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# The Impact of Foreign Direct Investment on Income Inequality in Asian Countries

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**Abstract:** *This study examines the impact of foreign direct investment (FDI) on income inequality in Asian countries using panel data from 47 nations, with 460 observations spanning the period from 2008 to 2022. The analysis employs the Pooled OLS regression model, incorporating dummy variables and interaction terms to assess the effects across different country groups: developing, developed, and least-developed economies. The results indicate that FDI positively correlates with income inequality across all three groups, with the strongest impact observed in developing countries. Furthermore, institutional quality significantly influences the distribution of benefits derived from FDI. Based on these findings, the study proposes policy recommendations to ensure sustainable development by mitigating income inequality while pursuing FDI attraction policies.*

**Keywords:** Income inequality; Asia; Foreign direct investment; Gini coefficient; FDI

## I. INTRODUCTION

The attraction of foreign direct investment has become a crucial driver of economic growth. However, FDI inflows also influence income inequality. The relationship between FDI and income inequality is a key concern for policymakers, particularly in developing countries, as achieving economic growth while ensuring social equity is fundamental to comprehensive development. In addition, increasing income inequality can hinder economic growth and exacerbate class conflicts [1]. Moreover, income inequality has been shown to affect poverty reduction efforts negatively [2].

In this article, the authors focus on countries within the Asian region, the region receives some of the highest levels of foreign direct investment (FDI) globally and comprises a significant proportion of developing nations. At the same time, this region is facing an extreme income inequality crisis. Therefore, by using a Pooled OLS regression model, this study aims to provide a more detailed assessment of the impact of FDI on income inequality across Asian countries. Based on the findings, the authors propose policy recommendations to help nations achieve their missions of equality and sustainable development through attracting foreign direct investment.

## II. LITERATURE REVIEW

There are four main schools of thought regarding the impact of FDI on income inequality.

*School of Thought 1: FDI Increases Income Inequality in Host Countries*

FDI generally exacerbates income inequality, particularly in wealthier nations with high economic growth rates [3]. It is argued that FDI, alongside factors such as education, urbanization, economic growth, and inflation, has contributed to rising income inequality in urban areas [4]. Similarly, FDI can widen income disparities if it is concentrated in specific industries or regions where only skilled labor benefits [5]. However, the labor force can effectively absorb new technologies, FDI can help reduce income inequality - assuming it is managed appropriately [6].

FDI tends to increase income inequality at the local level due to wage disparities between FDI enterprises and domestic firms [7]. Similarly, FDI is indicated, alongside trade openness, and migration all have negative impacts on income inequality in developing countries [8]. Meanwhile, FDI exacerbates income inequality, international trade has the opposite effect, for example, reducing inequality in Vietnam [9].

*School of Thought 2: FDI Reduces Income Inequality in Host Countries*

FDI reduces income inequality in agricultural economies with a predominantly low-skilled workforce [10]. Besides, FDI effectively mitigates inequality, especially when combined with human capital and GDP growth [11]. Resource-seeking FDI reduces income inequality by increasing demand for unskilled or low-skilled labor. Additionally, FDI in the trade and services sectors lowers inequality through education and economic development. While manufacturing FDI does not have a direct effect, it can indirectly reduce economic disparity by improving educational attainment and trade openness [12]. Furthermore, FDI enhances job opportunities and improves workers' compensation, thus reducing income inequality [13]

*School of Thought 3: The Nonlinear Relationship Between FDI and Income Inequality in Host Countries*

A study identified a nonlinear relationship between FDI and income inequality, following an inverted U-shaped curve [14]. This suggests that while FDI initially exacerbates income disparities, it eventually contributes to the decline of inequality once a certain threshold is reached. Similarly, FDI is associated with a rise in inequality in developed countries but contributes to its reduction in developing economies [8]. Additionally, it is highlighted that FDI may either widen or narrow income gaps depending on regulatory influences from education and institutional quality [15].

*School of Thought 4: FDI Has No Impact on Income Inequality in Host Countries*

There is no significant relationship between FDI and income inequality in 17 transitional economies [16]. Similarly, there is also an absence of a long-term link between FDI and income inequality in South Africa [17]. FDI does not significantly affect income inequality in Ghana [18]. Furthermore, it is concluded that FDI does not contribute to rising inequality in Sub-Saharan African nations, as profits from FDI are largely not reinvested in the host countries [19].

