



## FOREIGN DIRECT INVESTMENT: WHO GAINS?

*Although foreign direct investment (FDI) contributes to growth in developing countries, there is evidence that the benefits are not equally distributed. Foreign-owned firms tend to pay higher wages in developing countries, but skilled workers tend to benefit more than less-skilled workers. This conclusion is based on new research conducted into the effects of FDI on wages in five East Asian economies and the effects of foreign ownership in five African countries. While FDI may support development in the aggregate, more attention should be focused on the distribution of gains from FDI, notably effects on wage inequality.*

### The issue

Foreign Direct Investment (FDI) is an important source of private capital for developing countries. The UN conference on Finance for Development (FFD) argues that 'private international capital flows, particularly foreign direct investment, along with international financial stability, are vital complements to national and international development efforts' (Outcome: point 20, p. 5). Other international policy documents (e.g. the Cotonou Partnership Agreement, NEPAD) also emphasise the importance of private sector investment for development, both domestic and foreign, for development, and private sector investment features prominently in the UK White Paper Making Globalisation Work for the Poor (DFID, 2000).

An issue of current interest is whether FDI can contribute to the objective of reducing poverty. This will depend on how the gains from FDI are distributed, among sectors, workers and households. Systematic evidence on the effects of FDI on income distribution and poverty in developing countries is lacking. In principle, there is no direct link between FDI and poverty reduction – this does not include 'socially responsible' investment which may directly benefit the poor – but there are three possible indirect links.

- If FDI contributes to export growth, productivity growth and finance for the balance of payments, it supports increases in national income that offer the potential to benefit the poor. In this case FDI does not reduce poverty directly, but it helps to create an enabling economic environment.
- If FDI increases employment it may help some to move out of poverty. With the exception of FDI in textiles, a lot of FDI in manufacturing is likely to employ labour that is relatively skilled (in terms of the local market), and would not directly benefit the poor. Well-developed linkages with local suppliers may increase employment of various skill groups.
- Foreign firms may pay higher wages than local firms for workers with similar qualifications. Because of the skill-bias of FDI this will not directly affect the poor and is likely to increase inequality of wage incomes, increasing the skilled/unskilled wage differential, and to increase urban/rural income differentials. However, by establishing a higher paid labour force and developing a better skilled

labour force, it should increase incentives and effort and can generate dynamic benefits to the economy.

The evidence that FDI contributes to economic growth is encouraging rather than compelling (Lensink and Morrissey, 2000), and growth itself does not guarantee poverty reduction. Evidence also suggests that economic conditions and government policies determine in part the extent to which FDI contributes to growth (Te Velde, 2001). The poorest countries, such as those in Africa (that receive a very small proportion of FDI), appear the least able to derive growth benefits. One cannot simply assume that FDI will contribute to poverty reduction through fostering growth in poor developing countries.

If the foreign investment represents additional investment it should provide employment. This benefits workers and the economy in general, and may benefit some of the poor. Foreign firms tend to be larger than local firms, hence the presumption that greenfield investment increases employment. However, increasing amounts of FDI are for mergers and acquisitions, such as buying privatised firms, and this may not necessarily increase employment. If foreign firms are more capital intensive, employment levels will fall in the short-term (although labour income may rise). If they compete with local firms, employment may be reduced elsewhere in the economy. Unfortunately, there is little systematic evidence of the total employment effects of FDI, partly because such effects depend on the country, sector and time framework of interest.

This Briefing Paper concentrates on the third channel identified above, namely the effect of FDI on incomes of different groups of workers, as an indication of how gains are distributed. The evidence focuses on the differential impact of FDI on workers, specifically on wages. Depending on the distribution of different types of workers over rural and urban areas and over small and big firms, the findings have wider policy implications.

### The impact of FDI on different types of workers: theory

Foreign-owned firms, the manifestation of FDI, influence distribution of incomes partly because they demand different types of labour and pay higher wages than local firms. In general, one can focus on effects for skilled versus low-skilled or unskilled labour. At a global level, some FDI is attracted to countries that are abundant in unskilled labour relative to other countries (other FDI is attracted by natural resource endowments or policy factors). However, the foreign firms may still employ labour that is relatively skilled by local standards. There are a number of reasons why one would expect FDI to increase the demand for, and wages of, relatively skilled labour.

