BALANCING GROWTH AND EQUITY: THE IMPACT OF FOREIGN DIRECT INVESTMENT ON POVERTY AND INCOME INEQUALITY IN MIDDLE-INCOME COUNTRIES

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Abstract

This article examines the complex correlation between Foreign Direct Investment (FDI), poverty, and income inequality in middle-income countries from 1972 to 2024. We use a detailed analysis along with visual data to show how foreign direct investment (FDI) has led to substantial economic growth in countries like China, India, and Brazil, especially during the 1990s and 2000s. Although there have been economic gains, the positive effects of Foreign Direct Investment (FDI) have not been distributed equally, leading to varied results in reducing poverty and often worsening income inequality. The results of our research suggest that Foreign Direct Investment (FDI) has made a significant contribution to the creation of jobs and improvement in living standards. However, it is important to note that the effects of FDI differ significantly depending on the specific regions and economic structures. The analysis highlights the significance of local ability to absorb and utilize foreign direct investment (FDI) and the need for specific economic policies to optimize its positive impacts. Therefore, we suggest various policy recommendations, such as increasing investments in education and infrastructure, implementing progressive social policies, and promoting regional cooperation to ensure a fairer distribution of benefits from foreign direct investment (FDI). These strategies are essential for effectively utilizing foreign direct investment (FDI) to achieve inclusive and sustainable development, with the goal of reducing poverty and narrowing income inequalities in middle-income countries.

1 Introduction

Economic integration has been substantial in the post-World War II period, primarily driven by Foreign Direct Investment (FDI) flows, trade, and finance. The flows are classified into three primary categories: portfolio investment, foreign direct investment, and other foreign investments. The concept of foreign direct investment (FDI) facilitated by multinational enterprises (MNEs) can be categorized into two distinct types: direct FDI and indirect FDI. Direct foreign investment denotes investments made by foreign investors directly in the markets of host economies, whereas indirect investment is also prevalent. The International Monetary Fund (IMF) suggests that a subsidiary should possess a 10% ownership interest in a direct investment enterprise, while maintaining at least 50% control over the voting rights of the shareholders of the foreign investor. Foreign direct investment (FDI) flows are primarily motivated by the economic objectives of the host country and the profit-seeking intentions of investors from their home country.

In 2011, the United Nations prioritized the UNCTAD's role in determining the scope and definition of international investment, specifically addressing important issues pertaining to international investment agreements. The UNCTAD report explained the annual decline in worldwide foreign direct investment, attributing it to the United States' implementation of tax reforms and the subsequent decrease in FDI inflows. According to UNCTAD (2019), 54% of global flows are present in developing nations. Foreign direct investment is essential for accelerating development, as it enables the transfer of technological knowledge across borders in developing countries. This study provides valuable insights into the composition of different middle-income countries and their capacity to efficiently govern and maintain economic growth. Foreign investment is regulated by multiple treaties that delineate the guidelines and restrictions for both individual and corporate investments.

Asia receives the largest amount of foreign direct investment (FDI), with a total inflow of $476 billion, making it the highest in the world. The Latin America and Caribbean region witnessed a surge of 8% in foreign direct investment (FDI) inflows, reaching a cumulative sum of $151 billion. China, classified as a lower middle-income country, has received the highest amount of Foreign Direct Investment (FDI) compared to other countries in the same income category. The total FDI inflows into China amount to $175 billion. Foreign Direct Investment (FDI) is the transfer of capital, knowledge, technology, and skills with the aim of generating profit for investors. The effect of foreign direct investment (FDI) is contingent upon the specific attributes and structure of the host country. Foreign Direct Investment (FDI) acts as a catalyst for technological innovation, resulting in enhanced productivity, increased capital formation, and improved economic growth. Both trade and foreign direct investment (FDI) play crucial roles in promoting technological progress.

Foreign direct investment (FDI) plays a crucial role in stimulating a nation's economic development by channelling resources to areas where they are most required. Research has demonstrated a direct relationship between foreign direct investment (FDI) inflows and the expansion of gross domestic product (GDP). This connection is established by means of technology transfer, the creation of job opportunities, and the acquisition of managerial skills. Nevertheless, there exists an inverse relationship between foreign direct investment (FDI) flows and poverty, as FDI flows are not efficiently employed to alleviate poverty. FDI flows and income inequality exhibit a non-linear relationship, characterized by a U-shaped impact on income inequality. Foreign direct investment (FDI) indirectly contributes to the reduction of income inequality by fostering economic growth.

