Taking Account...

A look at FDI and domestic economic activity

As U.S. firms become more globally engaged, policymakers and researchers have been greatly interested in the domestic impact of their overseas activities. In particular, questions remain as to how foreign direct investment (FDI) relates to labor demand, wages, and the job polarization phenomenon recently seen in the United States.

While U.S.-based multinationals comprise less than 1 percent of all companies in the United States, their value added was 20.4 percent of gross domestic product, and they employed 18.6 percent of the domestic workforce in 2004. Thus, it is important to understand how the global activities of these large and important companies are related to their domestic operations.

In a recent working paper, economists Alexis Grimm of the Bureau of Economic Analysis and Mina Kim of the Bureau of Labor Statistics use a dataset in which the foreign activities of U.S. multinational entities are linked to their domestic employment characteristics.

Specifically, for each firm, the data provide information on its foreign operations as well as on the number of domestic employees in each occupation and the wage distributions within each occupation. With this rich trove of information, the authors shed new light on the domestic employment characteristics of these multinationals, documenting how firms that engage in more of a particular type of FDI employ more of a particular type of labor task domestically.

The paper finds that in firms with more expansive global scope, foreign and domestic labor are complements.

This result is based on a firm-level index of global scope that not only takes into account the level of FDI, but also the location of FDI; more weight is given to FDI in countries that are further away in income.

Of particular interest is the demand for tradeable tasks. For firms with global scope in the 75^{th} percentile, a 1 percent fall in the price of foreign labor is accompanied by an increase in the demand for domestic automated/routine tasks that is 4.6 times larger than that for the median firm. On the other hand, the difference in demand for domestic information content-related tasks is smaller; a 1 percent fall in the price of foreign labor is accompanied by an increase in demand that is 2.6 times larger than that for the median firm.

For firms with limited global scope, foreign labor and domestic automated/routine tasks may be substitutes, depending on the amount and type of offshoring in which these firms engage.

The paper examines specific parent-foreign affiliate relationships based on the type and location of intrafirm trade, finding that more intrafirm trade with high-income countries is positively correlated with domestic employment in tradeable tasks.

However, for firms that export a significant amount of goods to foreign affiliates for further processing, higher foreign employment in low-income countries is accompanied by lower domestic employment for automated/routine tasks. For firms importing a significant amount of goods from their foreign affiliates, demand for foreign labor in low-income countries appears to be complementary to domestic demand for automated/routine tasks and tradeable tasks in general.

Together, these new insights suggest that the domestic impact of FDI depends on the relative allocation of FDI across the different types and locations. The paper's results are consistent with the notion that multinational manufacturers adjust the composition of their domestic labor force in ways that are related to the composition of their FDI activity. However, firms that appear to substitute foreign labor in low-income countries for domestic automated/routine tasks play a small role in the global economy, accounting for just 1 percent of sales in the paper's sample. Domestically, these firms tend to employ fewer workers in innovation-related occupations.

(This item was prepared by SURVEY OF CURRENT BUSINESS *staff in conjunction with the authors, using the language of the paper.)*