

An Assessment of the Implications of EU Enlargement for Foreign Direct Investment and Jobs in Ireland

By Alan P Murphy*

ABSTRACT

This study examines the potential implications of EU enlargement for employment and foreign direct investment (FDI) in Ireland. Despite fears associated with this substantial pool of low-wage workers now inside the EU, our analysis of patterns of FDI suggests that Ireland faces a somewhat limited threat from FDI diverting into the Central and Eastern Europe (CEE) region, at least over the next few years. The sectoral composition of Irish FDI is very different to that of the FDI going to the CEE region. Much of the foreign direct investment going into Eastern Europe in the 1990s was through mergers or takeovers of existing enterprises, while in Ireland FDI projects are of the “greenfield” variety.

Currently Ireland has a somewhat narrow sectoral concentration of FDI in a handful of “high-tech” sectors and relies heavily on investment flows from US multinationals. Ireland could be vulnerable to worldwide shocks to our chosen sectors or to a general downturn in the US economy. A further potentially serious source of concern in relation to Ireland’s current FDI strategy is our ability to maintain relative cost competitiveness. This is highlighted by our finding that wage cost considerations are an important factor leading multinational firms to re-allocate jobs among the higher-wage countries in Europe.

1. Introduction

In a small open economy such as Ireland’s the maintenance of cost competitiveness is of key importance for sustaining a successful pattern of economic growth. The unprecedented expansion of the Irish economy in recent years has raised wage levels substantially relative to our European neighbours. While these developments have had the positive effect of boosting living standards for Irish workers, the consequent erosion of relative cost competitiveness is now an important concern for policy makers.

The enlargement of the EU in May 2004 has further highlighted these concerns relating to Ireland’s cost competitiveness. The demise of the Communist legacy and the opening up of the

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Central and Eastern European (CEE) economies at the start of the 1990s represented an abrupt shock. Virtually overnight, Western Europe was confronted with a group of neighbouring countries with a very different set of economic conditions. Given that these countries are now fully integrated members of the European Union, there are a number of concerns relating to potential negative effects that the enlargement process might have on countries such as Ireland. Many of these concerns relate to employment, because the CEE region represents a large reservoir of low wage labour in Western Europe's backyard.

One of the most obvious ways in which employment in Ireland might be affected by this accelerating economic integration is through the employment re-allocation decisions of Multinational Enterprises (MNEs). It is often argued that MNEs are footloose (e.g. Caves, 1996). By operating a portfolio of affiliates in diverse national markets they can re-allocate their factors of production across these markets to minimise their production costs. In this paper, we focus on this issue, and describe the results of a Bank study that has analysed how multinationals reshuffle jobs between the parent and their affiliates.

The contents of the paper are as follows. Section 2 provides some background facts and figures relating to trends of foreign direct investment (FDI) in Europe. Section 3 discusses some of the strategies followed by firms undertaking FDI. Section 4 describes the data used for our analysis of job re-allocation across parents and affiliates of MNEs and section 5 reports some of the results from this work. Section 6 discusses how EU enlargement may affect prospects for future FDI into Ireland. Section 7 concludes.