**Research Gaps**

Through reviewing, analyzing, and synthesizing related studies both domestically and internationally, the authors have identified several research gaps in this area as follows:

*First*, foreign direct investment (FDI) has both direct and indirect impacts on income inequality in developed, developing, and least developed countries in Asia. However, previous studies have yielded inconsistent results, and there is still considerable debate about the relationship between FDI and income inequality, specifically with four main schools of thought: (1) FDI increases inequality; (2) FDI reduces inequality; (3) FDI has a nonlinear relationship with inequality; and (4) FDI has no effect on income inequality. These discrepancies may arise from differences in model variables, research context, and periods.

*Second*, most previous studies have primarily focused on the factors contributing to economic growth in countries (including FDI, GDP, labor, inflation, trade openness, and trade volumes) when analyzing their impact on income inequality. While institutions have been recognized as crucial in controlling and distributing FDI to achieve socio-economic outcomes, the role of institutional quality in this process has not been explicitly addressed. Thus, the authors introduce the quality of government institutions as an additional factor to provide a stronger foundation for analyzing inequality.

*Third*, past studies have mainly focused on evaluating the impact of FDI on specific groups of countries or individual factors within those groups, without comprehensively examining the effects across all three country groups: developed, developing, and least developed countries. Additionally, the indirect influence of each group on economic factors has not been fully explored in the context of FDI's impact on income inequality. Therefore, the authors incorporate institutional quality into the model to assess government control over the allocation of FDI according to national development goals. Furthermore, dummy variables and interaction terms are included in the study to accurately evaluate the effects of FDI on each country group in the Asian region.

*Conclusion:* From the above observations, the authors recognize that although there have been several studies on the impact of FDI flows and their influence on income inequality in some countries, there has yet to be a comprehensive study that uses dummy variables, interaction terms, and institutional quality to assess the overall impact of FDI on income inequality in Asian countries. This gap in the literature is what the authors aim to address with the study titled "The Impact of Foreign Direct Investment on Income Inequality in Asian Countries."

## III. THEORETICAL BASIS AND CONCEPTUAL FRAMEWORK

***Endogenous Growth Theory:*** highlights that rising income inequality is associated with slower growth in workforce quality and the pace of technological innovation. The scarcity of highly skilled labor leads to a "technological stagnation" phenomenon, where only a portion of the workforce can effectively utilize new technology. When the rate of technological advancement surpasses the labor force's absorption capacity, income inequality intensifies. The shortage of skilled labor creates a "bottleneck effect," causing wages for this group to rise faster than for low-skilled workers, thereby exacerbating income inequality [20].

***General Equilibrium Trade Model:*** The Heckscher-Ohlin (H-O) model explains that countries will produce and export goods that intensively use their abundant production factors while importing goods requiring factors that are scarce domestically. Firms tend to relocate labor-intensive production stages to countries with lower labor costs, increasing productivity and wages for low-skilled workers. Meanwhile, as production in developed countries demands higher skill levels, the demand for skilled labor rises in both regions, leading to income inequality on both sides [21].

***Skill Supply and Demand Theory:*** suggest that FDI can contribute to wage inequality due to disproportionate wage increases between skilled and unskilled workers. Foreign firms tend to employ a higher proportion of skilled labor, leading to an increased wage gap between these two groups. Furthermore, it is emphasized that the impact of FDI depends on each country's policy framework [22][23].

Among these theories, endogenous growth theory underscores the role of workforce skills and technological innovation in shaping income inequality but does not directly address the impact of FDI. The general equilibrium trade model provides insights into the relocation of low-skilled labor to lower-cost countries and the rising demand for skilled labor in developed nations; however, it primarily focuses on trade and labor distribution rather than the direct influence of FDI on income inequality. The skill supply and demand theory, on the other hand, explicitly links FDI to wage disparity. Moreover, this theory argues that the effects of FDI are contingent upon the specific policy environment of a country. Therefore, this study adopts the skill supply and demand theory as its theoretical framework and incorporates institutional quality as a variable in the model.