- Skill-specific technological change. In addition to initial efficiency differences, FDI could induce faster productivity growth of labour in both foreign (technology transfer)

**Table 1 Distribution of FDI stocks in East Asia by sector**

	Hong Kong (flows 1997)	Korea (accumulated flows, 1962–98)	Singapore (stock of foreign direct equity investment, 1998)	Thailand (accumulated flows, 1970–2000)	Philippines (accumulated flows, 1985–99)
Agriculture & mining	0	0	0	1	7
Manufacturing	2	59	33	42	48
Food & textiles		7		5	12
Chemicals		12		6	14
Machinery & electrical appliances		16		20	} 21
Other manufacturing		25		11	
Construction		1	1	5	4
Trade	28	10	15	19	8
Services	70	30	52	33	34

Source: Te Velde and Morrissey (2002)

and domestic firms (spill-over effects). If such productivity growth is skill-biased (e.g. information technology), FDI may increase skill-biased technological change.

- Skill-specific wage bargaining. Skilled workers are usually in a stronger bargaining position than less-skilled workers, as they possess key skills in relatively scarce supply and may have better negotiation skills. As foreign firms have less knowledge of the local labour market, skilled workers are in a position to negotiate higher wages than they would get in local firms.
- Composition effect. Foreign firms may have different skill intensities from domestic firms in the same sector pushing up the average skill intensity. Foreign firms also tend to locate in skill intensive sectors. If FDI causes a relative expansion of skill intensive sectors, this will improve the relative position of skilled workers and raise wage inequality.
- Training and education. FDI may affect the supply of skills through firm-specific and general training and through contributions to general education (see Te Velde, 2001). While foreign firms generally train more than their local counterparts, after controlling for other factors that are positively related to training such as size, much of the training benefits skilled workers.

The above factors are each complex and potentially inter-related. The effect of FDI on relative wages and employment will vary between sectors, across countries and over time.

### The impact of FDI on different types of workers: evidence

Almost all evidence shows that FDI and foreign ownership are associated with higher wages for all types of workers. It is argued that skilled workers tend to benefit more than less-skilled workers (for any or a combination of the reasons outlined above). Studies of the link between FDI and wages fall into two broad types. Macro studies look for a relationship between FDI and wage differentials or wage inequality at a national level. Micro studies use worker and/or firm-level data to assess if wages or differentials differ between foreign and local firms.

#### Macro studies

Most evidence on the relationship between FDI and wage inequality at the macro level is for developed countries.

Blonigen and Slaughter find that multinational activity was not significantly correlated with skill upgrading within US manufacturing sectors, but other studies find evidence for a sector bias towards using skilled workers. Figini and Gorg find that FDI was associated with skill upgrading and increased wage dispersion in Irish manufacturing to a certain extent, while Taylor and Diffield find significant effects of FDI on wage dispersion in UK manufacturing. As regards the evidence for developing countries, Feenstra and Hanson (1995) find that inward FDI increased the relative demand for skilled labour in Mexican manufacturing. Freeman et al. (2001) find no evidence for a consistent relationship between FDI and wage inequality in a large sample of developing countries.

The relationship between FDI and wages at the country level will, amongst other influences, depend on the sectors in which FDI is directed. Table 1 shows the sector distribution of FDI in five East Asian countries analysed in Te Velde and Morrissey (2002). FDI in Hong Kong and Singapore has been mainly aimed at the financial sector, which is relatively skill intensive. In Korea, most of the relatively little FDI it has received was in manufacturing. The manufacturing sector in Thailand and Philippines also absorbed most FDI. Thailand in particular attracted a quarter of FDI flows in the capital-intensive and relatively skill-intensive chemical, machinery and electrical manufacturing sectors. The table shows that the skill-intensive sectors overall did attract significant FDI flows in all five East Asian countries, implying that the FDI-composition effect is unlikely to have reduced wage inequality.

