Impact of Foreign Direct Investment on Poverty Reduction and Economic Development

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Abstract

Purpose: The aim of the study was to investigate the impact of foreign direct investment on poverty reduction and economic development.

Methodology: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: The study revealed that FDI significantly contributes to poverty reduction and economic development. FDI is linked to higher economic growth rates, driven by its infusion of capital, technology, and market access. This influx of investment creates jobs in host countries, particularly in labor-intensive sectors, effectively reducing unemployment and improving living standards. Additionally, FDI promotes technology transfer and innovation, enhancing the competitiveness of domestic industries. Furthermore, FDI's positive spillover effects extend to human capital development through skill training and improved employability, leading to higher wages and overall poverty reduction. These findings underscore FDI's multifaceted role in fostering sustainable economic growth and social progress.

Unique Contribution to Theory, Practice and Policy: Dependency Theory and Resource-Based may be used to anchor future studies on Foreign Direct Investment. Investment Promotion Agencies should establish effective investment promotion agencies to attract quality FDI, offering incentives, streamlined regulations, and investor support services. Stringent environmental regulations should be enforced to prevent FDI from causing negative environmental externalities and promote sustainable development practices.

Keywords: Foreign Direct Investment, Poverty Reduction, Economic Development

How to Cite


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Introduction

Foreign Direct Investment (FDI) refers to the cross-border investment made by a company or individual in one country (the source country) into another country (the host country), with the intention of establishing a lasting interest and a significant degree of influence or control over the management and operations of an enterprise in the host country. FDI typically involves acquiring ownership stakes in existing enterprises or establishing new ventures. It is characterized by a long-term perspective, as the investor seeks to gain access to new markets, resources, technology, and managerial expertise. FDI is distinct from other forms of investment due to the direct involvement and control exerted by the investor in the host country's economic activities.

Poverty reduction and economic development are intertwined concepts that hold significant importance for developed economies. These countries aim to alleviate poverty while fostering sustainable economic growth. In the United States, for instance, poverty rates have experienced fluctuations over the years. According to a study by Smith et al. (2019), the poverty rate decreased from 12.7% in 2016 to 10.5% in 2019. This reduction was attributed to robust economic growth and targeted social programs. Similarly, Japan has made strides in poverty reduction through a combination of policies. A report by the Ministry of Health, Labour and Welfare of Japan (2020) highlighted a decline in the poverty rate from 16.1% in 2012 to 12.8% in 2018. This achievement was linked to strategies that promote workforce participation and social assistance.

In developing economies, poverty reduction and economic development play crucial roles in improving living standards. For instance, in India, a country with a significant population living below the poverty line, economic growth has contributed to poverty reduction. The World Bank reported a decline in the poverty rate from 49.9% in 2000 to 21.2% in 2011 (World Bank, 2020). This reduction was attributed to factors such as agricultural growth and social programs. In Brazil, another developing economy, the Bolsa Família program has been instrumental in reducing poverty. According to a study by Ferreira et al. (2018), this program led to a reduction in extreme poverty by 5.1% between 2001 and 2013.

Sub-Saharan economies face unique challenges in poverty reduction and economic development. In Nigeria, for instance, despite being one of the largest economies in the region, poverty rates remain high. According to the National Bureau of Statistics Nigeria (2021), the national poverty rate was 40.1% in 2019. Various factors, including inequality and lack of access to basic services, contribute to this challenge. In Ethiopia, economic growth has led to significant poverty reduction. The World Bank (2020) indicated a decline in the poverty rate from 44.2% in 2000 to 23.5% in 2016. This achievement was driven by agricultural transformation and investments in education and healthcare.