Developing countries, accounting for around 33% of the world's GDP and playing a crucial role in driving global economic growth, have a favourable influence on sustainable economic development through positive spillover effects. The transfer of skills in technology, management, and leadership from the home country to the host country has a positive impact on poverty reduction in the host country. Foreign direct investment (FDI) inflows play a crucial role in stimulating economic growth by filling the investment gap that exists between the current level of investment and the desired level, which includes domestic savings. Foreign direct investment (FDI) is essential for increasing domestic savings and promoting economic growth by bringing in advanced technology and management expertise.

Developed nations' governments provide strategies to mitigate poverty and inequality, recognizing their detrimental effects on economic development and growth in both developing and developed nations. This research will significantly contribute to addressing the issues of poverty and income inequality.

2 Historical trends in foreign direct investment, poverty, and income inequality in middle-income countries

From 1972 to 2024, middle-income countries experienced significant transformations in FDI, poverty, and income inequality. Initially, the 1970s and 1980s saw modest FDI inflows due to early economic liberalization. The 1990s marked rapid FDI expansion driven by globalization and liberal economic policies, particularly benefiting countries like China, India, Brazil, and Mexico. The 2000s witnessed diversified FDI growth across various sectors, with a brief slowdown during the 2008 financial crisis, followed by a swift recovery. In the 2010s, FDI stabilized, shifting towards technology and services, with countries like Vietnam and Indonesia emerging as new hotspots. Poverty levels, initially high, began declining in the 1990s due to economic reforms and social policies, with accelerated reductions in the 2000s, notably in China. However, progress varied in the 2010s due to economic and political challenges, including the COVID-19 pandemic. Income inequality, which rose in the 1970s and 1980s, showed mixed trends in the 1990s and continued to pose challenges in the 2000s. Despite efforts to promote inclusive growth in the 2010s, significant disparities remained, highlighting the need for enhanced absorptive capacities, equitable FDI distribution, and robust social policies for sustainable development.

Table 1: Historical trends in foreign direct investment, poverty, and income inequality in middle-income countries

Category	Period	Description
Foreign Direct Investment (FDI)	1970s-1980s: Emergence and Growth	During the 1970s and 1980s, many middle-income countries began to open their economies to foreign investment. This period marked the initial stages of liberalization and economic reforms aimed at attracting FDI. Countries in Latin America, Southeast Asia, and parts of Africa and Eastern Europe started to see modest inflows of foreign capital. The primary drivers were the need for capital to boost industrialization and the implementation of policies favouring market-oriented reforms.
	1990s: Rapid Expansion	The 1990s saw a significant surge in FDI inflows into middle-income countries, driven by globalization and the end of the Cold War. Many countries adopted more liberal economic policies, privatized state-owned enterprises, and reduced trade barriers. This period also witnessed the rise of multinational corporations seeking new markets and cheaper production bases. Notable recipients of increased FDI included China, India, Brazil, and Mexico.
	2000s: Diversification and Increase	In the early 2000s, FDI continued to grow, diversifying across sectors such as manufacturing, services, and technology. The global financial crisis of 2008 temporarily slowed down FDI flows, but recovery was relatively swift. Middle-income countries became attractive destinations due to their growing consumer markets and improving investment climates. This period also saw an increase in South-South FDI, where middle-income countries themselves became significant investors in other developing nations.
	2010s-Present: Stabilization and Shifts	FDI inflows stabilized in the 2010s, with some fluctuations due to global economic conditions and geopolitical uncertainties. While traditional sectors like manufacturing remained important, there was a noticeable shift towards technology and service-oriented investments. Countries with strong economic fundamentals, political stability, and favourable business environments continued to attract substantial FDI. China, India, and Brazil remained significant

