Abstract for "The Influence of FDI and Portfolio Investment on Developing Countries' Labor Share - An Empirical Investigation"

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This paper explores the influence of international capital movements - in form of FDI and portfolio investment - on the labor share of developing countries. The labor share reflects how much of national income is earned by labor. In developing countries, most people only have labor at their disposal to generate income and do not have relevant capital income, so the labor share directly relates to the personal income distribution. Regressive redistribution will be felt especially strong in these countries due to weak social safety nets. The labor share is assumed to be stable in the long run and only changes in case wages and productivity do not develop uniformly. Global capital and trade flows may, however, influence the level of the labor share. It is a well-known fact that the labor share has fallen in high-income economies over the last two decades. This is mainly explained with capital-augmenting technological progress and the specialization into capital-intensive commodities in the course of globalization - an argument based on the factor-proportion models by Heckscher, Ohlin, Stolper and Samuelson. To the extent that labor is abundant in developing countries, one would hence expect the labor share in developing countries to rise with international integration.

Research findings on the development of the labor share in developing countries remain incomplete though. This is mainly due to the poor data availability in these countries. A main contribution of this paper hence is the preparation of data on the labor share. Most studies rely on the relation of compensation of employees to GDP from national account statistics when measuring the labor share. A key problem of this simple definition is the fact that compensation of employees does not include the labor income of the self-employed, which can be a relevant fraction of the labor force in developing countries. As a consequence, shifts in the composition of employment one is not interested in automatically change the labor share. Another serious problem when measuring the labor share of developing countries is the relative importance of the informal sector. By definition, the so called hidden sector should be covered by the labor share, but due to its very nature it is not. Since the informal sector is usually labor-intensive, the overall labor share is likely to be understated in developing countries. The labor share data hence is adjusted for the informal sector as well.

After having prepared the labor share data, a first important finding is that labor's relative income in developing countries has fallen in the last two decades. In a second step, the role of cross-border financial flows for this decline is investigated. Within a political economic framework, it is argued that bargaining power is another important factor influencing the distribution of gains from financial globalization. The worldwide loosening of capital controls may raise the demand for labor in developing countries but can also weaken the bargaining power of workers vis-à-vis investors who now can easily relocate their capital abroad. The bargaining relationship is shaped by the fixed costs of reallocation which constitute the investor's outside options. Since reallocation of production and management entails more costs than reallocation of liquid financial assets, foreign portfolio investors are more mobile and can hence exercise more bargaining power than foreign direct investors. The effect is enhanced by the dependence of developing countries on foreign investments, the existence of surplus labor as well as the lack of a comprehensive social safety net.

A panel data analysis covering above forty countries from 1992 to 2009 supports this hypothesis: An increase of the FDI stock (in relation to GDP) by 1 percentage point is associated with an increase of the labor share by about 0.2 to 0.4 percent. By contrast, an increase of the FPI stock (in relation to GDP) by 1 percentage point leads to a decrease of the labor share by about 0.2 to 0.6 percent. The effects are robust when applying different models (static and dynamic) and various estimation techniques (least squares dummy variable, first differences, random effects and system general method of moments).