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The Impact of Foreign Acquisition on Wages and Productivity in the UK

by

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Abstract

This paper provides a systematic empirical analysis of foreign ownership on the levels of wages and productivity in the United Kingdom. Using a specially constructed database for the period 1989-1994, it uses ownership change (acquisition) to control for unobserved differences between plants. It finds that foreign firms pay equivalent employees 3.4% more than domestic firms, though this is wholly attributable to their higher levels of productivity.

Outline

1. Introduction
2. Database Construction and Some Sample Characteristics
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1 Introduction

A stylised fact for both the United Kingdom and United States is that foreign owned companies have higher levels of employee remuneration than domestic firms. It is partly for this reason that countries and regions compete for foreign direct investments (FDI) as jobs associated with FDI are viewed as being 'good'. This is however a severely under-researched area, and yet a thorough understanding of the link between wages and foreign ownership is vital if an assessment is to be made of the impact of foreign direct investment on the welfare of the host economy.

Using data from the US tariff commission, Dunning and Morgan (1980) found that in 1970, foreign owned companies paid a statistically significant 9.7% more than their domestic counterparts. More recently Lipsey (1994) found margins in favour of workers in foreign establishments within 2 digit industries of 10-12%, though wage differentials were lower in manufacturing (6-7%) than in non-manufacturing (12-15%). These results are confirmed in Feliciano and Lipsey (1999) using panel data who found differentials of 5-7% for manufacturing and 9-10% in other industries.

This phenomenon has also been identified in developing countries. Aitken, Harrison and Lipsey (1996) find higher wages in Mexico and Venezuela in foreign owned firms. This confirms earlier results of the International Labour Office (1976) who found that¹ foreign owners paid between 5.1% and 70.7% more than indigenous owners in developed countries and between 41.2% (Argentina) and 108.2% (Chile) in developing countries. A partial explanation for this phenomenon relates to the type of industries in which foreign firms locate. The ILO study *inter alia* indicates that multinational corporations are characterised by high tech, large scale, capital intensive production.

There is however good reason to believe that much of the wage differential also arises from productivity differentials between domestic and foreign firms. Davies and Lyons (1991) estimate that the foreign sector has a productivity advantage of 30%. Indeed the levels of productivity and the resultant profits appear to be so high that, despite the fact that wages are higher, wage shares² are lower for foreign owned firms (Cowling and Molho, 1982).

¹ With the exception of Australia.

² the percentage of value added that accrues to employees.

There are also good theoretical reasons for believing that foreign ownership will affect wage and productivity outcomes. The industrial relations literature has suggested that the transfer of knowledge within a multinational corporation means that plants will adopt new techniques related to the latest research and development and will therefore have higher levels of technology than domestic plants. There is also evidence to support the view that work practices are different in foreign owned plants (Cowling and Sugden (1987), Dunning (1986)). Recently established Japanese plants are frequently characterised by team working and task flexibility that attempts to avoid demarcation of job specifications. Single union bargaining and no strike agreements are also not uncommon. (Bassett, 1986).

The literature on acquisitions also suggests that foreign companies may have advantages over domestic ones. Balakrishnan and Korza (1993) suggest that higher costs are inevitably associated with evaluating an overseas acquisition and there are likely to be greater costs of learning institutional, cultural and other differences, together with costs of managing from a distance. Therefore in equilibrium we might expect that the marginal benefits of foreign acquisition should be higher to compensate. One frequent solution is to use joint ventures to get access to resources held by foreign firms (Thompson, 1999) or the acquiring firm may possess some under-exploited asset that it is unable to utilise via licensing or other market forms³. This implies that a foreign acquirer will bring in capital (of many possible forms) which will serve to raise the marginal productivity of the firm's employees relative to pre-acquisition. For example, an acquirer that brings an internationally known brand name may be able to sell more output and/or do so at higher margins than the domestic firm it has acquired. This will serve to raise value added per employee, even if the physical production process is identical. Therefore if the purpose of foreign acquisition is the transfer of specific assets, its effect is essentially capital augmenting.