		players, while countries like Vietnam and Indonesia emerged as new FDI hotspots.
Poverty	1970s-1980s: Persistent High Levels	In the 1970s and 1980s, poverty levels in middle-income countries were generally high. Economic growth was uneven, and benefits were not widely shared. Many countries faced structural challenges, including high population growth, low industrialization levels, and inadequate social services. The period was characterized by limited economic opportunities for large segments of the population.
	1990s: Gradual Decline	The economic reforms of the 1990s contributed to a gradual decline in poverty rates in many middle-income countries. Improved economic growth, increased FDI, and better integration into the global economy helped create jobs and improve living standards. Social policies aimed at poverty reduction, such as conditional cash transfer programs in Latin America, also played a role in reducing poverty.
	2000s: Accelerated Reduction	The 2000s saw an accelerated reduction in poverty levels, particularly in countries experiencing rapid economic growth. China, for example, lifted hundreds of millions of people out of poverty through sustained economic expansion and targeted poverty alleviation programs. However, the benefits were not uniformly distributed, and some regions and populations remained vulnerable.
Income Inequality	2010s-Present: Continued Progress with Challenges	Poverty reduction continued into the 2010s, but progress varied across regions. While many middle-income countries made significant strides, others faced setbacks due to economic slowdowns, political instability, or external shocks. The COVID-19 pandemic posed a significant challenge, reversing some of the gains made in poverty reduction and exacerbating inequalities.
	1970s-1980s: Rising Inequality	During the 1970s and 1980s, income inequality tended to rise in many middle-income countries. The benefits of economic growth and FDI were often concentrated among the wealthy, while the poor and middle classes saw limited improvements. Structural inequalities, such as access to education and healthcare, further exacerbated income disparities.
	1990s: Mixed Trends	The 1990s presented mixed trends in income inequality. While some countries managed to reduce inequality through effective social policies and inclusive economic growth, others experienced widening gaps. The nature of FDI inflows, which often favoured skilled over unskilled labor, contributed to rising inequality in certain sectors and regions.
	2000s: Continued Challenges	The 2000s saw continued challenges in addressing income inequality. Rapid economic growth and increased FDI helped reduce poverty, but income disparities remained significant. Middle-income countries with robust social safety nets and progressive taxation policies managed to contain

		inequality better than those without such measures. The rise of the middle class in countries like China and India was a positive development, but the wealth gap persisted.
	2010s-Present: Focus on Inclusive Growth	In the 2010s, there was a growing recognition of the need for inclusive growth to address income inequality. Policies aimed at improving education, healthcare, and social protection were increasingly prioritized. Despite these efforts, inequality remained a pressing issue, with significant differences in wealth distribution across regions and population groups. The pandemic highlighted and, in some cases, worsened existing inequalities, prompting renewed efforts to build more equitable economies.

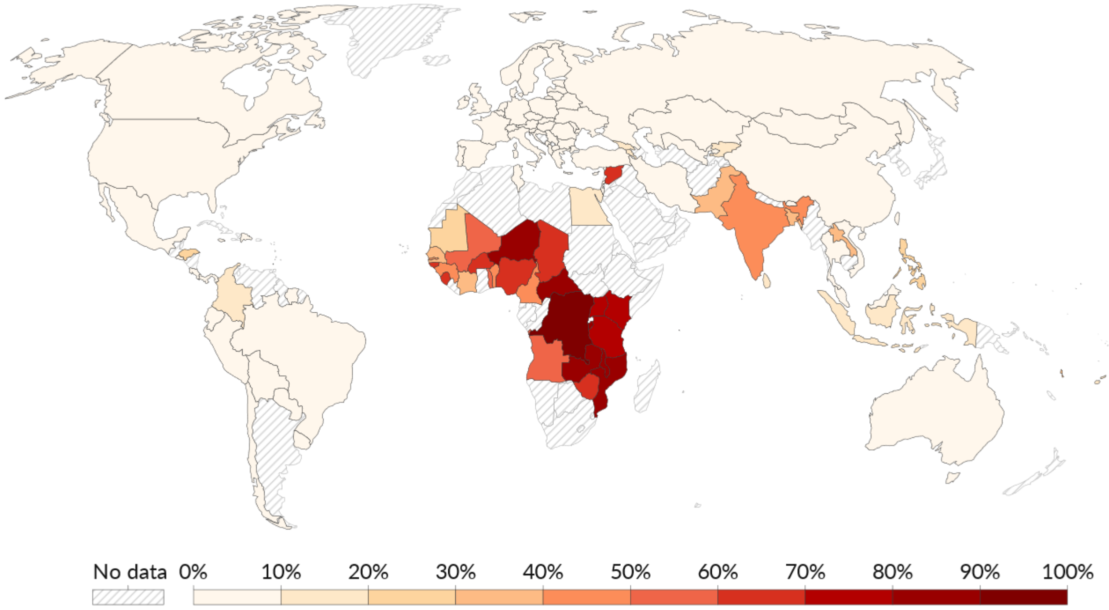
3 Interlinkages between Foreign direct investment, poverty and income inequality in middle-income countries

3.1 Empirical Evidence: Foreign Direct Investment and Poverty

This literature review examines the empirical relationship between Foreign Direct Investment (FDI) and poverty levels across various regions and economic contexts. The impact of FDI on poverty is found to be context-dependent, varying based on the specific conditions of the host country. In less developed countries, FDI tends to spur economic growth, which in turn lowers poverty levels. Oseghale and Amonkhienam (1987) suggest that increased economic growth due to FDI leads to greater prosperity and reduced poverty. Similarly, in Vietnam, FDI was found to significantly reduce poverty, with direct impacts being more substantial than indirect impacts through economic growth (Hung, 1999). Klein et al. (2001) also note that GDP growth, driven by FDI, is crucial for poverty alleviation.