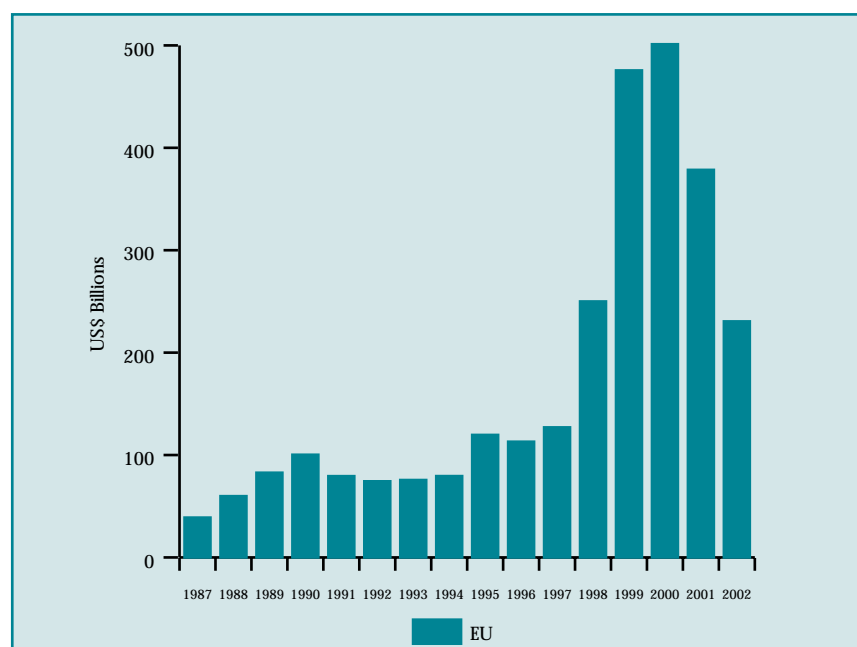
2. FDI Flows in Europe

Previous studies on foreign direct investment have shown that the process of economic integration in Europe has had a significant positive impact on FDI flows. In particular, the Single European Act and the ongoing eastern enlargement of the EU have commonly been cited as important factors influencing the source and destination of FDI. Prior to the mid-1980s, European FDI was largely dominated by investments made by US companies. These flows were concentrated in the relatively high-cost economies of Belgium, France, Germany, Italy, Netherlands and UK, which together gained about 90 per cent of total inward FDI.

The EU Internal Market Programme generated more intra-EU FDI flows and had a negative impact on outward FDI from the EU during the 1990s. It is estimated that the stock of world FDI located in the EU grew from 31 per cent in 1985 to 41 per

cent in 1998.¹ At the same time, the relative importance of US investment diminished, with a decline in total share from 28 per cent to 10 per cent between 1984 and 1996².

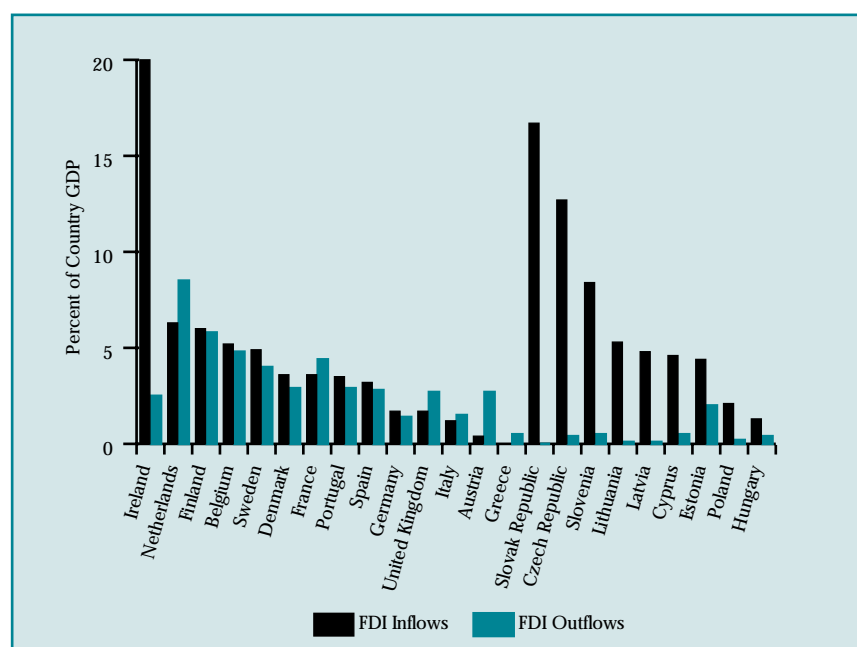
Figure 1: EU FDI Inflows 1987-2002



Source: UNCTAD.

Figure 1 shows the substantial growth in FDI inflows into the EU-15 region over the period 1987 to 2002. FDI inflows over the period 2000-2002 were about ten times as large as in 1987. Interestingly, this growth has largely been an intra-EU phenomenon: 72 per cent of FDI in the EU during the nineties was accounted for by intra-EU flows.³

Figure 2: EU-25 FDI Flows 2002



Source: Eurostat.