As well as increasing the scope of the bargain, multinational status may also impact on wages if it affects the relative bargaining power of the firm and the union. A company with plants in several countries may credibly threaten to shelve expansion plans or choose another market for additions to capacity in the face of excessive wage demands (Cowling and Sugden (1987), Huizinga (1990)). A multi country production structure may also impact on the wage outcome if it improves the fallback position of the firm in the event of a

strike. For example it may be able to temporarily switch production from one country to another. Finally, transfer pricing can obscure the cash flow of any one subsidiary and reduce the apparent surplus to be bargained over.

Ownership status can also affect labour relations within a company, which may impact on the level of negotiated wages. An older tradition in this literature stresses the difficulties that foreign owned companies might face in harmonising their industrial relations practices with those of the host country. The larger average size of foreign subsidiaries can also lead to alienation of the workforce and bureaucratic communication may impair the responsiveness of the multinational enterprise to local labour disputes. These factors have led to the suggestion that US multinationals in the UK attempt to buy industrial relations peace with higher wages (Carmichael, 1992). A more recent literature, based on the practice of Japanese multinationals in the UK has stressed the ability of an overseas company to transfer successful labour practices and innovations from one labour market to another (Bassett, 1986). Entry into the domestic market presents a clean sheet as regards union structure, and allows for innovations such as single union and no strike agreements.

In summary, the raw data suggests and theory supports the notion that wages and productivity differ between foreign and domestically owned firms. Looking at this question econometrically, Davies and Lyons (1991) attempt to explain why the foreign sector in their sample has a productivity advantage of 30%. They estimate that 60% of the differential results from advantages foreign firms have over equivalent UK firms in the same industry, rather than deriving from the fact that foreign owned firms are concentrated in high productivity industries. The suspicion remains however that some of this differential may not truly reflect efficiency differences but uncontrolled plant level differences in the characteristics of foreign and domestic plants and adding more controls would reduce this difference (Griffith, 1999). The same is true of the wage differential. For example Feliciano and Lipsey (1999) found that, although wage differences persisted in non-manufacturing establishments after controls were added for establishment, state and industry characteristics, the impact of ownership was more fragile for manufacturing. Foreign ownership had no impact on wages in 1987, though it persisted in 1992.

³ This may be physical, technological or brand name related.

The use of information on acquisition offers the opportunity to control for many of the unobserved differences between plants which may cause wages and productivity to differ since many factors remain unchanged before and after the event. By observing their values before and after the acquisition event, we should be able to observe what component of wages and productivity is solely due to ownership status. The use of a panel of data also allows the introduction of a further set of controls- those firms that are subject to domestic acquisition and those subject to no ownership change during the period of study.

The aim of this paper is therefore to provide an empirical analysis of the impact of foreign ownership on wage and productivity levels by examining the impact of ownership changes (acquisitions). It seeks to examine whether observed wage and productivity differentials are driven by unobserved or by real differences. It also seeks to fill a gap in the empirical literature relating to ownership change and labour market outcomes by distinguishing between foreign and domestic acquisition.

2 Database Construction and some Sample Characteristics

Our analysis focuses on the acquisition of on-going firms by foreign and domestic companies in UK manufacturing industry for the period 1989-94. The primary source of information relating to acquisitions is the OneSource database of private and public companies in the U.K. OneSource gives a subsidiarity indicator for each firm at each point in time and a firm is identified as being acquired at time t if its status changes from being independent to being a subsidiary of another firm. Firms with more than one ownership change between 1989 and 1994 are excluded from the analysis. To distinguish between foreign and domestic acquisitions, we use OneSource's "ownership status" variable that gives the nationality of the firm's ultimate holding company. It is worth noting that the firms we observe are acquisitions rather than more radical forms of organisational change such as merger.