Sub-Saharan economies grapple with unique challenges in their pursuit of poverty reduction and economic development. Take Ghana, for instance, which has shown promising progress. The Ghana Statistical Service (2020) reported a decline in the national poverty rate from 24.2% in 2013 to 23.4% in 2017. This achievement was attributed to policies aimed at diversifying the economy, promoting agricultural productivity, and expanding access to education and healthcare. On the other hand, the Democratic Republic of Congo (DRC) faces significant obstacles despite its vast
natural resources. A study by Shimeles et al. (2019) highlights the persistence of high poverty rates in the DRC due to governance challenges, political instability, and limited infrastructure development.

FDI can contribute to economic development by facilitating technology transfer and innovation. Multinational corporations often bring advanced technologies, managerial practices, and research and development capabilities to host countries, which can lead to increased productivity and competitiveness. These technological spillovers can stimulate economic growth, generate employment opportunities, and elevate the skill levels of the local workforce (Blomström & Kokko, 2003).

FDI can directly impact poverty reduction by creating employment opportunities in host countries. The establishment of new enterprises or the expansion of existing ones can lead to the hiring of local workers, reducing unemployment and providing income to households. Additionally, as FDI contributes to skill development and knowledge transfer, it can improve the employability and earning potential of local workers, thereby enhancing their livelihoods and contributing to poverty reduction (Hansen & Rand, 2017).

FDI can drive economic development through investments in infrastructure and supply chains. Foreign investors often bring not only financial resources but also expertise in building and upgrading critical infrastructure such as transportation networks and energy systems. These infrastructure improvements can lower production costs, enhance trade connectivity, and attract further domestic and foreign investments, ultimately fostering economic growth and development (UNCTAD, 2019).

FDI can promote poverty reduction and economic development by integrating host countries into global markets. Foreign investors often establish linkages between local suppliers and global value chains, thereby boosting the export capacities of host country industries. Increased exports can generate revenue, create jobs, and drive economic diversification, leading to sustained economic growth and improved living standards (Li & Resmini, 2020).

**Statement of Problem**

Foreign Direct Investment plays a significant role in poverty reduction and economic development through mechanisms such as technology transfer, job creation, infrastructure development, and trade integration. However, the impact of FDI is context-dependent, influenced by host country policies, institutions, and absorptive capacity. Foreign Direct Investment (FDI) has become a pivotal driver of economic growth and development for many countries in the globalized world. Over the past decade, FDI has gained substantial attention due to its potential to stimulate economic development and alleviate poverty in host countries (Li & Resmini, 2020). While FDI inflows are often seen as catalysts for increased capital investment, technology transfer, and job creation, the exact extent and nature of its impact on poverty reduction and overall economic development remain subjects of debate and investigation.

Although a substantial body of literature suggests positive relationships between FDI, economic growth, and poverty reduction (Hansen & Rand, 2017; Aitken & Harrison, 2019), there are also studies that raise concerns about the potential downsides of FDI, such as exacerbating income
inequality and fostering dependency on external actors (UNCTAD, 2015; Ostry et al., 2018). Furthermore, the effectiveness of FDI as a means of sustainable development varies across different sectors, regions, and policy contexts (Kumar & Pradhan, 2016).

The complexity of the FDI-poverty relationship is compounded by the heterogeneity of host countries, including variations in institutional frameworks, governance structures, and economic diversification strategies (Javorcik, 2020). As developing economies seek to attract FDI inflows to drive poverty reduction and achieve sustainable economic growth, a comprehensive understanding of the nuanced linkages between FDI, poverty reduction, and broader development objectives becomes imperative.

This study aims to address this gap by conducting a rigorous examination of the impact of FDI on poverty reduction and economic development across a diverse range of countries. By critically analyzing the mechanisms through which FDI affects poverty reduction and exploring the mediating role of policy interventions and institutional factors, this research seeks to provide evidence-based insights that can inform policy decisions, enhance development strategies, and maximize the positive impact of FDI on host economies.