1 Source: UNCTAD (2003).

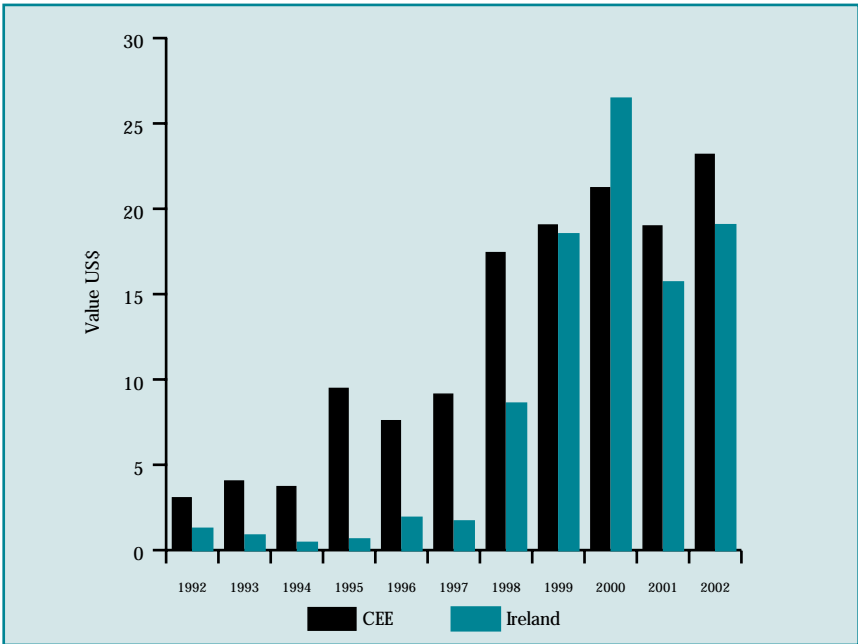
2 Source: UNCTAD (2003).

3 Source: Eurostat (2004).

Figure 2 gives a snapshot (as of 2002) of FDI flows into and out of countries in the enlarged EU, reporting these inflows and outflows as shares of GDP.⁴ A striking conclusion from the figure is that Ireland has performed remarkably well in attracting FDI inflows. Indeed, as of 2002, Ireland's inflows as a share of GDP exceeded any of the other EU-15 country inflows by a factor of 3. On the other hand, Irish FDI outflows are only 12 per cent of inflows, perhaps reflecting the stage of development of our indigenous industry.

The figure also shows the key role that FDI inflows into Central and Eastern Europe are playing in promoting economic development of that region. These countries on average are experiencing far higher levels of FDI (as shares of GDP) than the EU-15. For instance, both the Slovak Republic and Czech Republic are in double-digit figures for FDI in terms of GDP for 2002. These are broadly in line with the levels experienced in Ireland during the boom period of the 1990s, and indeed many in Eastern Europe look to the Irish experience in this area as a guide. It should be stressed, however, that while these FDI flows are clearly playing an important role in developing Eastern European economies, the overall level of these flows is still quite modest.

Figure 3: CEE and Irish FDI Inflows 1992-2002



Source: Eurostat and Authors own calculations.

Consider Figure 3, which shows the level of CEE and Irish FDI inflows over the period 1992-2002. Inflows into the CEE area have seen a six-fold increase since 1992. However, using absolute values it is clear that these economies still receive a relatively small volume of FDI in a European context. Ireland has only one per cent of the EU-15's population and yet, since 1999,

4 The FDI reported in figure 2 are gross figures, so for example the Irish data includes IFSC activities and retained earnings.

it gained a volume of FDI inflows comparable to the 10 CEE accession countries with a population of circa 100 million. So, while the level of FDI into Eastern Europe is large relative to their GDPs, these GDPs are very low by Western European standards.

3. Two Views of the FDI Process

Research on FDI has generally stressed two different motivations that may lie behind a firm's decision to undertake investments to locate production abroad. One of these views suggests that the ongoing expansion of FDI into Eastern Europe may pose a threat to jobs in Western Europe. The other suggests that FDI in CEE economies may have little impact on employment in the rest of the EU.