The influence of FDI on poverty reduction also depends on the host country's economic structure. Jalilian and Weiss (2002) argue that FDI's impact on poverty is mediated through economic development, while Tsai and Huang (2007) note that FDI directly affects poverty by influencing employment, human capital, and output, and indirectly through economic growth. Lahimer (2009) finds that FDI can increase poverty levels due to inequality effects despite growth effects. Gohou and Soumare (2012) analyze the impact of FDI on poverty reduction in Africa, finding a positive association, especially in poorer regions. Sarisoy and Koc (2012) examine 40 developed and developing economies, revealing mixed impacts of FDI on different income groups, with the poorest groups often benefiting less.

Figure 1: Share of population living on less than $6.85 a day



Source: Our World in Data

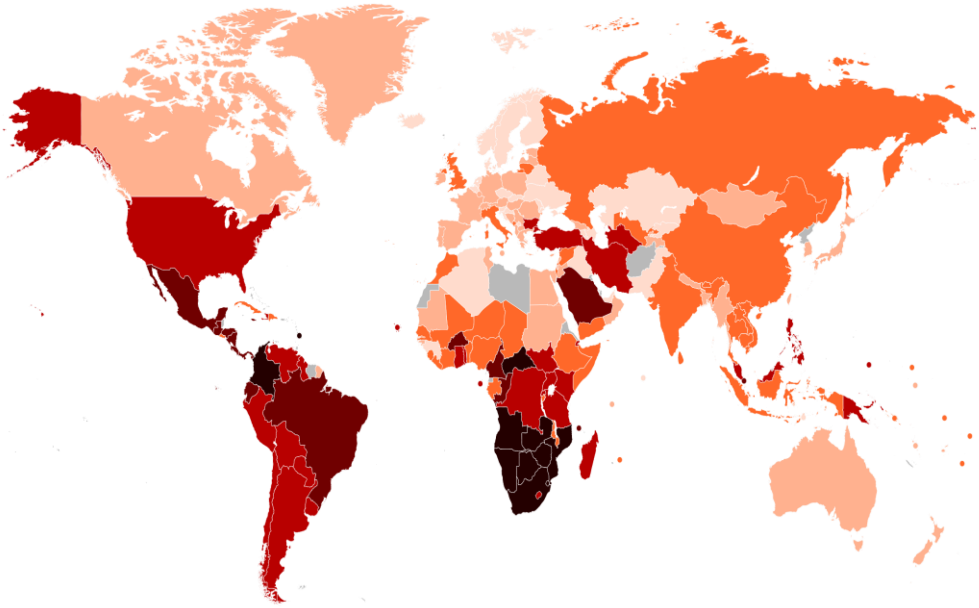
In Pakistan, Zaman et al. (2012) and Rafi and Hussain (2013) find that FDI positively correlates with poverty reduction, although income inequality remains a significant issue. Shamim et al. (2014) use a co-integration model to show that FDI promotes growth and indirectly reduces poverty. Ogunniyi and Igberi (2014) study Nigeria, concluding that FDI positively correlates with real per capita GDP but shows no significant direct impact on poverty reduction due to structural weaknesses in the economy. Anigbogu et al. (2016) also find that FDI significantly reduces poverty in Nigeria, influenced by factors like market size and technology. Studies covering broader regions, such as those by Fauzel et al. (2016) in Mauritius and Quinonez et al. (2018) in Latin America, show varying results. While FDI generally promotes welfare and reduces poverty, the effectiveness depends on local economic conditions and institutional capacities. Recent research by Ahmad et al. (2019) and Faridi et al. (2019) in South Asia and ASEAN countries further supports the positive impact of FDI on poverty reduction. These studies highlight the significant role of human capital, infrastructure, and institutional quality in maximizing the benefits of FDI.