THEORETICAL FRAMEWORK

Dependency Theory
The Dependency Theory was developed in the 1950s and 1960s by economists such as Raul Prebisch and Andre Gunder Frank. Dependency Theory posits that developing countries are often locked into unequal relationships with developed nations, leading to economic and social imbalances. These imbalances can result from the exploitation of resources and markets by powerful foreign actors, such as multinational corporations, which can hinder local economic development. In the context of FDI and its impact on poverty reduction and economic development, Dependency Theory highlights the potential risks of over-reliance on foreign capital and technology. It underscores the importance of examining whether FDI actually leads to sustainable development or reinforces economic dependency (Prebisch, 1973).

Resource-Based Theory
The Resource-Based Theory was developed in the 1980s by scholars such as Jay Barney. The Resource-Based Theory focuses on a firm's internal resources and capabilities as key determinants of its competitive advantage and success. This theory suggests that a host country's ability to effectively absorb and leverage FDI depends on its existing resources, technological capabilities, and institutional infrastructure. In the context of FDI's impact on poverty reduction and economic development, the Resource-Based Theory underscores the importance of host countries' absorptive capacity. It suggests that FDI can contribute to poverty reduction and development when it aligns with the host country's existing resources and capabilities (Barney, 1991).

Spillover Theory
The Spillover Theory has roots in various economic literature and models, including externalities theory. The Spillover Theory posits that FDI can have positive externalities, leading to knowledge and technology spillovers to domestic firms and industries. This can result in increased
productivity, innovation, and economic growth beyond the direct impact of Fade-in the context of FDI's impact on poverty reduction and economic development, the Spillover Theory highlights the potential for FDI to contribute to poverty reduction through indirect channels. By facilitating knowledge and technology diffusion, FDI can enhance local firms' capabilities and competitiveness, thus driving economic development (Blomström & Kokko, 2003).

These theories offer different perspectives on the complex relationship between FDI, poverty reduction, and economic development. By incorporating these theoretical frameworks into research, a more comprehensive understanding of the multifaceted impacts of FDI on host economies can be achieved.

Empirical Review

Asiedu & Lien (2011) discussed the role of FDI in promoting growth and poverty reduction in developing countries. It also provides some policy recommendations to attract and benefit from FDI. The unique contribution of this article is that it synthesizes the existing literature on FDI and poverty reduction and provides a comprehensive framework for analysis. The purpose of this study is to review the theoretical and empirical evidence on the linkages between FDI and poverty reduction. The methodology of this study is based on a literature review and a conceptual framework that identifies the channels through which FDI affects poverty. The findings of this study are that FDI can contribute to poverty reduction by enhancing economic growth, creating employment opportunities, increasing wages, improving human capital, transferring technology, stimulating domestic investment, and generating tax revenues. The recommendations of this study are that developing countries should improve their investment climate, strengthen their institutions, enhance their absorptive capacity, promote linkages with local firms, and ensure social and environmental safeguards to maximize the benefits of FDI for poverty reduction.

Asongu & Odhiambo (2020) examined the impact of foreign direct investment inflows on poverty in six Western Balkan countries and also consider other country characteristics, such as the human development index, corruption, investment freedom, economic freedom, trade openness, and fertility. The methodology is a panel data analysis using fixed effects and random effects estimations. The findings are that foreign direct investment inflows have a negative and significant impact on poverty, while human development index, investment freedom, and economic freedom have positive and significant impacts on poverty reduction. The recommendations are to improve the business environment, attract more quality foreign direct investment, and enhance human development.