## IV. DATA AND RESEARCH MODEL

### 4.1. Research Data

The authors utilize secondary data, which includes annual statistical reports, data from regional organizations such as ASEAN and OECD, and information extracted from the World Bank database. Data from journals, newspapers, and other international publications are also important sources for analysis and calculations to achieve the research objectives.

The efficiency and convenience of secondary data due to its accessibility. By using secondary data, the authors minimize resource expenditure on data collection, as statistical departments have already compiled it. Moreover, secondary data enables better time management, allowing researchers to maintain research progress and contribute timely knowledge to the academic field [24]. By adopting this approach, researchers gain opportunities to test new ideas, theories, frameworks, and models. Furthermore, the authors' access to high-quality data with a large sample size ensures a better representation of the target population, enhances data validity, and increases the generalizability of research findings.

**Table 1. Data Collection Basis and Variable Classification**

| Symbol | Variable Name | Unit | Source |
|---|---|---|---|
| Dependent Variable | | | |
| Gini | Gini coefficient | % | World Bank (https://databank.worldbank.org) |
| Independent Variable | | | |
| FDI | Foreign Direct Investment (FDI) inflows | Billion USD | World Bank (https://databank.worldbank.org) |
| GDP | Gross Domestic Product (GDP) | Billion USD | |
| Control Variable | | | |
| INF | Inflation rate | % | World Bank (https://databank.worldbank.org) |
| LAB | Labor force participation rate (15+ years) | % | |

| | | | |
|---|---|---|---|
| INS | Institutional quality | % | |
| Dummy Variable | | | |
| LDC | LDC = 1 for least developed countries; LDC = 0 for developed and developing countries | | Aggregated and calculated by the authors |
| DC | DC = 1 for developing countries; DC = 0 for least developed and developed countries | | |
| Interaction Variable | | | |
| (GDP*LDC) | Interaction variable between GDP and dummy variable | Billion USD | Aggregated and calculated by the authors |
| (GDP*DC) | | Billion USD | |
| (FDI*LDC) | Interaction variable between FDI and dummy variable | Billion USD | |
| (FDI*DC) | | Billion USD | |
| (FDI* INS) | Interaction variable between FDI and institutional quality | Billion USD | |

*Source: Compilation by the authors*

**4.2. Model and Research Methodology**

**Model Development**

Building on previous research models, the authors adopt an econometric model to evaluate the extent of FDI's impact on income inequality. The econometric model allows for a relatively precise assessment of the influence of factors such as FDI, GDP, and others on income inequality in Asian countries. Additionally, this model offers flexibility in incorporating dummy variables and interaction terms, enabling a detailed analysis of FDI's impact on income inequality across different groups of countries classified by development levels in Asia. The model has been widely employed by scholars studying FDI's impact on income disparity [7][25].

**Proposed Model**

$Gini = \beta_0 + \beta_1*FDI + \beta_2*GDP + \beta_3*LAB + \beta_4*INF + \beta_5*INS + \beta_6*DC + \beta_7*LDC + \beta_8* GDP*LDC + \beta_9*GDP*DC + \beta_{10}* FDI* LDC + \beta_{11}* FDI* DC + \beta_{12}* FDI* INS.$

## V. RESEARCH FINDINGS AND DISCUSSION

### 5.1. Descriptive Statistics

**Table 2. Descriptive Statistics**

| Variable | Observations | Mean Value | Standard Deviation | Minimum Value | Maximum Value |
|---|---|---|---|---|---|
| *Least-Developed Countries* | | | | | |
| Gini | 37 | 35.95 | 3.73 | 28.5 | 38.8 |
| FDI | 37 | 1.42 | 1.24 | 0.01 | 4.08 |
| GDP | 37 | 146.24 | 167.13 | 1.45 | 460.13 |
| INS | 37 | -7.74 | 241.16 | -125.89 | 672.04 |
| INF | 37 | 5.53 | 2.78 | 0.85 | 9.45 |
| LAB | 37 | 58.63 | 9.48 | 36.25 | 65.32 |
| *Developing Countries* | | | | | |
| Gini | 364 | 33.97 | 4.24 | 25.1 | 44.6 |
| FDI | 364 | 23.45 | 60.71 | 0.05 | 344.08 |
| GDP | 364 | 1168.85 | 3069.76 | 4.41 | 17820.46 |
| INS | 364 | 16.34 | 153.08 | -114.78 | 774.33 |
| INF | 364 | 6.15 | 8.07 | -1.40 | 43.49 |
| LAB | 364 | 62.81 | 9.53 | 40.23 | 81.01 |
| *Developed Countries* | | | | | |
| Gini | 59 | 34.77 | 2.20 | 31.20 | 39 |
| FDI | 59 | 13.31 | 4.56 | 6.05 | 22.06 |
| GDP | 59 | 1637.65 | 1642.50 | 297.73 | 5212.33 |