#### Micro studies

To determine the 'true' effect of foreign ownership on wages, one must control for other determinants of wages. The most important control variables are skill intensity, size, region and sector. Foreign firms are likely to employ relatively more skilled labour, so average wages will be higher (see above). One should therefore compare wages of workers with equivalent qualifications. Foreign firms tend to be larger than local firms, and large firms pay more for equivalent workers than smaller firms do so one must control for size. One should control for industry type as foreign firms locate in particular industries in which wages may be higher. Similarly, foreign firms locate in areas, such as the capital city, where wages may be higher so one should control for location. Ideally, one would also try to control for firm-level efficiency as labour productivity may be higher in foreign firms.

**Table 2 Wage differentials between foreign-owned and local firms in developing countries**

Authors of study	Country, year	Key variable	Controls	Results
Aitken, Harrison and Lipsey	Mexico (1990) and Venezuela (1987)	Wage of skilled and unskilled	Firm characteristics, industry and region	FOE* pay 29% per more in Venezuela, and 22% in Mexico (skilled); 22% more in Venezuela and 3.3% in Mexico (unskilled)
Haddad and Harrison	Morocco, manufacturing firms, 1985-1989	Average wage level in firm	Size	FOE* pay 30% more
Lipsey and Sjöholm	Indonesia, manufacturing plants, 1996	Average wage	Worker and firm characteristics	FOE* pay 12% more to blue collar and 22% more to white collar workers
Matsuoka	Thailand, manufacturing, 1996 and 1998	Hourly wages	Labour productivity, region and industry	FOE* pay 20% more for non-production and 8% for production workers in 1996; 28% and 12% for 1998
Mazumdar	Cameroon, and Zambia, manufacturing, 1993	Earnings	Worker and firm characteristics	FOE* pay 18% more in Cameroon and 24% in Zambia
Ramstetter	Hong Kong (1983-1996), Malaysia (1972-1979, 1981-1995), Singapore (1975-1996), Taiwan (1974-1995), manufacturing plants/firms	Real compensation per employee		FOE* pays higher wages in Hong Kong (27%), Malaysia (20%), Singapore (9%), Taiwan (16%)
Te Velde and Morrissey	Cameroon, Ghana, Kenya, Zambia and Zimbabwe, manufacturing firms, early 1990s	Average monthly earnings	Worker and firm characteristics	FOE* pay higher wages – Cameroon (8%), Ghana (22%), Kenya (17%), Zambia (23%) and Zimbabwe (13%), but skilled workers gain more

\* Foreign-Owned Establishments

References: see Te Velde and Morrissey (2001)

Empirical evidence on wage differentials summarised in table 2 conveys three important conclusions:

- Foreign-owned firms pay more to their workers than local firms. Wage differentials can be up to 60% (Indonesia), but often are more modest.
- Studies that do not control fully for other effects overstate the effect of foreign ownership on wages.
- Studies that distinguish between average wages in two separate skill categories find that wage differentials are greater for non-production (relatively skilled) workers than for production (less skilled) workers.

Te Velde and Morrissey (2001) find that foreign ownership is associated with higher wages at the individual worker level in five African countries, after controlling for other influences on wages. Skilled workers tend to benefit more than less-skilled workers. This may be because foreign ownership is associated with skill-biased technology or because skilled workers in foreign firms are more effective in bargaining. In practice it is difficult to distinguish between these effects (for this we would need the effects of foreign ownership on productivity, not only the effects on wages), and it is likely that an element of both is present.

### Implications for policy

Governments try to attract FDI for expected beneficial effects on employment, wages, balance of payments, technology and growth. They are not usually, or at least have not been in the past, concerned with effects on inequality or poverty. Furthermore, FDI is only one of many factors affecting skill-

specific wages and wage inequality. Others, some of which were considered as controls above, may be more amenable to influence by government policy. This includes education, training and technology transfer.