Since our aim is to evaluate the change of ownership on wages and productivity, we screen the data for the availability of employment, wages and output for at least five consecutive years. In this way we have at least two years of pre- and post-acquisition information for each acquired firm, so that the sample period stretches from 1987 to 1996. To mitigate the impact of outliers, we exclude firms exhibiting a yearly growth/decline in wages of more than one third. The final sample consists of 331 domestic and 129 foreign acquisitions, the

yearly frequency distribution of which is given in Table 1. An industry-stratified random sample of 642 firms, that acts as a control group, was drawn from the population of foreign and domestic *subsidiaries* which did not experience a change in ownership during the sample period, provided they satisfied the data screening criteria. The overall balance of the resulting panel is described in Table 2.

In Table 3 we report the means and standard errors of four-digit SIC industry-adjusted employment, wages and labour productivity in our sample. As in previous studies foreign firms are generally larger than domestic firms, pay a higher average wage (10.3%) and exhibit higher levels of productivity (28.8%). Additionally we see that acquired firms are smaller, in terms of employment, than the industry average, and only those acquired by foreign firms seem to exhibit a growth in their *relative* sizes post acquisition. Firms acquired by foreign (domestic) firms pay wages that are higher (lower) than the industry average by a factor of 1.01 (.98) and 1.03 (.94) during the pre- and post- ownership change periods respectively. This is an early indication that foreign ownership is associated with an increase in the level of *relative* employee remuneration. Whether this is due to the noticeable increase in productivity from a pre-acquisition level that was just above the industrial average (1.02) to an impressive looking 1.16, or due to other factors will be investigated later. Finally, a somewhat surprising result is the fact that firms acquired by domestic firms appear to lose their productivity advantage *relative* to the average firm.

By way of a preliminary analysis, we examine the relationship between wages and other firm and industry level characteristics and the incidence of acquisition. A multinomial logit is estimated for the two mutually exclusive events of domestic and foreign acquisitions versus a non-event (no ownership change). Following the argument of Shleifer and Summers (1988) that take-overs are motivated by the opportunity they offer to renege on implicit labour contracts and to reduce extra-marginal wage payments, the wage level is included as a regressor. Past profitability is also included to proxy the disciplinary motive for acquisitions⁴. So too are the size of the firm, the four-digit industry Herfindahl index, and a measure of foreign presence in the industry. The rationale for including size as a determinant of takeover probability is that it may be more difficult for larger firms to be

⁴ Both the wage level and the profitability are measured relative to the 4 digit SIC industry average.

acquired due to financial constraints (Palepu, 1986). The industry concentration is used as some authors have suggested that foreign acquisitions are less responsive to barriers to entry (Shapiro, 1983). The existing foreign presence in the industry, measured as the share of four-digit level industry employment in foreign owned companies, proxies the sectors' attractiveness from the perspective of previous and hence to future foreign entrants.

Table 4 presents the results. Size is found to be an important deterrent of acquisitions, although foreign acquirers seem to be less sensitive to this than their domestic counterparts. Foreign firms also appear to target firms with lower than average profitability though the wage level does not play a significant role in their acquisition decision. The converse is true for domestic acquirers with high wage levels having a negative impact. Foreign acquirers are positively (albeit insignificantly) affected by the presence of other foreign companies in the sector, and unaffected if the industry is highly concentrated. By contrast, both foreign presence and concentration are found to be barriers to acquisition by domestic firms.

The major focus of this paper is to assess the impact of foreign ownership changes on wages and productivity. Table 5 examines the post-acquisition trajectories of wages using t-tests of equality between the pre-acquisition and post-acquisition values. Both domestic and foreign ownership changes are associated with a significant increase in real wages and productivity over this period due to real growth in both factors. In the case of foreign acquisitions, for example, average real wages and labour productivity have grown by 13% and 20.2%⁵ respectively, in the four-year period between the year prior to ownership change and three years following the event. The post-acquisition firm-level employment figures do not significantly differ from the pre-acquisition values which suggests that some of the apparent productivity improvement may have resulted from a more efficient use of labour rather than through downsizing. It would be inappropriate to conclude from Table 5 that ownership changes are associated with wage and labour productivity increases however. The simple t-tests presented do not control for other factors that may have impacted on wages and productivity over the period- for example technological progress.