The first view of the FDI process is that it is driven by *cost minimisation*. According to this view, cost considerations are the most important element for investment decisions. Thus, while the parent firm may undertake the more high-skill activities, production that is low skilled and labour intensive is outsourced to the low-wage and low-cost countries. In other words, MNEs fragment the production process in stages, locating each stage according to best cost advantage. According to this view, many firms will be attracted to the CEE in preference to the EU-15, because it is a low cost location (e.g. Braconier and Ekholm, 2001).

An alternative view sees FDI as driven largely by the desire for *market access*. According to this theory, MNE investment arises in preference to exporting, so that instead of producing all output in one location and exporting it around the world, the MNE chooses to locate affiliates in multiple markets. So, for example, firms may wish to locate a production plant and sales office in Poland to expand sales in that country, instead of trying to directly export to Poland from elsewhere. This strategy is likely to have advantages, if locating the production and sales departments close to the market leads to improved knowledge of local consumer preferences in this market. In this framework, it is this type of strategic consideration that drives the investment and resource allocation decisions of MNEs, with production costs playing a relatively minor role (e.g. Lankes and Venables, 1996; Abraham and Konings, 1999).

In reality, of course, it is likely that both of these motivations are important, with the relative importance of cost-minimisation and market access differing for each specific investment project. For instance, once a firm has decided that it wants to open an affiliate in Western Europe to gain access to this market, cost considerations may then heavily influence which specific Western European country it chooses to produce in.

4. Data on European Multinational Enterprises

In the next two sections, we report some results from a Bank study of job re-allocation across countries by MNEs.

This analysis uses a rich and unique database. It is the first of its kind to comprehensively link information on EU parent MNEs with information about their affiliates based in Europe. The data contain complete information on the financial accounts and ownership of medium and large firms. The information contained in the data covers affiliates located in 24 countries in the European region, with parent firms having their headquarters in the pre-accession EU-15. This means that the majority of the parent firms in the data set are European-owned corporations. However, it is worth stressing that the data set does not completely exclude US firms either. Many of the so-called “parent firms” in our data set are actually European headquarters of US conglomerates. For example, General Motors’ European headquarters appears as a parent firm in our data set.

The data set that we used in this study offers a number of advantages relative to earlier work:

- It contains a substantial amount of information about medium and large-sized MNEs with parents located in various EU countries.
- It includes information on both manufacturing and non-manufacturing parent firms and their affiliates. This allows a distinction to be made between MNEs with affiliates operating in the same sector or different sectors compared to their parents. This helps to shed some light on the strategies that MNEs are pursuing.
- We are able to differentiate on the basis of wage costs across the European regions.⁵ In particular, we can distinguish between “very low” wage locations (CEE), “moderate” wage locations (South EU) [i.e. Spain, Italy, Portugal and Ireland⁶] and “high” wage locations (North EU).
- This allows us to examine whether low wage competition may potentially be important for “footloose” multinationals, enabling them to reshuffle expensive jobs to cheaper ones in the “very low” wage locations within greater Europe.

5. Employment Relocation Effects in Europe

The employment share of parent MNEs in our data set declined from 85 per cent to 72 per cent between 1993 and 1998, while

⁵ Wages here refer to total labour costs including social security contribution and payroll tax.