The African and East Asian studies reviewed suggest that foreign ownership or FDI does increase wages, but more so for skilled workers thereby increasing wage inequality. This does not necessarily imply that national income inequality will increase. In general, FDI may have most effect on those in the middle of the income distribution, and little effect on those at the bottom (the poor, unless some of these are the unskilled who gain jobs). The effect may be to bring some in the middle closer to the top group, reducing inequality, but further from the bottom, increasing inequality. Concern here is not about policies towards inequality or the poor per se, but about policies to ensure greater and more equitably distributed gains from FDI.

### Host-country policies

The best policies are those that increase the potential for workers and for the economy to benefit from FDI. The former policies relate primarily to education, training and industrial relations. The latter relate to encouraging increased efficiency of domestic firms, to benefit from linkages with and spillovers from foreign firms, and to attracting FDI into areas or sectors that are most likely to benefit the poor (e.g. rural areas or agricultural processing).

Growth in FDI will increase the demand for skilled workers. Good quality and appropriate education in this context

requires increased enrolment in secondary education to provide the foundation for vocational and tertiary technical education. Governments in developing countries have tried various schemes to boost enterprise training, but take-up and coverage rates remain low. There is a case for public policy intervention as private firms may not have sufficient incentives to train low-skilled workers. The problem is also severe in the poorest countries that lack adequate resources to finance secondary and vocational training. Foreign firms offer more training than their local counterparts, and should be encouraged to offer more to low-skilled workers. This would be an appropriate element of corporate social responsibility if foreign firms are committed to increasing the benefits for all workers.

If governments want to ensure that some benefits of FDI go to the poor directly, they may want to encourage foreign firms that employ relatively unskilled labour and/or attract investment in sectors that are likely to benefit the poor. This Briefing Paper has concentrated on FDI in manufacturing. If FDI increases employment of unskilled workers who were poor, it can reduce poverty whilst increasing wage inequality. FDI that supports employment in rural areas and agricultural sectors is more likely to benefit the poor, even if the gains are also unequally distributed.

Whilst certain policies that directly affect FDI can help to ensure that all workers gain from FDI, other, more indirect and more general policies are sometimes as effective or efficient. There are various policy options through which the benefits of FDI can be made to reach the poor indirectly. These include maximising employment opportunities and learning effects in local firms through promoting linkages within the guidelines set by international regulations and using fiscal receipts of the foreign investment to spend on productive infrastructure or social sectors such as education and health.

### International community

The international community has various options. First it could emphasise the importance of the social dimensions of globalisation, by reiterating the need that all benefit from FDI. In doing so, it can support the implementation of the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (which are related to the OECD MNE guidelines on training/industrial relations), setting out principles in the field of employment, training, working conditions and industrial relations. The right of collective bargaining and the need to provide training 'for all levels of their employees' seem important in the context of FDI and wage inequality, and more research is needed to examine whether practices differ between foreign and local firms.

Second, the donor community could support developing country efforts to improve the impact of FDI on wages of low-skilled workers. Support for good quality and appropriate education and general training for low-skilled workers is justified. Donors should recognise the potential benefits from vocational training schemes (an appropriate element of a private sector development programme).

Whilst it is clear that FDI and foreign ownership are one factor in increasing average wages, skilled workers tend to gain more than low-skilled workers. Although low-skilled workers do benefit (and therefore the poor may benefit), the tendency for FDI to raise wage inequality may require a policy response.

The policy implications can be summarised as follows:

- FDI raises average growth and wages, but does not reduce and may increase wage inequality in developing countries. Policy should be aware of whether wage inequality leads to national income inequality.
- Policies to use FDI can be effective in ensuring that FDI works for less skilled as well as skilled workers, and that it is more likely to provide employment benefits to the poor.
- Support for good quality and appropriate education and general training for low-skilled workers is required to make FDI work for development for all types of workers.
- More attention should be focused on the bargaining position of low-skilled workers in a globalising world. Much of the micro-evidence finds that skilled workers in foreign firms are able to obtain a higher wage premium than low-skilled workers, not necessarily because foreign-owned firms make skilled workers more productive but rather because skilled workers in foreign-owned firms are relatively more effective in wage bargaining.

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