



Effects of Foreign Direct Investment on Wages in The Emerging Markets: Review and Analysis

Vipin Negi¹

¹Keshav Mahavidyalaya (University of Delhi) Pitampura Delhi - 110034 India

*Corresponding Author Email: vipinnegidu@gmail.com

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Abstract: In the present study we analyse the impacts of surge in FDI inflows on the labour market, particularly the effect on the real wages and labour productivity. The impact of the FDI is assessed on the growth of the economy and spillover impacts on the rival firms of the same industry. However, studies on the impacts of the labour market are still limited especially for the developing countries. The aim of this study is to measure the amount of effect of FDI on the real wages and labour productivity in twenty leading emerging markets. The econometric results shows that the real wages are increasing in these countries due to the large inflows of FDI and the relation between the FDI and labour productivity is also positive

Keywords: Foreign Direct Investment, Labour, Wages, Labour Productivity

Introduction

Foreign direct investment (FDI) is defined as an investment made to acquire a lasting interest by an entity resident in one economy in an enterprise resident in another economy. The investment should allow the investing entity to exert direct control over the management of assets in the invested firm. For statistical purposes, it is typically assumed that this is the case when a foreign investor owns 10 percent or more of the ordinary shares of voting power (or the equivalent). Investments that fall short of the 10 percent ownership threshold are classified as portfolio investments (UNCTAD, 2013). Although the bulk of FDI continues to take place between developed countries, the relative importance of developing countries for inward and outward FDI has grown substantially during the past 25 years, reflecting the integration of developing countries into the world economy, and particularly, of the so-called BRICS – i.e. Brazil, Russia, India, China and South Africa.

FDI inflows to Emerging Market Economies (EMEs) have increased substantially since the early 1990s. Total inflows as a percentage of total emerging market GDP shows a sustained trend increase. Although FDI inflows are perceived to be more stable compared to other types of foreign capital inflows, they also have fluctuated significantly over the sample period. In particular, it is possible to identify two surge episodes associated with a significant and sharp rise in inflows. The first such episode started in 1990 and reached a peak in 1999. Total flows declined starting in 2000 and reached a trough in 2003. The second surge of flows took place during 2003–07 and reached a peak of 4 percent of total emerging market GDP just before the global financial crisis in 2008. Inflow episodes are identified following the methodology adopted in the October 2007 by World Economic Outlook. The number of countries that experienced inflow episodes started to increase in 1995 and reached its peak in 2006.

Although it seems that there is a common trend in FDI inflows among EMEs, there was also significant dispersion in terms of the magnitude of inflows. However, the variation among EMEs also increased as some countries received significantly larger inflows. Looking at the experiences of particular EMEs, one can see that in Egypt, Turkey, Russia, and India inflows were relatively stable until the mid-2000s, when these countries experienced a sharp surge. By contrast, Thailand and China had an initial FDI surge in the 1990s but did not experience another surge after 2005. Differences in the timing of inflow surges can offer useful information on global and domestic determinants of FDI inflows to EMEs.

During this period of globalisation of capital, the US government and international financial institutions promoted neo-liberal policies and enshrined them in the Washington consensus. This particular view of globalisation deems necessary that governments "increase foreign direct investment by reducing barriers" and also "the abolition of regulations that impede the entry of new firms or restrict competition (except in the areas of safety, environment and finance)" (George, 2007). As these views were not shared by many governments, the International Monetary Fund (IMF) and other international financial institutions introduced conditionality of finance assistance to the completion of these policies (George, 2007). National policy changes that promote FDI include: easing foreign ownership of assets, reducing sector restrictions, the approval of procedures for foreign investment, easing operational conditions, stabilization of foreign exchange, promotion measures (including incentives), guarantees and favourable corporation regulations (Kobrin, 2005).

Alongside the liberalisation of capital flows, the global workforce has doubled. This is due on one hand, to the world rapid population growth (especially in developing countries) and the fall of the "Iron Curtain". On the other hand, it is due to the incorporation of countries like Russia, China, India and other emerging country workers' to the global markets (Freeman, 2005 and Friedman, 2006). This additional 1.5 billion people plus the fact that supply of capital has virtually remained unchanged has contributed to the lowering of the share of wages in the aggregate product as a whole. From the US, to Japan and the European Countries (EU), all developed countries suffer from declining labour incomes, while corporate profits are more robust (Freeman, 2005). In developed countries, labour shares declined from about 75 percent of national income in 1975 to about 65 percent prior to the current crisis. In developing countries the picture is the same. Average labour shares of developing countries declined from 62 per cent of GDP in the early 1990s to 58 per cent just before the crisis (ILO, 2013). However, even if there is a decrease in the labour share, there were increases in average wages between the year 2000 and 2011.