| | | | | | |
|---|---|---|---|---|---|
| INS | 59 | 1054.45 | 298.73 | 115.67 | 1436.06 |
| INF | 59 | 0.76 | 0.08 | -0.61 | 2.50 |
| LAB | 59 | 63.36 | 2.03 | 59.25 | 65.64 |
| *Asian Countries* | | | | | |
| Gini | 460 | 34.16 | 3.99 | 25.1 | 44.6 |
| FDI | 460 | 20.38 | 54.42 | 0.01 | 344.08 |
| GDP | 460 | 1146.73 | 2812.06 | 1.45 | 17820.46 |
| INS | 460 | 147.55 | 394.57 | -125.89 | 1436.06 |
| INF | 460 | 5.41 | 7.45 | -1.4 | 43.49 |
| LAB | 460 | 62.54 | 8.98 | 36.25 | 81.01 |

*Source: Results of Data Analysis from Stata 17*

Table 2 reveals a significant disparity in income inequality across different country groups. Specifically, in least-developed countries, the Gini coefficient is 1 to 1.5 points higher than in the other two groups. Meanwhile, the developed and developing countries exhibit similar inequality levels, approximating the Asian average. In terms of FDI inflows, less developed countries attract only $1.42 billion per year, significantly lower than the $23.45 billion per year in developing countries and the $13.31 billion per year in developed nations. Within these groups, developing countries have better conditions to utilize FDI compared to developed economies, which have already completed their economic transformation, and less developed countries, which still face major obstacles. These developing nations are prime destinations for international investment due to ongoing infrastructure development, favorable investment policies, and a large low-skilled labor force, making them attractive for industrial FDI from advanced economies. In contrast, less developed countries struggle to attract FDI due to low social quality, which hampers the capital transfer process, and governmental inefficiencies. Other factors also contribute to differences in income inequality. Institutional quality in less developed countries is significantly lower (-7.74%) compared to developing countries (16.34%) and developed countries (1054.5%). This directly affects living standards, making it harder for citizens to access higher incomes. Additionally, inflation fluctuation impacts household spending and, in turn, income levels. Developed countries maintain low and stable inflation at 0.78% while developing countries (6.15%) and less developed countries (5.53%) experience higher rates. Some nations, like Iran, even face extreme inflation nearing 50%, worsening income distribution. Furthermore, the working-age population in developed and developing countries (above 62%) is higher than in less developed nations (59%). When income is distributed among fewer individuals, the gap between employed and unemployed citizens widens, leading to greater income inequality within society.

**Table 3. Estimation Results of the Pooled OLS Regression Model**

| | |
|---|---|
| Observations | 460 |
| F(12,447) | 18.86 |
| Prob > F | 0.0000 |
| $R^2$ | 0.7159 |
| Adjusted R | 0.7083 |
| RMSE | 0.2927 |

| Source | SS | df | MS |
|---|---|---|---|
| Model | 5920.86 | 12 | 493.40 |
| Residual | 5920.73 | 447 | 5.26 |
| Total | 8270.585 | 459 | 18.02 |

| Gini | Coefficient | Standard Error | t | P-value | 95% Confidence Interval | |
|---|---|---|---|---|---|---|
| FDI | 0.352 | 0.057 | 6.18 | 0.000 | 0.240 | 0.464 |
| GDP | 0.003 | 0.007 | 4.05 | 0.000 | 0.002 | 0.005 |
| INS | -0.867 | 0.293 | -2.96 | 0.003 | -1.443 | 0.464 |
| INF | 0.111 | 0.025 | 4.34 | 0.000 | 0.061 | 0.005 |
| LAB | -0.103 | 0.020 | -5.02 | 0.000 | -0.143 | -0.292 |
| LDC | 2.444 | 0.449 | 5.45 | 0.000 | 1.563 | 0.161 |
| DC | 1.404 | 0.395 | 3.55 | 0.000 | 0.627 | -0.063 |
| GDP*LDC | 0.004 | 0.001 | 5.28 | 0.000 | 0.003 | 3.327 |
| GDP*DC | 0.004 | 0.001 | 5.21 | 0.000 | 0.003 | 2.181 |
| FDI*LDC | 0.133 | 0.049 | 2.72 | 0.007 | 0.037 | 0.006 |
| FDI*DC | 0.153 | 0.049 | 3.10 | 0.002 | 0.056 | 0.006 |
| FDI*INS | -0.194 | 0.019 | -10.47 | 0.000 | -0.230 | 0.229 |