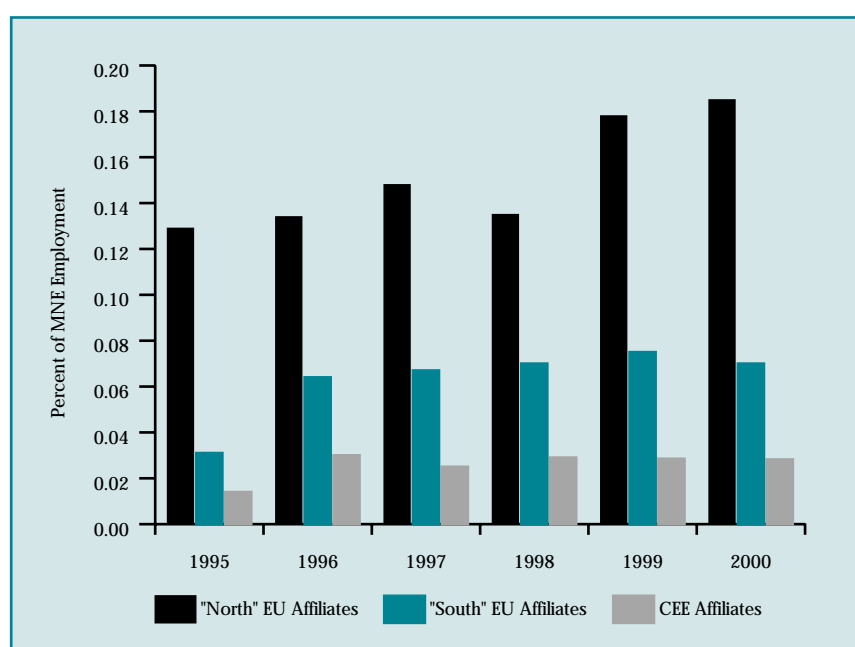
⁶ The period of this study is 1993 to 1998. During this period Ireland was the highest wage country in the “moderate” wage region.

the employment share of the affiliates steadily increased from 15 per cent to 28 per cent over this period. This suggests that a relatively significant reshuffling of jobs between parent firms and their affiliates took place over this relatively short time period. In this section, we take a closer look at the data and examine the relationship between parent and affiliate employment in a more formal way.

5.1: Summary Statistics on Job Relocation

Looking at the data in more detail, the first pattern that emerges is that the data are not consistent with a large “job drain” to Eastern Europe. Affiliates located in the EU have increased their employment shares, while the employment shares of the affiliates in CEE remained relatively stable.

Figure 4: Evolution of Affiliate Employment in Total Employment



Source: Authors own calculations.

Figure 4 makes the distinction between affiliates located in “South” Europe, “North” Europe and the CEE region. We can see that the increased fraction of affiliate EU employment is mainly driven by an increased fraction of employment in affiliates located in the relatively high-wage North. A closer look at the data tells us that most of the job relocation took place between EU parent firms and their affiliates located in the North of Europe.

Table 1 shows some summary statistics on the mean employment, wage and value added in our sample. Parent companies in this sample employed on average 1,728 persons for the 1993-2001 period. Affiliates employ fewer workers on average. The typical EU affiliate employs 282 workers on average, while the typical affiliate in CEE employs almost twice as many workers (477).

Table 1: Summary Statistics

	Mean 1993-2001
Parent Employment	1,728
In 'CEE' Affiliate	477
In 'South' EU Affiliate	263
In 'North' EU Affiliate	300
Parent Wage Cost per Worker	\$54,000
In 'CEE' Affiliate	\$9,000
In 'South' EU Affiliate	\$42,000
In 'North' EU Affiliate	\$49,000
Parent Value Added per Worker	\$109,000
In 'CEE' Affiliate	\$24,000
In 'South' EU Affiliate	\$87,000
In 'North' EU Affiliate	\$93,000
Number of affiliates	4

Source: Authors own calculations.

Note: Rounded to the nearest \$1,000.

The more intensive use of labour in CEE affiliates is perhaps not too surprising given that labour costs are much lower in the latter region. The average labour cost per worker per year is \$54,000 in parent firms and only \$9,000 in the typical affiliate in the CEE region. That said, it should also be noted that average labour productivity is also much lower for CEE workers. In our sample, value added per worker in the “North” EU is \$93,000 and is \$87,000 in the “South” EU, but only \$24,000 in the CEE region on average. The low productivity of CEE workers explains why these countries have not tended to get much FDI from high-skill sectors.

5.2: Are MNEs Relocating Jobs to Low-Wage Countries?

The first method that we used to assess the relationship between employment in parent firms and employment in affiliates was to check the correlations between these two series. If there is a positive correlation between employment in parent firms and their affiliates, then these can be seen as complementary inputs. On the other hand, if the relationship is negative this indicates the employment in the parent and affiliate firms are potentially substitutes for one another.