In the present study we analyse the impacts of surge in FDI inflows on the labour market, particularly the effect on the real wages and labour productivity. The impact of the FDI is assessed on the growth of the economy and spillover impacts on the rival firms of the same industry. However, the studies on impacts of FDI on the labour market are still limited particularly for the developing countries. The aim of this study is to measure the amount of effect of FDI on the real wages and labour productivity in twenty one leading emerging markets.

Literature Review

Recent empirical literature has evolved in two directions. First set consists of the studies which use firm and sector level data that provide micro-level and sector specific information on the labour income effect of FDI (e.g. Aitken et al.1996; Lipsey and Sjöholm, 2004). A second set of studies use aggregate data and a panel approach. These studies have a broader coverage of countries and a longer period of time in their analysis (Vijaya and Kaltani, 2007; Gopinath and Chen, 2003). Lipsey (2004) in his study concludes that the evidence is strong enough to say that FDI increases wages on average. Gorg and Greenaway (2004) fixed empirical evidence on productivity and wage spillovers from FDI on domestic firms is mixed at best. According to

Eckel and Egger (2009), multinational firms are in a better position in wage bargaining because they have plants and operations in different countries.

By using a plant level dataset for the period 1977 to 1990, Aitken et al.(1996) study the relationship between wages and FDI in Mexico, Venezuela and the United States. For the combined data foreign and domestically-owned plants they find that for both skilled and unskilled workers a larger share of FDI raises the wage level. Gopinath and Chen (2003) explore the impact of FDI on wages with a factor endowment approach. With a panel dataset of twenty six countries for the period of 1970-1995, they conclude that FDI inflows increase the host country wage level of skilled labour both in developing and developed countries. The elasticity of wage with respect to FDI for the aggregate labour force is estimated 0.12. Ugur and Ruane (2004) in their study of foreign direct investment and host country wages examines how foreign plants may impact on the average wages paid by domestic firms within a host country. The study analyse the plant level panel data for Irish manufacturing industry and concludes that respective wages for both skilled and unskilled workers are relatively higher in foreign firms within the same sector.

Pradhan et.al. (2004) suggested that foreign firms do not have any adverse effects on the manufacturing employment. In their analysis they compare foreign companies with domestic companies and conclude that foreign firms pay relatively higher to their workers. This study tends to imply that labour had benefited from foreign investment in India. The empirical verification of the impact of FDI on wages and employment has been proceeded by (i) comparing the average wage rate and employment elasticity of output between foreign and domestic firms and (ii) estimating appropriate wage and employment model. Vijaya and Kaltani (2007) presented a cross country empirical investigations of the impact of FDI on manufacturing wages. The study derives this conclusion that FDI flows have a negative impact on overall wages in the manufacturing sector and one possible explanation for such an impact may be a decrease in the bargaining power of labour. This may due to the new labour market formations and arrangements in the new economic system where capital is free to move across countries in search of more favourable conditions. Since FDI represents more mobile capital, it lowers the bargaining capabilities of workers attached to the foreign firms. Moreover the foreign firms can also use the incentive of knowledge transfer to bargain with the workers for lower wages. Pittiglio et.al. (2012) test the impact of incoming FDI on local wages in the Italian manufacturing sector by using firm level data from 2002 to 2007. They empirically proved that there is no wage spillovers at both horizontal and vertical level, which implies that the effects of foreign investment are completely internalized within each firm. However, when considering the impact of the technology gap on wage spillovers, there is some significance on the spillover variables. In particular horizontal wage spillover is negative when the technological distance between domestic and foreign firms is low and/or medium, and significantly positive when the size of the technological gap becomes larger.

Another study by Hale and Long (2008) on FDI and wages reveals that FDI may have contributed to increase in wages in China. Using a World Bank survey data set of 1500 Chinese enterprises conducted in 2002, this study shows that the presence of FDI has both direct and indirect effects on wages of skilled workers, while it did not appear to affect wages of production workers. Moreover, the indirect effect of the FDI presence on wages of skilled workers is limited to private firms. The findings highlights the relevance of labor market institutions in determining FDI spillovers.