3.2 Empirical Evidence: Foreign Direct Investment and Income Inequality

The correlation between FDI and income inequality shows a complex pattern influenced by various factors. Girling (1973) observed that FDI increased the Gini index because wages for trained workers rose more than for untrained workers. Conversely, Weede and Tiefenbach (1981) found no increase in the Gini index due to FDI in their study country. Bornschier and Chase-Dunn (1985) noted that while FDI increased income inequality in developing nations, it decreased inequality in developed nations.

Tsai (1995) and Feenstra and Hanson (1997) found that FDI generally increased income inequality, benefiting skilled workers more than unskilled ones. Velde (2003) emphasized that the impact of FDI on income inequality depends on the host country's ability to absorb FDI. Jensen and Rosas (2007) reported that while FDI decreased income inequality at the state level in Mexico, it increased national inequality. Mahutga and Bandelj (2008) highlighted that the heterogeneity of the country plays a crucial role in the impact of FDI on income disparity.

Figure 2: World Bank Gini Index Estimate



Source: Gini index (World Bank estimate).

Wu and Hsu (2012) analyzed 54 countries from 1980 to 2005, using endogenous threshold regression to show that FDI's effect on income inequality is nonlinear and depends on the country's absorptive capacity. In countries with higher absorptive capacity, FDI reduced income inequality, while in countries with lower absorptive capacity, FDI increased it. Chintrakarn et al. (2012) studied the U.S. from 1977 to 2001, finding a long-term correlation between FDI and income inequality. They concluded that FDI reduced income disparity in some states while increasing it in others, depending on the state's specific characteristics.

Herzer and Nunnenkamp (2013) examined eight European nations from 1980 to 2000, discovering that both inward and outward FDI stocks had a long-term negative but short-term positive impact on income inequality. Farhan et al. (2014) found that in ASEAN-5 economies, FDI decreased income inequality in some countries while increasing it in others, influenced by the sectors benefiting from FDI. Lin et al. (2014) investigated 42 developed and developing economies from 1976 to 2005, concluding that FDI's impact on income inequality is nonlinear and depends on the level of financial development. Herzer et al. (2014) found that in five Latin American countries, FDI stocks increased income inequality, with no causality between the two.

Mihaylova (2015) studied Eastern and Central European countries from 1990 to 2012, revealing that FDI could reduce income inequality when the education level is high. Ucal et al. (2016) analyzed Turkey from 1970 to 2008, finding that FDI decreased income inequality in the short and long term, although the effect was small. Suanes (2016) explored 13 Latin American economies from 1980 to 2009, discovering that FDI in the service and manufacturing sectors increased income inequality. Cho and Ramirez (2016) studied Southeast Asian economies from 1990 to 2013, finding that FDI initially increased income inequality but reduced it in the long run.

Majeed (2017) examined developing countries from 1970 to 2008, showing that FDI increased income inequality in countries with low economic development. Ngwakwe and Dzomonda (2018) found no long-term impact of FDI on income inequality in South Africa.

Babatunde (2018) revealed that in Nigeria, FDI reduced income inequality in the short run, with mixed results in the long term.

The empirical evidence indicates that the relationship between FDI and income inequality is highly context-dependent. Factors such as the host country's absorptive capacity, sectoral distribution of FDI, and level of financial development play critical roles in determining whether FDI will increase or decrease income inequality. To maximize the benefits of FDI, policies should focus on enhancing absorptive capacities, promoting equitable sectoral distribution, and improving financial development.

3.3 Is foreign direct investment (FDI) always beneficial for development?

The widespread enthusiasm for FDI is often rooted in the neoclassical perspective that developing economies lack sufficient physical capital investment. According to Solow's savings-centered theory, increasing FDI represents a clear opportunity for economic growth (Cypher & Dietz, 2009). Several studies have examined the relationship between FDI and economic growth, assuming that growth translates to increased welfare, as discussed by Gohou & Soumaré (2012). FDI can benefit developing economies through both direct and indirect channels. Direct benefits include capital inflows, increased tax revenues, and higher employment levels, while indirect benefits involve access to foreign markets, technology transfer, and knowledge spillovers (Reiter & Steensma, 2010). Thus, FDI is seen as a "composite bundle of capital stocks, know-how, and technology" with a multifaceted impact on growth, offering unique advantages over other forms of external financing (De Mello, 2012; Nunnenkamp, 2004). However, empirical evidence questions the assumption that FDI universally benefits host countries. Even the basic positive correlation between FDI and economic growth is inconclusive (Reiter & Steensma, 2010). This aligns with Lipsey & Sjöholm's (2005) argument that industry and country-specific differences prevent universal conclusions. In Latin America, Alvarado, Iñiguez, & Ponce (2017) found that FDI's effect on economic growth is not significant in aggregate and benefits mainly high-income countries in the region.