Table 3 reports the parent and affiliate employment correlations. The figures in brackets under the correlations are the standard errors of these estimates: only if the estimated correlation is greater than twice the magnitude of the standard error can we claim to have found statistically significant evidence of a relationship between the two sets of employment figures. Two patterns are worth noting from the table. First, there is evidence of a negative correlation between parent and affiliate employment for both EU and CEE affiliates. However, only the correlation for the EU affiliates is statistically significant. Thus, there is only weak evidence that parent firms are substituting Western European jobs for jobs in Eastern European affiliates.

Second, when the sample is split between manufacturing and non-manufacturing, it becomes clear that the employment substitution effect is stronger in the manufacturing sector. Column 2 shows that there is statistically significant evidence of employment reshuffling between EU manufacturing affiliates and their parents. Column 3 reports that there is no statistically significant evidence for reshuffling of jobs in the non-manufacturing sector.⁷ This is most likely due to the nature of this sector, in that it includes many non-tradable services.

Table 2: Parent MNE to Affiliate Employment Correlations

	Whole Sample (1)	Manufacturing (2)	Non-manufacturing (3)
EU Affiliate	-0.034** (0.016)	-0.049** (0.022)	-0.019 (0.023)
CEE Affiliate	-0.044 (0.103)	-0.019 (0.020)	-0.196 (0.263)

Notes: (1) Fixed effects regressions; log of Parent employment on Affiliate employment.

(2) *** indicates 1%, **5% and * 10% levels.

(3) Standard errors in brackets.

(4) All equations include year dummies.

(5) Wholesale and Retail excluded from non-manufacturing.

In further econometric analysis, the relationship between wage costs and job reshuffling was directly tested. It was found that job reshuffling between parents and their “North” EU affiliates is significantly influenced by wage cost differences, but that wage costs had a limited influence in causing job reshuffling to “South” EU or CEE affiliates. This effect is magnified if the affiliate is operating in a different sector to the parent firm. The results suggest that an increase in labour costs in a “North” EU affiliate of 10 per cent is associated with a reduction in the affiliate’s employment of about 1 per cent, which is quite substantial.

Overall, our results suggest that both the “cost minimisation” view and “market access” views appear to be operating. There is little evidence of firms substituting jobs from high-wage countries to the CEE region, so FDI in that region seems to be driven mainly by market access considerations. However, within the high-wage “North EU” region, cost considerations seem to play an important role in determining the level of employment.

While these results suggest that Eastern Europe’s low cost base is not a great threat to Irish employment as of now, they do suggest that a loss of cost competitiveness in relation to other western European countries could potentially have a large negative impact. Using the estimated effect of “North” EU wages on affiliate employment, a back-of-the-envelope calculation implies that a 10 per cent loss in wage competitiveness relative to other Western European countries could result in an initial loss

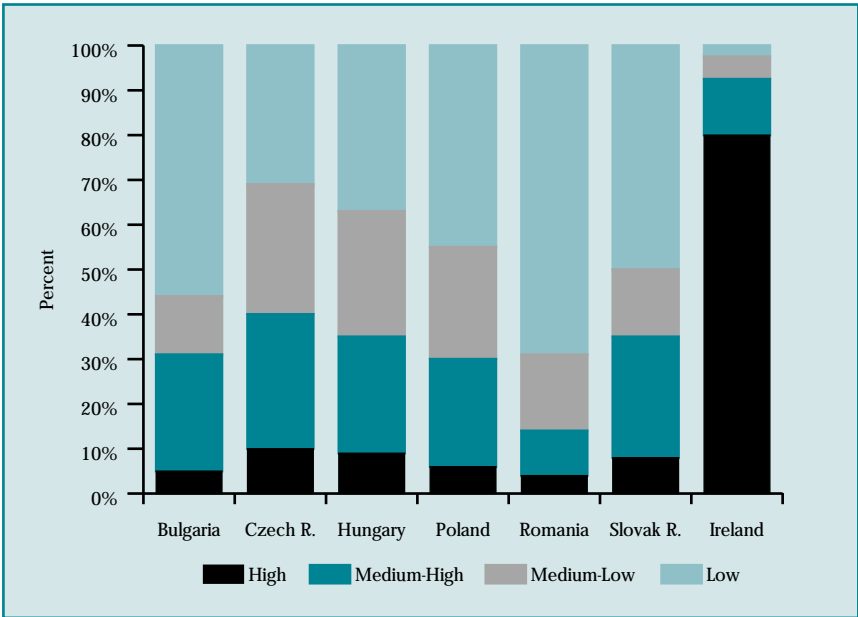
⁷ The wholesale and retail sector is excluded in this estimation.

