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Foreign Direct Investment, inequality, and growth

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Abstract

This paper examines the interactions between Foreign Direct Investment (FDI), inequality, and growth, both from an empirical and a theoretical point of view. Using a panel of 119 developing countries, we observe that FDI promotes both inequality and growth, and tends to reduce the share of agriculture to GDP in the recipient country. We then set up a growth model of a dual economy in which the traditional (agricultural) sector uses a diminishing returns technology, while FDI is the engine of growth in the modern (industrial) sector. The main predictions of the model are consistent with the stylized facts observed in the data.

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1. Introduction

A recent United Nations Human Development Report (1999) suggests that in an era where there is massive infusion of modern technology, the inequality in the level of access

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to technology in different countries is widening.[1] This paper attempts to explain why this is the case by looking at how FDI impacts human capital inequality, an issue which has been neglected in the literature.

We first present some stylized facts relative to the interactions between FDI, human capital inequality, growth, and the share of agriculture to GDP in the recipient country. These stylized facts are based on a panel of 119 developing countries over the period 1970–1999. We find that there is a positive association between FDI and inequality, as well as between FDI and growth, and a negative relationship between FDI and the share of agriculture to GDP in the recipient country. These findings suggest that, in developing countries, FDI induced growth exacerbates human capital inequality.

We then develop a growth model with the aim to explain these stylized facts. Our model is based on a dynamic dual economy in which the traditional (agricultural) sector uses a diminishing returns technology, while FDI is the engine of growth in the modern (industrial) sector. There are two types of altruistic agents in this economy: the poor with a low initial human capital, and the rich (entrepreneurs) with a high initial human capital. In this world, foreign capital benefits the rich who have enough human capital to operate modern manufacturing enterprises. It does not benefit the poor, unless they are able to accumulate sufficient human capital to operate the modern technologies by becoming entrepreneurs. Their ability to become entrepreneurs depends on the productivity of agriculture and on their initial level of human capital.

An enclave economy scenario, where it is not feasible for the poor to become entrepreneurs, portrays that there is rising inequality between the rich and the poor as foreign capital enhances the total factor productivity of the modern sector. Along the trajectory of growth and inequality, the agricultural sector, which uses traditional indigenous technology, diminishes in importance. In an alternative scenario where the poor have the potential to become entrepreneurs, the model makes similar predictions, barring some special transitional paths. The theoretical results are, therefore, broadly consistent with the stylized facts.

The rest of the paper is organised as follows. Section 2 presents a brief literature review. Section 3 describes the stylized facts aimed at motivating our theoretical analysis. In Section 4, we lay out the theoretical model. In Section 5, we discuss the model's predictions regarding the interactions between FDI, inequality, and growth in the enclave economy scenario, and the scenario where it is feasible for the poor to actually become entrepreneurs. Section 6 concludes the paper.

2. Literature review

Two distinct branches in the growth literature focus on how growth relates with inequality on the one hand, and with FDI, on the other. Within the first branch, there

[1] According to the United Nations Human Development Report (1999): "...the disparities are [...] stark. In mid-1998, industrial countries – home to less of 15% of people – had 88% of Internet users. North America alone—with 5% of all people—had 50% of Internet users. By contrast, South Asia is home to over 20% of all people, but had less than 1% of the world's Internet users". This shows that a very small proportion of people have access to modern technologies.