⁵ The average pre-acquisition output per worker is £69,000. Thus a 20% increase in productivity in four years is not as unrealistic as it might appear.

3 Econometric Methodology

In order to estimate the impact of ownership change on wages and productivity we adopt a differences-in-differences methodology. This proceeds by comparing the average wage level before the acquisition with the average wage post-acquisition. The resulting quantity ($\Delta^a w$) would, however, be a biased estimator of the impact of the ownership change on wages since it would also be affected by other factors which are contemporaneous with the acquisition. A randomly selected control group of firms is therefore also included and the changes in wages for the control group firms corresponding to the pre and post acquisitions periods ($\Delta^c w$) are calculated. If it is assumed that shocks which are contemporaneous with the acquisitions affect the acquired and control firms in similar fashion, then the differences-in-differences estimator $\delta = \Delta^a w - \Delta^c w$, would purge the effects of common shocks and provide an unbiased estimator of the impact of ownership change.

We implement the above methodology within a regression framework by estimating the following equation based on the sample of acquired companies plus the control group:

$$w_{it} = \alpha + \delta A_{it} + \varepsilon_{it}$$

where, i and t index firms and time periods respectively; A is a post-acquisition dummy⁶ and w represents the logarithm of wages. The estimator for δ will then yield the percentage of the wage differential that can be attributed to the change in ownership. In addition, year dummies (α_t) are included to control for aggregate shocks, and firm-specific fixed effects (f) control for permanent differences across firms. Such effects may be due to unobservable human capital attributes or other time-invariant industry level variables that affect wages. A vector X is also included to control for observable changes that are correlated with wage rates such as firm size (proxied by fixed assets), four-digit industry average wages and productivity. Finally, we allow for the possibility that domestic and foreign acquisitions may affect wages in different ways by constructing separate dummies for take-overs by foreign (F) and domestic (D) companies. The extended version of our regression equation can then be written as:

$$w_{it} = \alpha_t + \beta X_{it} + f_i + \delta_1 D_{it} + \delta_2 F_{it} + \varepsilon_{it} .$$

⁶ To allow for the possibility that acquisition year values may reflect values from the previous calendar year, A_{it} is defined as 1 if $t-s > 0$, where s is the year of ownership change for firm i .

A similar methodology is implemented to assess the impact of ownership change on the level of labour productivity, with the following equation being estimated:

$$(q-l)_{it} = \alpha'_t + \beta' Z_{it} + f_i + \delta'_1 D_{it} + \delta'_2 F_{it} + \varepsilon_{it}$$

Where $(q-l)$ is the logarithm of output per worker and Z is a vector that controls for observable changes that are correlated with productivity.

Note that, within this framework, the fact that the acquisition itself may impact on wage and productivity levels is allowed for by including domestic acquisitions as a control in the analysis. A potential complication arises however if foreign and domestic acquirers exploit the opportunities offered by the acquisition differentially. For example Shleifer and Summers (1988) argue that take-overs are partly motivated by the opportunity they offer to renege on implicit labour contracts and to reduce or eliminate extra-marginal wage payments⁷. Foreign and domestic firms may differ in the extent to which this provides a motivation for merger. Dunning and Morgan (1980) argue that a low wage policy is less likely to be followed by foreign managers following acquisition, since they are more likely to be faced by hostile public opinion. Also, since foreign acquisitions may be motivated by the desire to gain access to home markets and avoid tariffs, quotas and excessive transportation costs (Bergstein and Furland, 1981), this may relegate disciplinary and expropriation motives to a secondary concern. Some evidence for this view is found in the United States. Peoples and Hekmat (1998) find a negative association between domestic acquisition activity and wages, which is especially pronounced for unionised workers. Foreign acquisition on the other hand has no effect on unionised wages whilst increasing the wages of non-unionised workers. This is true even after controls for industry characteristics, such as concentration and capital intensity,