Literature on wages in foreign–invested enterprises includes the study by Aitkin et.al. (1996) that concludes, higher FDI is associated with higher wages in foreign–investment firms; Almeida (2007), and Heyman et.al.(2007) study that there are no effects for Sweden and Portugal, respectively. The studies by Conyon et.al. (2002) and Girma and Gorg (2007) find some positive effects for unskilled wages in the UK; and Lipsey and Sjöholm (2004) study of Indonesia finds positive effects of FDI on wages. In a related paper, Braconier et.al. (2005) assesses the role of low labor costs is attracting FDI. Three things stand out from the FDI inflow analysis: First, FDI inflows already took off in the 1990s. In 1990, total world FDI inflows

amounted to around 176 billion dollars. Only twenty years later, this figure multiplied by eight, adding to a total of 1,433 trillion dollars (UNCTAD, 2011). Second, although most of the world FDI flows originate and are directed to developed countries, the proportion of FDI going to developing countries has been gradually increasing. Developing countries received about 20 percent of world FDI in 1980s. This number increased to 32 percent during 1992-1994 and reached 37 percent in 1997 (United Nations, 1999). FDI inflows in developing countries between 1986 and 1997 increased from \$10 billion to \$163 billion and they accounted for about 45 percent of total net foreign resources flows to developing countries in 1997 (Perkins et al., 2001). Third, FDI inflows in developed countries showed a steep increase before the ICT revolution and current crises indicating the different nature of FDI inflows. FDI represent significant addition in developing countries form of international finance and have surpassed other development assistance (ODA) in importance as a source of financing.

Wage - Productivity Relationship

The theory of FDI takes a very different approach to the same wage-productivity relationship. It studies the location of production, as a choice variable of the firm, taking wages as given. From the firm's perspective, wages are now exogenous, but their location decisions will, in equilibrium, determine both a country's wage level and its aggregate productivity. Helpman (2006) provides an in-depth overview of this literature. In many models technology differs between countries. It leads to higher productivity in some countries and lower productivity in the rest of the world. If there are scale economies, an exogenous size difference between countries can generate such a productivity difference endogenously. Often the difference is simply the result of the past history. Given these primitives, firms will choose a location and hire workers, always paying wages equal to the marginal productivity which in these models tends to be constant (Biesebroeck, 2015).

In analyzing the effects of inward FDI on host countries, it is common to distinguish between two broad types of effects: direct and indirect. The primary contribution of direct investment to the host economy is to provide additional capital to the host economy, thus alleviating the indigenous capital shortage. In MacDougall's (1960) capital movement model, he showed that, as there exists a gap in the marginal productivity of capital in the home and host countries, capital movement will increase the total output of capital, and both countries will benefit. FDI also may benefit the host economy by increasing job opportunities, improving real wages to their employees, and supplying consumers with better goods at lower prices. Tax revenue of the host government may be boosted in the long run. If the FDI is export oriented, it tends to enhance the host economy's export activity, which has a positive effect on the balance of payments sheet. These benefits usually are referred to as the direct effects of FDI. Beyond this, FDI also can influence indirectly the host economy through various channels. These indirect effects can be characterized into two groups: demonstration and contagion effects and competition and technological effects. Demonstration and contagion effects arise when foreign firms enter the host-country market, thus demonstrating new technologies and their management expertise, which are subsequently imitated by local firms. Caves (1974) suggests that FDI may speed up the transfer of technology and innovation to the host economy, causing them to disseminate faster than otherwise. Dunning (1993) argues that demonstration effects also could take place through the foreign affiliates' membership of trade associations and research consortia in the host country. Factory visits, seminars, and trade fairs are all means through which the working practices and production methods of foreign firms are revealed to the domestic sector.

Theoretical Background

The debate about the effects of capital mobility in the recipient economies started already in the 1960s. Originally, FDI was understood as the expression of monopolistic activities of multinational corporations. Since then, different fields of study have developed alternative theories to explain its effects on wages.

The following sections include a general review of literature on the effects of FDI on wages according to three *ad hoc* approaches we distinguish in the social sciences literature; the neoclassical approach, the political economy approach and the sociological approach.

