Summary
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.

1 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’ (Draft Outcome: point 20, p. 5). Other international policy documents (e.g. the Cotonou Partnership Agreement, NEPAD) also emphasise the importance of private sector investment, both domestic and foreign, for development, and FDI features prominently in the 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, but there are three possible indirect links.

- If FDI contributes to economic growth, it supports increases in national income that offer the potential to benefit the poor. In this case it is not FDI that reduces poverty, but it helps to create an enabling economic environment.
- If FDI increases employment it may help some to move out of poverty. 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. FDI in primary sectors (except the gas and oil sectors) is more likely to employ unskilled labour and to provide benefits to rural areas and could reduce poverty in those areas.
- Foreign firms may pay higher wages than local firms for workers with similar qualifications. 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 better skilled and higher paid labour force, it should increase incentives and effort and can generate dynamic benefits to the economy.

1 We are grateful to DFID for funding under grant R8003. More details can be found in Te Velde and Morrissey (2001 and 2002).
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. The poorest countries, such as those in Africa (that receive a very small proportion of FDI), are also 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 (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 employment effects of FDI.

This Briefing 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.

2 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) and domestic firms (spill-over effects).

- **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, and can get higher wages. 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 pushing up the average skill intensity. 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, 2002).

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

3 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. 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*

The relationship between FDI and wages at the country level will, amongst others influences, depend on the sectors in which FDI is directed. Table 1 shows the sector distribution of FDI in five East Asian countries. 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.

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<td>5</td>
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For sources see: Te Velde and Morrissey (2002)

Te Velde and Morrissey (2002) focus on a panel of East Asian countries and discuss the relationship between the stock of FDI as a per cent of GDP and skill-specific wages (controlling for other determinants of skill-specific wages, such as employment effects, unionisation rates and trade). It may be expected that FDI would locate in countries such as Thailand and Philippines to avail itself of abundant low-skilled labour. Employing low-skilled workers would help to reduce wage inequality. The results indicate that while FDI benefited both skilled and low-skilled workers to the same extent in four Asian countries (Hong Kong, Korea, Philippines and Singapore),
it benefited skilled more workers in Thailand. Feenstra and Hanson (1995) find that inward FDI increased the relative demand for skilled labour in Mexico over 1975-1988. Freeman et al. (2001) find no evidence for a consistent relation between FDI and wage inequality in sample of developing countries.

**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, regional 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 (Strobl and Thornton, 2001), so one must control for size. One should control for industry type as foreign firms locate in particular industries (Aitken et al., 1996, Aitken and Harrison, 1999), 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.

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 per cent (Indonesia), but more 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.

**Table 2 Wage differentials between foreign-owned (FOE) and local firms**

<table>
<thead>
<tr>
<th>Study</th>
<th>Country, year</th>
<th>Dependent variable</th>
<th>Controls</th>
<th>Results</th>
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<tbody>
<tr>
<td>Aitken, Harrison and Lipsey (1996)</td>
<td>Mexico (1990) and Venezuela (1987),</td>
<td>Wage of skilled and unskilled</td>
<td>firm, industry and region dummies</td>
<td>FOE pay 29% per more in Venezuela, and 22% in Mexico (skilled); 22% more in Venezuela and 3.3% Mexico (unskilled)</td>
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<tr>
<td>Haddad and Harrison (1993)</td>
<td>Morocco, manufacturing firms, 1985-1989</td>
<td>Average wage level in firm</td>
<td>Size</td>
<td>FOE pay 30 per cent more</td>
</tr>
<tr>
<td>Lipsey and Sjoholm (2001)</td>
<td>Indonesia, manufacturing plants, 1996</td>
<td>Average wage</td>
<td>Worker and firm characteristics</td>
<td>FOE pay 12% more to blue collar and 22% more to white collar workers.</td>
</tr>
<tr>
<td>Mazumdar (1995)</td>
<td>Cameroon, and Zambia</td>
<td>Earnings</td>
<td>Worker and firm characteristics</td>
<td>FOE pay 18% more in Cameroon and 24% in Zambia.</td>
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<tr>
<td>Te Velde and Morrissey (2001), table</td>
<td>Cameroon, Ghana, Kenya, Zambia and Zimbabwe (manufacturing firms)</td>
<td>Average monthly earnings</td>
<td>Worker and firm characteristics</td>
<td>FOE pay higher wages - Cameroon (8%), Ghana (22%), Kenya (17%), Zambia (23%) and Zimbabwe (13%).</td>
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</table>
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, and it is likely that an element of both is present.

4 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 above suggested 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 little effect on those at the top 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 is 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 spill-over 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 most 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, they will need to encourage foreign firms that employ relatively unskilled labour and/or attract investment in sectors that are likely to benefit the poor. This Briefing has concentrated on FDI in manufacturing. If there is increased employment of unskilled workers who were poor, the FDI in manufacturing 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.

**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’s 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 skilled as well as less 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 type 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 because foreign owned firms make skilled workers relatively more effective in wage bargaining.
References and Further Reading


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