of 1,300 jobs in Irish affiliates of MNEs.⁸ This figure does not include the jobs lost in other sectors whose profits and revenue are supported by MNEs or persons involved in these activities. It is estimated that for every job lost in an MNE affiliate, three jobs are lost in other sectors.

6. Future Issues Facing Ireland and the EU

The results just presented suggest there is only limited evidence that MNEs have been substituting jobs out of high-wage countries and into the low-wage CEE region. However, this still leaves open the question of whether Ireland is likely to lose out to these countries in terms of future FDI, particularly now that these countries have gained full entry into the EU. Our analysis of patterns of FDI investment suggests that Ireland faces a somewhat limited threat from FDI into the CEE region, at least over the next few years.

Figure 5: Sectoral Composition of FDI for Selected European States in 2002⁹



Source: Authors own calculations.

One reason for this is that the sectoral composition of the FDI into the CEE region has been quite different to the Irish pattern. In Ireland, the growth in manufacturing FDI during the 1990s was driven mainly by the pharmaceutical, medical instrument and IT sectors. Another difference between FDI into Ireland and the CEE region is that a significant proportion of investment into Eastern Europe was due to takeovers and mergers. This is consistent with the “market access” view of FDI: Western European firms have

8 One qualification to this calculation is that it is based on the estimated effect of wage costs on employment in the high-wage “North EU” group of countries. Over the period examined in this study, Ireland was not part of this group of countries. However, given recent developments in Irish wages, this is probably a reasonable estimate of the likely effects of future losses in cost competitiveness.

9 Figure 5 is based on IDA employment data from Irish based multinationals and the Central and Eastern European figures are derived from multinational firm level investment data.

looked to boost their sales in Eastern Europe by taking over existing local plants and distribution chains. In contrast, Irish FDI projects were far more likely to be “greenfield” operations serving the EU rather than the local market.

Figure 5 shows how foreign direct investment into these sectors has transformed the composition of Irish manufacturing FDI, with the majority of jobs now in the high-tech sectors. In contrast, the composition of FDI into the CEE region has tended to be dominated by investments into low and medium-low technology sectors. Foreign investment into Eastern Europe has largely focused on oil and mineral extraction, assembly operations (for example in the car, computer and white-good sectors), and extensive chemical production.

Of course, policy-makers in the CEE region likely view Ireland’s success in attracting high-tech FDI as a potential role model for their future economic development. Hence, it is possible that in the future, Ireland will face more competition from this region for high value-added FDI projects, as the countries of this region seek to make better use of their relatively well-educated workforce.

That said, Ireland currently holds a substantial lead over the CEE region in terms of its ability to attract FDI into high value-added areas. Ireland’s current success is the result of a forty-year strategy that has seen us develop substantial pools of labour with the skills demanded by these specialised industries. The availability of this skilled workforce is likely to be a key factor that will help Ireland to continue attracting FDI projects. In contrast, despite relatively high levels of general education, Eastern European countries are still only in the early stages of re-orienting their education system to the needs of a market economy.

The IT sector probably provides a good example of how high-tech industries in Ireland may develop over time. To assess if EU enlargement might shift IT production located in Ireland to Eastern Europe we looked at five sub-segments of the IT sector: computer assembly, electronic components, mass market packaged software, R&D and other software production (mainly business software). In this area, it appears as though jobs in lower-skill sub-sectors such as computer assembly are going elsewhere in Europe.