Neoclassical approach: technology spillovers

The neoclassical literature of the effect of FDI on wages can be divided into two: direct and indirect effects. If we consider standard neoclassical theories, wages are depicted in the following way: $W=P*MPL$, where P represents the price of final goods and MPL is the marginal product of labour. From here, real wages are: $W/P=MPL$, which means that any increase in the marginal productivity of labour increases real wages (Tintin, 2012). The direct effects have to do with the accumulation of capital as well as faster restructuring of the economy (Vijaya and Kaltani, 2007).

However, FDI is considered to have indirect effects on wages through technological spillovers. This research field explains that along with foreign capital, multinationals bring many intangible assets i.e.-knowledge and organizational skills-. These in turn make local labour force permanently more productive (Aitken et al., 1996). When workers move from foreign to local firms they take this acquired technology to local companies (Liu, 2008). Thus, FDI will have an additional impact on wages through technological spillovers.

Political Economy approach: bargaining power theory

According to political economists, prevailing neoclassical theories omit social, cultural and institutional variables that are behind the actual process of capital movements. Thus, any technical analysis has to incorporate the social dimension of the process. This is the relationship between social classes and groups between them and their institutions.

In relation to FDI, the political economy approach underscores the imbalance between capital's high mobility due to ongoing capital deregulation with respect to labour which suffers from natural (language and culture) as well as institutional (immigration laws) barriers to move. This approach argues that wages are the result of the bargaining process between employees and employers and the outcome is dependent on the power that these two actors have. Whilst working hours are specified in working contracts, these do not contain the actual level of work and effort that is put during these hours (Reich, 1996; Bowles and Gintis 1990). In this way, a labour contract is not directly enforceable and follows a "contested exchange". Employers and employees follow a bargaining process in which actual work, effort and wage are the outcomes. According to this approach, FDI would be a variable measuring bargaining power.

There are three threats studied to pressure the bargaining power of labour down: the threat of capital to relocate or outsource, the increase in the mobility of capital and the consequent increase in the elasticity of labour demand. The political economy literature has long criticised that increase in productivity translates to wages (Reich, 1981; Bowles and Gintis, 1990). This literature argues that relative bargaining power of capital and labour is not accounted for in the relatively recent studies.

Firstly, the threat of capital to relocate or outsource. The threat takes place even if the firm finally decides not to move. Seguino (2007) suggests that this mechanism is behind a low-wage-low productivity trap. The idea is that an increase in FDI leads to lower wages and thus productivity growth. Accordingly, the decline in productivity takes place for two reasons. In the first place because firms face less pressures to make investments that raise productivity. In the second place, deregulation of FDI permits companies to outsource their production.

Secondly, Vijaya and Kaltani (2007) argue that capital deregulation has made capital owners uphold increasing power when entering a market. With the shift in the relative importance of domestic to international markets, wages are no longer seen as a source of demand, but as a cost item and capital owners will move to markets with low wages. This way, FDI inflows have negative effects on wages in all countries. Thirdly, Mehmet and Tavakoli (2003) argue that FDI deregulation has made labour demand more elastic.

The fact that many countries have cut restrictions on foreign capital has allowed that MNC's can benefit from lower wages in labour abundant countries, leaving production in others. In this way, FDI net inflows would have no effects wages. Considering the unlimited labour supply of certain developing countries as opposed to industrialized economies, the increased elasticity demand of labour is bound to push wages down in developed countries but leaving wages in developing countries in subsistence levels.

The proposed study differs from existing literature in two aspects: First, the study examines the effect of manufacturing FDI on manufacturing wages, instead of using aggregate economy FDI figures which mismeasure the effect of FDI on wages. By making use of data from the International Trade Centre (ITC), we are able to provide more accurate estimates of FDI in the manufacturing sector. Secondly, this study examines the effect of FDI on wages considering both domestic and multinational firms, while most previous studies have focused on the effects of FDI on either domestic or multinational firms with firm-level data and for a single or few countries.

Data and Methodology

We have estimated the relationship between real monthly wages, foreign capital and labor productivity. The study is for period 2005-2015 for twenty one countries, which are the leading emerging markets according to United Nations *Conference on Trade and Development* (UNCTAD) classification. Countries under study are: 1. Argentina 2. Bulgaria 3. China 4. Costa Rica 5. Croatia 6. Czech Republic 7. Estonia 8. Hungary 9. Israel 10. Kazakhstan 11. Korea, Republic 12. Lithuania 13. Malaysia 14. Poland 15. Romania 16. Saudi Arabia 17. Slovak Republic 18. South Africa 19. Turkey 20. Venezuela

However, earlier we had selected twenty two countries for the period of 1991-2016, but the data were not uniformly available for the two countries for period 1991-2004 and the year 2016. The data for mean nominal monthly earnings of employees and labor productivity are collected from International Labor Organization (ILO), stocks and flows of foreign direct investment are enumerated from UNCTAD. The data is structured into panel for the twenty-one countries and for eleven years. The fixed effect and random effect panel regressions are estimated and tested by the Hausman and Breusch and Pagan Lagrangian multiplier tests for the checking the feasibility or preferences of panel regressions of fixed effects and random effects for better estimates.

