Multinational enterprises and the welfare state

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EXECUTIVE SUMMARY

This paper presents an empirical analysis on the extent to which a country's welfare spending influences foreign direct investment (FDI) decisions, particularly as they relate to relocations.

The authors argue, and subsequently test, that higher welfare spending by governments attracts foreign investment and that multinational enterprises (MNEs) located in high welfare spending countries have a lower likelihood of relocating to foreign markets compared with MNEs in countries with lower levels of welfare spending.

Using data for MNEs in 27 OECD countries, the results show that MNE location decisions are positively related to welfare spending. This challenges the conventional view that welfare states and globalisation are incompatible.

Welfare spending and the global economy

Welfare support has declined in many developed countries since the global financial crisis of 2008 following reductions in public spending. This austerity, a state of reduced spending and increased frugality, has partly been justified by the argument that high welfare spending is unsustainable in the context of globalisation.

It's also been argued that it reduces international competitiveness as it contributes to additional costs to firms. A larger welfare state with higher tax rates is often seen as detrimental to international competitiveness, and particularly a country's ability to attract and retain multinational enterprises.

Foreign Direct Investment (FDI)

FDI is an ownership stake, usually 10% or more, in a foreign company or project made by an investor, company, or government from another country. It is a key element in international economic integration because it creates long-lasting links between economies. It takes place in three forms – new investments, expansions or merger and acquisitions. Benefits for firms can be lower labour costs, avoiding trade barriers, reducing transport costs, while advantages for host countries include foreign expertise, higher wages for staff and improved working conditions.

Multinational Enterprises (MNEs)

MNEs are firms that engage their activities in more than one country. They are one of the main conduits through which investment is channelled and are important for the diffusion of technology and as a source of tax revenues. In this analysis, MNEs are defined as having ownership of greater than 10% in a foreign affiliate. They are also known as Multinational corporations. Examples include BP, Apple, Amazon, Microsoft, McDonald's and Walmart.

Relocation

A relocation in this analysis is defined as a firm reducing their operations at home by more than 10 per cent of their size, as measured by the number of employees, while concurrently opening up a new foreign affiliate or acquiring an existing firm abroad.

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The data

A unique set of firm level data was used to define relocation events and link them with welfare spending in both a firm's home and host countries. Results are found for 1997-2007 (before the start of the financial crisis) and 2013-2019 (before the start of global pandemic where welfare spending dramatically increased). The social policy areas covered relate to expenditure on old age; incapacity-related benefits; health; family; unemployment; active labour market programmes; housing; and other social policy.

The full paper details how independent variables – home welfare spending, firm size, labour intensity, unit labour costs and host welfare spending – are taken into account. Researchers also compare developing and developed countries.

The results

- A larger welfare state does not push MNEs to relocate activity away from the home country
- Overall, welfare spending serves to both attract and retain international investment
- Result is stronger for high-tech MNEs than for low-tech MNEs
- High welfare spending in developing countries in recent years has acted to deter FDI but the effect is small
- Welfare provides stability that acts to attract and retain MNEs

War for talent

Researchers found that the positive effect of host welfare spending on attracting MNEs only holds for relocations to developed countries. In high-tech manufacturing industries, where there is high demand for skilled labour, the absence of welfare support deters firms and encourages their relocation. While the issue of skill shortages among high-tech firms has been known for some time, it's not been previously considered in the context of welfare spending and FDI, suggesting that firms attach value to a home country's welfare state. In low-tech manufacturing industries, which tend to be more labour intensive, labour costs may matter more in location and relocation decisions than a social and economic environment that is characterised by welfare expenditure.

Why welfare is important for international business

Welfare spending is as an important indicator within the **Varieties of Capitalism** literature in the post- global financial crisis period. The concept of Varieties of Capitalism says the capitalist economy does not assume a single form, but varies across nation states in the areas of industrial relations, corporate governance, financial markets, inter-firm relations and the management of employees and their contribution to the firm. The two main types are:

- **Liberal Market Economy** (USA, Britain, Ireland, Canada, Australia) where coordination occurs through market mechanisms
- **Coordinated Market Economy** (Germany, Japan) where formal institutions play a more central role in governing the economy

The authors assert that a suitable welfare system is a key part of the employee management strand. They argue that welfare can be viewed as an important host country institution and a business support mechanism, as well as one that can reduce the risks to a firm's investment and underpin labour market efficiency.

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CONCLUSION

- This research challenges the conventional view that the welfare state hinders firm competitiveness or that social expenditure (financed through corporate taxation) deters inward FDI. Instead, it finds that welfare spending may be attractive to inward investors and may also act to keep MNEs in the home country.
- These findings appear to be more pronounced for MNEs operating in high-tech rather than in low-tech manufacturing industries. The results suggest that high welfare spending does deter FDI in the case of host developing economies, but that these effects are small. This could be a result of firms being more hesitant to invest in developing countries where they will be expected to contribute to welfare. This suggests that a degree of trust between firms and host country governments is required on institution building and the delivery of welfare.
- The results suggest that the conventional wisdom of firms avoiding or relocating away from locations due to the associated additional costs of high welfare spending is questionable, but that firms need to be confident on the efficacy of this welfare expenditure.

POLICY TAKEAWAYS

The researchers wish the findings to be part of the wider debates on globalisation by the international business community and to help policymakers understand how, with capital mobility threatening the incomes of relatively immobile labour, the state can underpin productivity, and both retain and attract internationally mobile capital. Some interpretations by the researchers of their findings for policymakers:

- Welfare spending works to retain investments that a country has already won and is not in any sense associated with relocation away from a "high-tax, high-spend" country. This is because of the importance of welfare spending in encouraging labour mobility in industries where labour markets are tight, and where there are skill shortages.
- Welfare states and globalisation are compatible as they enable firms to perform well in a stable environment, which in turn retains existing firms and attracts new ones to high welfare locations.
- Welfare spending is an important indicator of how a state supports its workers when they are ill. While countries, such as the United States, continue to attract investment, firms recognise that the additional cost of employing people in countries with low public welfare, i.e. in contexts where people need health and dental insurance, not just for themselves but also their families. This has to be set against the higher taxes sometimes associated with high welfare locations, e.g. in places where taxes can be significant, especially in sectors with high proportions of skilled, internationally mobile workers. At the lower end of the income distribution scale, welfare spending may encourage labour mobility, with workers less concerned about "last-in first-out" re-deployment decisions if a welfare net exists.
- The significance of unit labour costs in explaining relocation has declined over time, suggesting that add-on labour costs, such as national insurance or health provision, do not influence relocation decisions. There is some evidence that for the later period at least, relocations by firms in high-tech industries to developing economies may be deterred by welfare spending in host countries. This suggests that host-country governments may need to persuade firms of the value of this spending, showing that it is associated with, among others, health care or better functioning labour markets, rather than merely reflecting a bloated government sector.

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