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Does FDI in Manufacturing Cause FDI in Business Services? Evidence from French Firm-Level Data

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NON TECHNICAL SUMMARY

In most developed economies the services sector accounts for approximately two thirds of GDP and is its most dynamic component. While consumer services as retail or entertainment mainly satisfy final demand, a large share of the output of business services sectors as telecommunication, IT or consulting is used as an intermediate input in the manufacturing sector. It is therefore often claimed, both by academics and by policy makers, that the opening of services sectors to international competition would not only benefit the services sectors themselves but also downstream manufacturing sectors. One channel through which such benefits may materialise is through the international relocation of efficient services firms to economies in which the services sector is comparatively inefficient.

This paper uses a large French firm-level dataset to evaluate the determinants of location choices in services. In a first step, estimates for four broad services sectors are compared to the estimates for the manufacturing sector in a gravity type of framework. It is shown that the parameter estimates of a gravity type of model for services are fairly close to the ones in manufacturing. Location choice probabilities in services decrease with distance but increase with cultural proximity, a shared border and market potential. The effect of GDP per capita varies across services subsectors. While it is negative for total services and transport, it is insignificant for business services, retail and finance.

In a second step, we check whether similarity in estimated parameters for manufacturing and services is due to a complementarity, in the sense that manufacturing location choices may influence location choices in services. A particularly appropriate services sector for this purpose is the business services sector for which input-output linkages with the manufacturing sector are strong. It is found that the downstream demand of French manufacturing affiliates has a positive effect on the location choice probabilities of French business services affiliates.

In the preferred specification a doubling of downstream demand in a location would lead to an 20% increase in the probability of French business services affiliates of choosing this location. This effect is robust to controlling for unobserved determinants of the choice probabilities that may possibly be correlated with the downstream demand variable. Granger causality tests provide further evidence on a causal effect of manufacturing downstream demand on business services FDI in the sense that manufacturing downstream demand causes FDI in business services but that the reverse does not hold true. In contrast, there is no empirical evidence for a complementarity in location choices between manufacturing and retail, a services sector for which input output-linkages with manufacturing are weak. This lends plausibility to the proposed mechanism underlying the complementarity in location choices between manufacturing and business services that depends critically on strong input-output linkages between the two sectors. The obtained results weaken the view often advanced by policy makers that developed economies can be expected to increasingly specialise in services whereas developing economies can be expected to specialise in manufacturing. While the empirical analysis supports this view for services sectors depending mainly on local final demand, as for instance retail, it is not supported for the business services sector that depends strongly on demand from manufacturing. A continuing trend in manufacturing offshoring may be accompanied by increased business services offshoring.