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Labor Market Flexibility and Inward Foreign Direct Investment: Incentive or Outcome?

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Abstract

Are inward FDI and its increase related to the domestic labor market conditions in the host economy? This is still an open question, as literature to date has provided mixed evidence. This paper empirically addresses this question by testing the debated relationship in both possible "causal" directions—i.e., testing (i) whether the host's labor market flexibility—or strictness—leads an increase in inward FDI and (ii) whether it follows inward FDI, using publicly accessible macro-level data. The first set of estimation shows that a host country with relaxed employment protection tends to attract more inward FDI, which is consistent with the findings in some recent studies. The analysis also indicates that this relationship should chiefly be the case in the "traditional" OECD members but may not apply to other countries. On the other hand, the second set of estimation indicates that increased inward FDI could result in loosened employment protection. This impact may not be immediately apparent but could be more significant in a longer time horizon.

Keywords: Foreign direct investment, labor market flexibility, labor conditions, employment protection

JEL classification: F16, F21, F66, J80