4 Empirical Results

The results from the fixed effects panel estimation of the wages equation are reported in Table 6. Column A gives the wage differentials after controlling for fixed firm and industry effects and aggregate time shocks only. It can be seen that there is a 3.44% premium paid to workers in foreign acquired firms, whilst wages fall by 2.11% in domestically acquired

⁷ As evidence for this claim they cite the large windfall gains which accrued to shareholders following the wave of corporate restructuring in the 1980s which cannot be explained by increased efficiency.

companies. In column B firm size and industry wages are controlled for, but the wage differentials observed previously appear to persist. When productivity is added in the vector of control variables, however, the wage premium due to foreign acquisitions disappears. Combining this result with our earlier evidence of no significant downsizing by acquired firms, it is justifiable to conclude that the impact of foreign acquisitions on wages is entirely driven by productivity growth.

In order to investigate this contention further, Table 7 reports panel regression results from a differences-in-differences analysis of the productivity and employment series. Controlling for capital intensity, fixed assets, fixed firm effects and autonomous technical changes (via time dummies), we find a 14 % percent labour productivity improvement due to foreign acquisitions. Combining this information with that relating to the quasi-rents splitting parameter of the wages equation, this translates into a 4.2% percent increase in wages as a result of foreign ownership. This is of comparable magnitude to the 3.4% wage premium estimated in column B of Table 6 and provides additional evidence for our hypothesis.

The efficiency inducing effects of foreign acquisitions that were observed in the productivity equations is further reinforced by the derived labour demand equation estimates reported in the first column of Table 7. It can be seen that, *conditional* on output and wages, labour demand of the typical firm has decreased by 6.2% during the years following acquisition by a foreign company. That is, there is an increase in the technical efficiency with which labour is used.

The experience of firms acquired by domestic firms is markedly different. Table 6 indicates that the reduction in wages due to acquisition is unaffected by the introduction of productivity in the control vector. Read in conjunction with Table 7 which shows that there are neither discernible drops in productivity that can be attributed to the changes of ownership nor any efficiency inducing effects of domestic acquisitions, some support is found for the hypothesis of wealth-transfer away from workers to shareholders. This may reflect reductions in extra-marginal wage payments as suggested by Shleifer and Summers (1988).

5 Concluding Remarks

This paper provides a systematic empirical analysis of the impact of foreign ownership on firm level wages and productivity in U.K manufacturing industry for the period 1989-94. It has identified a significant labour productivity differential between foreign and domestic firms which is partly translated into higher wage levels in foreign owned companies. The study also finds evidence that domestic acquisition activity is motivated by the opportunity that it offers to renege on implicit labour contracts and transfer surplus from the workforce.

Table 1. Frequency of ownership changes by year

Year	Domestic	Foreign
1989	64	27
1990	67	27
1991	54	19
1992	61	21
1993	47	19
1994	38	16
Total	331	129

Table 2. Balance of the panel

Number of time series	Domestic	Foreign	Control
5	7	9	42
6	23	4	47
7	20	10	54
8	35	18	45
9	94	45	199
10	152	43	255
Total	331	129	642

**Table 2a. Domestic and Foreign owned firms in U.K Manufacturing industry:
Average employment, wages, and labour productivity**

Variables	1989	1994
Domestic		
Employment	414 (1650)	327 (1369)
Wage rate	11.35 (3.87)	13.29 (4.31)
Labour Productivity	72.45 (163.77)	74.48 (96.77)
Foreign		
Employment	549 (1641)	434 (1098)
Wage rate	12.71 (3.90)	15.22 (4.40)
Labour Productivity	104.68 (137.67)	118.28 (154.24)

Notes:

- (i) Variables are given in real terms
- (ii) Standard deviation in parentheses.
- (iii) Outliers excluded.