The success of FDI in promoting development largely depends on government policies and attitudes towards foreign investment (Chang, 2004; Agosin & Machado, 2005). It is important to recognize that FDI is driven by Transnational Corporations (TNCs), whose primary objective is to maximize profits and minimize costs, goals that may not always align with the development objectives of host countries, especially in developing nations. Concerns about the redistributive effects of FDI are also notable. Basu & Guariglia (2007) argued that while FDI may boost economic growth, it can also exacerbate inequality. Lessmann (2013) found that FDI inflows were linked to increased regional inequality in low and middle-income countries. In Latin America, Herzer, Hühne, & Nunnenkamp (2014) provided robust evidence that inward FDI stocks have contributed to significant income disparities in the region.

4 Conclusion

The correlation between Foreign Direct Investment (FDI), poverty, and income inequality in middle-income countries is complex and heavily influenced by specific circumstances. Our comprehensive analysis, enhanced by visual data on worldwide poverty and inequality, uncovers several vital observations. FDI has played a crucial role in driving economic growth in middle-income countries, especially in the 1990s and 2000s. Countries like China, India, and Brazil have greatly benefited from the influx of foreign direct investment (FDI), which has propelled their industrialization and economic growth. The increase in capital has generally facilitated the modernization of economies and improved global integration.

Furthermore, there has been a significant decline in poverty rates in numerous middle-income countries, particularly throughout the 2000s. China's extensive economic reforms and focused poverty alleviation initiatives have successfully raised millions of people out of poverty. However, there has been an uneven distribution of progress, resulting in certain regions and populations still being susceptible to economic disparities. Although Foreign Direct Investment (FDI) has led to the creation of jobs and improved living standards in certain regions, its advantages have not been evenly distributed among all sectors of society.

Furthermore, although foreign direct investment (FDI) has been associated with favourable impacts on both economic growth and the alleviation of poverty, it frequently leads to a rise in income inequality. The economic advantages linked to Foreign Direct Investment (FDI) and economic expansion have often been focused on the affluent, thus worsening income inequalities. The presence of structural inequalities, such as disparities in the availability of education and healthcare, has exacerbated the divide between the affluent and the impoverished. This trend highlights the intricate nature of the connection between foreign direct investment (FDI) and socio-economic results, where economic benefits do not consistently lead to fair advancements for all individuals.

The regional variations in the impact of FDI on poverty and inequality are substantial. Certain regions have derived significant advantages from foreign direct investment (FDI), whereas others have encountered limited favourable consequences or even detrimental impacts, contingent upon their ability to absorb and utilize the investment and their economic frameworks. Latin America and certain regions of Africa have demonstrated varied outcomes, with foreign direct investment (FDI) occasionally exacerbating regional disparities while simultaneously enhancing overall economic growth. The variability emphasizes the significance of considering local contexts and specific economic conditions when assessing the impacts of Foreign Direct Investment (FDI).

5 Policy implications

Considering these discoveries, policymakers in middle-income countries should implement sophisticated and focused approaches to optimize the advantages of foreign direct investment (FDI) while minimizing its potential drawbacks. Investing in education, infrastructure, and healthcare is essential for improving absorptive capacities. Implementing such measures would enhance the ability of these countries to incorporate foreign direct investment (FDI) into their economies and ensure that its advantages are more equitably shared among the population. In addition, the implementation of strong social policies, such as progressive taxation and comprehensive social safety nets, can effectively tackle income inequality. These policies should have the objective of ensuring a more equal distribution of the economic benefits derived from Foreign Direct Investment (FDI) and aiding with vulnerable populations. Governments should prioritize the establishment of a conducive business environment that attracts sustainable and inclusive foreign direct investment (FDI), with a particular emphasis on sectors that generate widespread employment and development advantages.

Moreover, promoting collaboration among neighbouring nations and adopting successful strategies can assist middle-income countries in formulating and executing efficient foreign direct investment (FDI) policies. Cooperative endeavours can improve the consistency of policies and help nations better navigate the intricacies of globalization. By implementing these tactics, middle-income countries can utilize the potential of foreign direct investment (FDI) to stimulate comprehensive and sustainable growth, ultimately diminishing poverty and narrowing income disparities.

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