Looking at evolution of this sub-sector in more detail, during the early to mid-1990s the bulk of computers sold in Europe were assembled in either Ireland or Scotland. In addition, Ireland accounted for over 40 per cent of all packaged software and 60 per cent of business software sold in Europe. However, computer

assembly operations in Ireland have experienced serious job-losses and plant closures in Ireland since the late 1990s. In 1998, five microcomputer makers and one contract manufacturer employed nearly 10,000 workers out of a total of 16,000 in this sector in Ireland. By 2002, only Dell and Apple continued as assemblers, with Apple's operations dramatically downsized (e.g. Frank Barry, 2003).

In contrast, the production of electronic components such as microchips is a more highly skilled activity and Ireland is expected to have continued growth in this sector. It is likely that MNEs undertaking R&D will continue to operate in a portfolio of locations, including Ireland, to benefit from differing national systems of innovation (such as Science Foundation Ireland). Software localisation is another area in which Ireland has specialised, and this appears likely to remain the case. Paradoxically, the availability of higher wages for these jobs in Ireland relative to the CEE region may help these industries to expand their Irish operations, since they rely in part on attracting foreign workers.

7. Conclusion

This paper has examined the potential implications for Irish employment and foreign direct investment of the enlargement of the EU to incorporate the countries of Central and Eastern Europe (CEE). Despite fears related to the incorporation of a substantial pool of low-wage workers inside the EU, our study found limited evidence for the substitution of jobs between parent firms and their foreign affiliates.

Concerning job re-allocation by multinational enterprises, we reported a set of results from a Bank study based on a large data set of European-based parent firms and their affiliates. The study found evidence that parent companies tended to reallocate jobs among their affiliates in the high-wage regions of Europe so as to minimise their costs. In contrast, limited evidence was found of job substitution between parent firms and their affiliates located in the lower-wage regions of Europe.

In terms of relating this conclusion to Irish-based multinational affiliates, a caveat is that the data set for the Bank study featured only a limited number of US-owned corporations. This is in contrast to the composition of Irish affiliates, which are approximately 50 per cent US-owned. It is possible that the behaviour of US-owned firms could differ from the patterns found in our study. That said, other recent studies that have focused solely on US multinationals have come to similar conclusions to those discussed here (see N. Gregory Mankiw and Philip Swagel, 2005), specifically that there is limited evidence of US multinationals substituting high-tech jobs from

affiliates in high-wage countries to affiliates in very low-wage countries.

Concerning the threat to future foreign direct investment in Ireland posed by the enlargement of the EU, the evidence reported here has shown that the sectoral composition of FDI is very different to that of the FDI going to the CEE region. The growth in Irish manufacturing FDI has primarily been focused in the pharmaceutical, medical instrument and IT sectors. In contrast, FDI into the CEE region has been concentrated in activities such as oil and mineral extraction, assembly operations (for example in the car, computer and white-good sectors), and extensive chemical production. In addition, much of the foreign direct investment going into Eastern Europe takes the form of mergers or takeovers of existing enterprises, whereas the vast majority of FDI projects in Ireland are of the “greenfield” variety. To summarise, as of now, there seems to be little competition between Ireland and the CEE region for foreign direct investment projects.

This is not to say that there should be no concerns relating to our ability to attract FDI in the future. While Ireland’s FDI-orientated strategy has clearly brought significant benefits, it may carry some risks for the future performance of the economy. Ireland currently has a relatively narrow sectoral concentration of FDI in a handful of “high-tech” sectors. Our economy has relied heavily on investment flows from US multinational companies, which have tended to be the international leaders in these sectors. For these reasons, Ireland could be vulnerable to worldwide shocks to our chosen sectors or to a general downturn in the US economy that led to lower levels of outward foreign direct investment.

Another potentially serious source of concern in relation to Ireland’s FDI strategy is our ability to maintain cost competitiveness. This is underlined by our finding that wage cost considerations are an important factor leading multinational enterprises to reallocate jobs among the higher-wage countries in Europe. This suggests that, while the results of our research are perhaps somewhat reassuring, they do not justify complacency about the cost competitiveness of the Irish economy relative to our international competitors.

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