



# Foreign direct investment, intellectual property rights, and wage inequality in China

Xiaodong WU\*

*Department of Economics, University of North Carolina at Chapel Hill, Gardner Hall 304, CB#3305,  
Chapel Hill, NC 27599, USA*

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## Abstract

This article incorporates foreign direct investment (FDI) and product differentiation in a general equilibrium trade model. The analysis shows that freer trade and FDI will upgrade China's technology, improve its skills of labor, and increase the competitiveness of local firms in the international market. At the same time, the relative wage of skilled labor to unskilled labor will rise. The size of this rise will be affected by the degree of protection for intellectual property rights. These theoretical results are consistent with empirical evidence. The analysis provides insights in coordinating policies on FDI, labor market reform, and intellectual property rights protection. © 2001 Elsevier Science Inc. All rights reserved.

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## 1. Introduction

Attracting foreign direct investment (FDI) has been a strategic economic policy adopted by China to upgrade technology and boost economic growth. FDI inflows into China have increased rapidly in the past three decades, especially into the 1990s. Since 1993, China has become the second largest FDI recipient after the United States (United Nations, 1999). Firms with FDI have contributed to over 40% of China's total trade since the mid-1990s.

With China's imminent accession to the World Trade Organization (WTO), FDI will penetrate more of the Chinese economy. Notwithstanding the benefits FDI can bring, what

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*E-mail address:* wux@email.unc.edu (X. Wu).

potential risks can such influxes of FDI impose on the domestic economy? What policies can help a host country reduce such risks and maximize the benefits, especially with large FDI inflows as in China's case? Moran (1998) synthesizes evidence drawn from a wealth of case studies to assess policies toward FDI in developing countries and economies in transition. He finds that there is indeed a large and vital role for host country authorities to play in designing policies to manage FDI inflows, and that the needed actions differ substantially from conventional wisdom.

This article will focus on the effect of FDI on China's relative wage of skilled and unskilled labor, and explore the policy implications for China's labor market reform. This is particularly important as access to the Chinese market by foreign trade and investment under the WTO rules can bring dramatic changes to China's employment and division of labor. The significance of the impact of FDI on China's relative wages may be concealed by the relatively small share of foreign-funded enterprises (FFE) in China's total employment. But wages, like all the other prices, are set at the margin. FFEs can push up the wages even if their employment share is small.<sup>1</sup> Indeed, multinational firms are found to have contributed to increasing inequality in income distribution in China. Zhang and Zheng (1998) show that the GINI coefficient of the per capita wages in industrial sectors almost doubled between 1985 and 1995. One of the culprits identified for this increase in income inequality is the entering of multinationals.

Table 1 shows that the employment shares of the state-owned enterprises (SOEs) and collective-owned enterprises (COEs) in urban areas have declined, while that of the FFEs has increased since 1985. From 1985 to 1998, the average wage of the SOEs was, on average, 5% higher than the total average wage; that of the COEs was, on average, 23% lower; while that of the FFEs was, on average, 46% higher; as shown in Table 2. These data demonstrate that FFEs have been successfully expanding their market shares by using higher wages to attract labor from other domestic firms.

The relationship between the amount of FDI and the average wage in each sector is, however, not monotonic as illustrated in Fig. 1. This suggests that not all FDIs have the same effect on wages. To understand the variation, we can trace to the sources and patterns of China's FDI. Fig. 2 shows that most FDIs in the manufacturing sector from developing countries are relatively labor-intensive, while that from developed countries are relatively capital- or technology-intensive. Overall, developed countries invest mostly in technology- or human capital-intensive (high-tech) sectors, such as electronic and machinery, while developing countries invest mostly in labor-intensive (low-tech) sectors, such as food and textiles (Chen, 1997a, 1997b; Zhang & Zheng, 1998).

Given these differences, a question is whether FDI in different sectors has different impacts on the relative wage of skilled and unskilled labor. Since most FDIs in China are export-oriented, as FDI provides a channel for foreign firms to exploit China's cheaper labor input, the traditional Heckscher–Ohlin–Samuelson model predicts that, as FDI induces more trade,

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<sup>1</sup> Leamer (1994, 1998, 2000) and Wood (1994, 1995) demonstrate that wages are linked to prices rather than to volumes. Their empirical results show that trade can be the main cause of growing wage inequality between skilled and unskilled labor, regardless of trade's contribution to total GDP.

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