Note: The dependent variable is output growth per capita, PG = population growth, PC = physical capital, GE = government expenditure, HC = human capital, FDI = foreign direct investment, LMF = labour market flexibility, p-value was bootstrapped with 1000 replications and 10% trimming value.

The sensitivity test is carried out to evaluate whether the previous finding is robust. The test of the sensitivity of the p-value is carried out for testing the null of no threshold effect to different numbers of bootstrap replications and trimming percentages. The results are reported in table 3. Based on the results presented in the table, we can conclude that at all of the bootstrap replications that we examined (1000, 5000 and 10,000) and with 10%, 15%, 20%, 25% and 30% of trimming percentage, we can easily reject the null hypothesis of no threshold. This indicates that the existence of the threshold effect in the FDI-growth relationship is not driven by trimming percentages and the number of bootstrap replications.

### Table 3. Bootstrap p-value

<table>
<thead>
<tr>
<th>Threshold Estimate: 1.9052</th>
<th>Trimming Percentage</th>
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<tbody>
<tr>
<td>LR test of the threshold: 7.1622</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Bootstrap Replications</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
<th>30</th>
</tr>
</thead>
<tbody>
<tr>
<td>1000</td>
<td>0.0298</td>
<td>0.0249</td>
<td>0.0245</td>
<td>0.0197</td>
<td>0.0175</td>
</tr>
<tr>
<td>5000</td>
<td>0.0223</td>
<td>0.0191</td>
<td>0.0209</td>
<td>0.0182</td>
<td>0.0163</td>
</tr>
<tr>
<td>10000</td>
<td>0.0191</td>
<td>0.0155</td>
<td>0.0188</td>
<td>0.0174</td>
<td>0.0152</td>
</tr>
</tbody>
</table>

Note: Bootstrap replication and trimming percentage obtain by using R statistical software.

**Conclusion**

Economic growth and productivity improvement are among the most important issue in the field of economics. This issue has been examined extensively using many different methodologies. Over the years, economists have been looking into factors that influence growth and inquire on policies which are required for the nations to maintain and promote sustained output growth. The literature on this issue is filled with many controversies in both theoretical and empirical due to several
studies revealed that there are more than sixty different variables which are able to improve our understanding of variations in long-term growth performance across countries (Durlauf et al., 2005; Sala-i-Martin, 1997). Among these factors, FDI appeared to be important for output growth and productivity improvement.

The theory suggests that FDI bring tremendous benefit to many countries. However, the empirical literature suggested that their impacts are ambiguous. Recent literature argued that the benefit of FDI could be contingent on other intervening factors, which are usually referred to as "absorptive capacity". Departing from this argument, this study has conducted empirical analyses regarding the issues in developing countries. Specifically, issues addressed in this study are examining the role of labor mobility in moderating the impact of FDI on economic growth.

This study takes a step further by examining the role of labor market flexibility in moderating the growth-effect of FDI. Threshold estimation was employed to data collected from 80 developing countries for the 2000-2016 period. The main finding indicates that the FDI-growth link is influenced by the level of labor market flexibility in the host countries. Specifically, it shows that the impact of FDI on output growth is positive and significant only after host countries have achieved a certain level of labor market flexibility which allows new knowledge to be transferred to local firms via labor mobility. This finding is consistent with the growing view that host countries must have absorptive capacity in order to successfully benefit from positive externalities linked to FDI inflows.

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