*Source: Compilation by the authors*

The $R^2$ value of 71.59% indicates that the explanatory variables in the model explain 71.59% of the variation in the Gini coefficient.

Foreign Direct Investment (FDI) is positively related to the Gini coefficient. FDI primarily flows into Asia, focusing on the manufacturing sector, which has a high growth potential, leading to income disparity. Furthermore, FDI enterprises usually set higher demands for the skills of workers, meaning that most of the benefits from FDI will be advantageous for skilled laborers. The rise in income inequality is also due to the uneven distribution of FDI across regions, causing an

imbalanced regional economic structure. However, FDI reduces the Gini coefficient, explaining that FDI focused on resource exploitation often requires labor with few or no skills, meanwhile, FDI in trade and services is influenced by education, trade openness, and government spending, which directly affects inequality. The data used in this study is from the 2002-2011 period, and thus, during the 2008-2022 period, the impact of FDI on social issues, particularly increasing income inequality in Asia, remains valid [12].

The variable gross domestic product (GDP) of the host country and the interaction between GDP and dummy variables have a positive relationship with the Gini coefficient. Developing countries in Asia have seen growth in technology sectors, which results in a large wage gap between labor in industry and services versus agriculture [26] Additionally, less developed countries often focus on GDP growth through key sectors without paying adequate attention to equitable distribution policies, leading to uneven development and income disparities across sectors and regions [2].

Inflation (INF) has a positive relationship with the Gini coefficient. This is explained by the fact that rising inflation distorts the economy, and low-income individuals are more directly and quickly affected than higher-income individuals. The wealthy are better able to cope with inflation through investments in inflation-hedged assets, thereby increasing the income gap between the rich and the poor.

The labor force participation rate has an inverse relationship with the Gini coefficient. It is suggested that countries can effectively reduce inequality by increasing human capital [11]. In Asia, the predominant low-skilled labor force is paid wages with little variation, and as more individuals join the workforce, the income gap narrows.

Institutional quality (INS) has an inverse relationship with the Gini coefficient. Institutional quality is reflected in the improvement of public policies set by the government, creating a legal framework for economic-social activities, investments, and trade. Strong institutional quality helps protect the rights of all citizens, creating a fair economic environment [27]. When institutional quality is low, the wealthy benefit disproportionately from growth, increasing income inequality [28], while the poor face greater economic limitations [29], leading to rising inequality.

Dummy variables representing less developed (LDC) and developing countries (DC) have a positive relationship with the Gini coefficient. This is attributed to the disparity between urban and rural areas in these groups. More developed countries have a higher urbanization rate, where income is more evenly distributed. Rural residents, mostly from less developed countries, face higher poverty rates, uncertain income, and inadequate social welfare, leading to a brain drain from skilled labor to urban areas for better benefits.

The interaction between the FDI and LDC dummy variables (FDI*LDC) and the FDI and DC dummy variables (FDI*DC) also has a positive relationship with the Gini coefficient. Corruption, politics, and legal frameworks strongly influence FDI decisions in less developed countries [33]. Countries with better institutions typically attract more FDI and utilize it more efficiently. Developing countries are often willing to accept low-quality FDI, which leads to the development of an incompatible economic structure, thereby increasing income inequality.

The interaction term between FDI and institutional quality (FDI*INS) has an inverse relationship with the Gini coefficient. This suggests that when a country's institutions are strong, they can effectively regulate and control FDI flows, contributing to job creation and economic growth, and helping to reduce income inequality. In contrast, weak institutions may lead to ineffective allocation and use of FDI, with benefits not being evenly distributed in society, thus increasing income inequality.