Table 3. Sample means (and standard errors) of Employment, wages and labour productivity

Variable	Domestic		Foreign		Control	
	Before	After	Before	After	Foreign	Domestic
Employment	.58 (.86)	.57 (.70)	.60 (.87)	.70 (.84)	.90 (1.18)	.75 (.92)
Wages	.98 (.31)	.94 (.29)	1.01 (.30)	1.03 (.27)	1.07 (.25)	.97 (.22)
Labour Productivity	1.14 (1.48)	1.02 (1.04)	1.02 (.69)	1.16 (.89)	1.34 (.79)	1.04 (.68)

Notes:

- (i) All of the variables are divided by the corresponding 4-digit SIC average values .
- (ii) Productivity is measured by output per employee.
- (iii) “Before” and “After” refer to the observed time periods before and after the ownership changes.

Table 4. Multinomial Logit estimates for the determinants of ownership changes

Regressor	Domestic	Foreign
Wages _(t-1)	-.78 (4.10)	.06 (.83)
Wages _(t-2)	-.03 (0.10)	.27 (1.09)
Profit _(t-1)	-.002 (0.62)	-.022 (3.16)
Profit _(t-2)	-.001 (0.54)	-.023 (3.50)
Size _(t-1)	-.36 (11.74)	-0.27 (6.29)
Concentration _(t-1)	-.12 (3.58)	-.03 (0.49)
FDI _(t-1)	-.16 (5.49)	.05 (1.07)
P-value for test of IIA	.81	.99

Notes:

(i) Wages and profits per worker are measured relative to the 4-digit SIC averages. Size is proxied by employment.

(ii) Concentration is the 4-digit SIC Herfindahl index and FDI is the share of foreign employment from total 4-digit level SIC industry employment.

(iii) “No change of ownership during the year” is used as the base category.

(iv) The absolute values of the t-statistics are reported in parentheses.

(v) IIA stands for the assumption of Independence of Irrelevant Alternatives. In our context, this implies that the effects of the regressors on the probability of being taken over by a domestic firm is not affected by the inclusion of foreign acquisitions as a possible outcome. We fail to reject the validity of this assumption by conducting Hausman –type tests suggested by Hausman and McFadden (1984)

**Table 5. Post-ownership changes of employment, wage rates
and labour productivity**

Variables	t+1	t+2	t+3
Domestic			
Employment	3.7(1.23)	3.7 (1.10)	6.1 (1.59)
Wage rate	1.0(0.42)	3.7 (2.42)	8.8 (5.59)
Labour Productivity	-1.8 (-0.83)	5.3 (2.64)	10.2 (4.46)
Foreign			
Employment	4.5 (1.51)	4.4 (1.17)	2.2 (0.53)
Wage rate	3.9 (2.11)	6.4 (3.41)	13.0 (5.98)
Labour Productivity	11.8 (3.50)	13.5 (3.99)	20.2 (5.27)

Notes:

- (i) Column $t+s$ represents the % changes in the relevant variables which are due to the two types of ownership changes s years after the event. Here the pre-ownership change year (i.e. $t-1$) is used as the base.
- (ii) The values in parenthesis are t-values obtained from paired t-tests for equality to the base year values.

**Table 6. The impact of ownership changes on wages:
differences –in-differences estimates**

	A	B	C
Industry wage		.09 (7.92)	.05 (4.93)
Fixed assets		.004 (1.84)	.01 (3.75)
Labour Productivity			.30 (5.42)
Domestic	-2.11 (3.16)	- 2.10 (3.13)	- 2.17 (3.79)
Foreign	3.44 (3.46)	3.38 (3.42)	0.00 (0.00)
Joint year effects	Yes	Yes	Yes

Notes:

- (i) The coefficient of Domestic and Foreign represent the average post ownership percentage growths.
(ii) Absolute values of t-stats are given in parentheses.

Table 7. The impact of ownership changes on derived labour demand and labour productivity

	Employment	Labour Productivity
Output	0.73 (126.76)	
Wages	-.703 (47.83)	
Capital intensity		.052 (8.61)
Domestic	-.01 (0.09)	0.00 (0.00)
Foreign	-6.17 (4.70)	14.1 (8.31)
Joint years effect	Yes	Yes

Notes:

- (i) Absolute values of t-statistics are given in parenthesis.
- (ii) Capital intensity is measured by fixed assets per worker.

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