Empirical Results

With the help of Hausman and Breusch, and Pagan Lagrangian multiplier tests, it is tested that in random effect model the null hypothesis is rejected, which states that "*there is no heterogeneity*" in the panel data. All the variables of the large values have been used in the logged values. With the help of regression, the effects of foreign capital, both stocks and flows and labour productivity empirically tested on wages (logged wages, *lnwages*). The results are shown in the Table 1.

The coefficients of logged labour productivity (*lnproductivity*), logged foreign direct investment (FDI) stocks and flows (*lnfdistock & lnfdiflow*) are estimated. The values of coefficients are 1.42, 0.13, and 0.04 respectively, which are significant at 1 percent level. The coefficients of *lnfdistock* and *lnfdiflow* are relatively lower than that of *lnproductivity*. As 1 percentage, on an average, of increase in labour productivity leads to 1.42 percent increase in monthly wages, which signifies the higher payment for high-skilled and more productive labour in the emerging economies. In an average increase in FDI stock by 1 percent leads to 0.13 percent increase in real wages and FDI flows has relatively lower effect on the real wages as 1 percent increase in FDI flows leads to only 0.04 percent increase in monthly real wages. This implies that FDI flows have lower effect in comparison to FDI stocks. It was expected because the stocks variable is cumulative of flows variable, so higher magnitude of FDI stocks has higher effect on wages.

Table 1: Estimated Regression Results

Random-effects GLS Regression				
Number of obs = 71				
R-sq: within = 0.2801 Obs per group: min = 1				
between = 0.9406 avg = 3.5				
overall = 0.9427 max = 7				
corr(u_i, X) = 0 (assumed) Prob > chi2 = 0.0000				
rho .75515716 (fraction of variance due to ui)				
<i>lnannualwage</i>	Coef.	Std. Err.	z	P> z
<i>lnrealprod</i>	-3.11	1.93	-1.61	0.10
<i>Realprodsq</i>	0.21	0.10	2.06	0.04
<i>lnfdistock</i>	-1.22	0.74	-1.66	0.09
<i>Fdisq</i>	0.05	0.03	1.63	0.10
<i>lnfdiflows</i>	0.04	0.02	2.08	0.03
<i>lntrade</i>	-0.09	0.07	-1.41	0.15
<i>lninv</i>	-0.09	0.11	-0.84	0.40
<i>lnp</i>	0.17	0.12	1.39	0.16
<i>lnmanugdp</i>	0.05	0.10	0.44	0.65
<i>Constant</i>	27.64	9.26	2.98	0.00

Note: *lnannualwage*–annual wages, *lnrealprod*-real production level *realprodsq* – real production square, *lnfdistock* – foreign direct investment stock, *fdisq* –foreign direct investment square, *lnfdiflows*- foreign direct investment flows, *lntrade* – trade, *lninv* – investment level, *lnp* – price level, *lnmanugdp* – annual gross domestic product

The random effect panel regression is better goodness of fit as the R² (within) is 0.92 and significant at 1 percent level as p-value is close to zero. The coefficients of the regression are also tested by the dynamic panel regression to address the problem of endogeneity; however the coefficient of *lnfdiflow* is not significant at 1 percent level, which corresponds with lower effect in the random effect regression.

Conclusion

The present study empirically analyses the effects of foreign capital, both stocks and flows and labour productivity empirically tested on real wages. It shows that there is a positive impact of the real wages of labour in emerging markets. Average wages have been increasing due to FDI inflows in the emerging markets. Labour is being rewarded with higher wages for its work. The reason for this is higher labour productivity. However, the benefits are more to the skilled labour as compare to the unskilled labour. The sectoral differences may also be studied further in the micro-level studies in different countries. These results are more of macro in nature and study, which needs to be corroborated with the micro level studies in future.

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