## VI. CONCLUSION AND RECOMMENDATIONS

### 6.1. Conclusion

FDI plays an essential role in shaping income distribution in Asian countries. However, its impact differs significantly between country groups due to differences in economic, political, and social environments. In developing countries, FDI primarily focuses on economic zones and industries that require low-skilled labor, leading to increased income inequality between regions and labor groups. This exacerbates the gap between economically developed and underdeveloped regions within the country. In developed countries, FDI tends to flow into high-value industries such as artificial intelligence and renewable energy, which require skilled labor, creating an ever-widening gap between high-skilled and low-skilled workers. At the same time, low-skilled workers in developed countries face competition from migrant labor, further increasing the income gap if not properly managed.

### 6.2. Recommendations

#### 6.2.1 Recommendations for Developing Countries

Firstly, based on the study results, a stable political environment and appropriate legal regulations will improve citizens' livelihoods, helping to narrow the income gap between different groups. Governments need to create a stable, fair legal environment where labor regulations, taxation, and social welfare policies are applied equitably.

Secondly, governments in developing countries should implement policies to improve the skill levels of the labor

force by investing in education systems and vocational training. This would ensure workers can meet the demands of industries driven by FDI. It would also provide citizens with higher incomes, which would not only contribute to the national economy but also help reduce income disparities across social classes.

Thirdly, governments should develop policies for equitable FDI distribution across regions. Offering tax incentives for investments in underdeveloped regions and investing in infrastructure will not only attract foreign investors but also improve local living standards, reducing the developmental gap between economic regions.

Fourthly, developing countries should pursue expansionary monetary policies while carefully controlling inflation. This will help both stimulate economic growth and safeguard the purchasing power of the poor. Governments should also maintain flexibility in fiscal and monetary policies. Quantitative Easing, as implemented by developed countries such as Japan, the EU, and the US, could be adopted.

**6.2.2 Recommendations for Developed Countries**

Firstly, governments in developed countries could apply progressive tax policies, similar to those in North America, to redistribute income. Higher-income individuals would contribute more to the budget, helping fund social welfare programs and providing subsidies for low-income groups.

Secondly, governments should regulate immigrant labor by defining clear limits on the industries and timeframes for which these workers are allowed to work. This will help balance the labor supply without negatively affecting the wages and employment of local workers, especially low-skilled labor. Additionally, conducting regular impact assessments on immigration's effect on the labor market and income inequality will help adjust policies to balance economic development and social equity.

Thirdly, governments should implement policies to support job search efforts for low-skilled labor. In Singapore, the Workforce Singapore (WSG) was established to promote the development, competitiveness, and inclusiveness of the workforce at all levels.

**6.2.3 Recommendations for Least Developed Countries**

Firstly, least-developed Asian countries face severe capital shortages and rely heavily on Official Development Assistance (ODA), which diminishes economic self-reliance. However, deep global integration has made access to diversified financial sources from international organizations such as ASEAN, SAARC, and APEC increasingly feasible. To capitalize on these opportunities, these countries should enhance their integration efforts, participate in Free Trade Agreements (FTAs), and liberalize investment policies. These measures will help attract foreign capital and advanced technology, foster sustainable socio-economic development, and improve national income levels.

Secondly, governments of least-developed countries must enhance institutional capacity and public governance by establishing a transparent, robust, and effective system. A cautiously expansionary monetary policy should be implemented to control inflation and protect household income. Additionally, a well-balanced combination of fiscal and monetary policies should be adopted, with the potential application of Quantitative Easing (QE) strategies to stimulate investment. Strengthening transparency, accountability, and budget disclosure is also essential to reducing corruption and ensuring the equitable allocation of resources.

Thirdly, investing in infrastructure is a key driver of balanced economic growth. Modernizing transportation networks, including highways, seaports, and airports, can reduce logistics costs, improve regional connectivity, and create employment opportunities for rural labor. Moreover, investments in energy infrastructure, clean water supply, and waste management in underdeveloped areas will help meet international standards and attract foreign investment. Expanding telecommunications infrastructure in remote regions is another critical solution, allowing broader access to digital technology, improving workforce skills, and integrating local labor into higher-income industries. These measures collectively contribute to sustainable economic growth while fostering a more attractive and equitable investment environment across different regions.

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