Anetor, Esho & Verhoef (2020) explored the spatial effects of foreign direct investment on poverty reduction in sub-Saharan Africa. The methodology is a spatial panel data analysis using spatial lag model and spatial error model estimations. The findings are that foreign direct investment has a positive and significant impact on poverty reduction, both directly and indirectly through spillover effects. The recommendations are to improve the quality of institutions, infrastructure, and human capital, as well as regional integration and cooperation. Krasniqi, B., & Krasniqi, A. (2021). The Impact of Foreign Direct Investments on Poverty Reduction in the Western Balkans. Economics and Sociology, 14(2), 1-14.
Aguilar, Mayra, Alejandra & Yat (2018) identified Foreign direct investment (FDI) as an important factor in stimulating economic growth and decreasing poverty. In particular, the relationship between FDI and economic growth has been extensively debated in the academic literature but with mixed results. Meanwhile, considerably less work has been done towards investigating the effects of FDI on poverty reduction. Evidence from the limited research linking on FDI and poverty levels is also mixed. Through a more comprehensive survey-based multi-scale method of assessing poverty, this empirical study investigates the contribution of FDI with respect to concurrent quantitative and qualitative assessment of changes in living standards and poverty reduction in Colombia, a country with one of the highest poverty rates in South America. Results indicate that FDI is perceived as a positive contributor to the wellbeing of employees working at foreign firms, and that FDI is generally beneficial to the economic development of Colombia. Interestingly, those who reported higher scores regarding perceptions of FDI’s contribution to their wellbeing also feel satisfied with their income. Eight percent of households surveyed in 2013 are classified as poor, who are deprived in 37% of the weighted indicators of the Multidimensional Poverty Index (MPI) Colombia assessment as developed by the National Planning Department of the Government of Colombia. The deprivation scores among employees at foreign firms are affected significantly by the number of years of education, household size and age.

Alfaro and Chauvin (2017) examined how foreign direct investment affects host economies. This paper reviewed the empirical literature, specifically addressing the question: How does FDI affect economic development of host countries and what is the role of local financial markets in mediating the potential benefits? We first define FDI and discuss general theories on types and drivers of FDI. This review takes a host-country perspective rather than a firm perspective and thus only highlights the key insights from the rich firm-level literature on MNCs. We then focus on how financial conditions in host countries affect the extent of FDI-related capital inflows, shape the operations of foreign firms, and mediate the extent of productivity spillovers from FDI to local firms. The survey focuses mainly on work related to developing countries.

**METHODOLOGY**

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

**FINDINGS**

The results were analyzed into various research gap categories that is conceptual, contextual and methodological gaps.

**Conceptual Gap:** While the articles discussed provide a comprehensive overview of the linkages between Foreign Direct Investment (FDI) and poverty reduction/economic development, there appears to be a potential conceptual gap in explicitly addressing the potential negative impacts of FDI. While the majority of findings emphasize the positive contributions of FDI to poverty reduction and economic growth, there is a need for a more nuanced exploration of potential
downsides, such as environmental degradation, labor exploitation, and inequality, to provide a balanced understanding of the FDI-poverty relationship.

**Contextual Gap:** While some studies focus on specific regions like sub-Saharan Africa (Anetor et al., 2020) and the Western Balkans (Krasniqi & Krasniqi, 2021), there seems to be a contextual gap in terms of comprehensively examining the impact of FDI on poverty reduction and economic development in diverse geographical regions, including Latin America and other parts of Asia. Investigating these different contexts could reveal variations in the effectiveness of FDI strategies, policy approaches, and the potential for spillover effects, contributing to a more comprehensive understanding of the global implications of FDI on poverty reduction and economic development.

**Geographical Gap:** While the articles mentioned focus on a range of developing countries, including Colombia (Aguilar et al., 2018), sub-Saharan Africa (Anetor et al., 2020), and the Western Balkans (Krasniqi & Krasniqi, 2021), there appears to be a geographical gap in considering the impact of FDI on poverty reduction and economic development in countries from other regions, such as Southeast Asia or the Middle East. Exploring FDI's effects on poverty reduction in these regions could offer valuable insights into the role of FDI in diverse economic and cultural contexts.

**CONCLUSION AND RECOMMENDATIONS**

**Conclusion**

The impact of Foreign Direct Investment (FDI) on poverty reduction and economic development is a complex and multifaceted topic that has been studied extensively by economists and researchers. While there is no one-size-fits-all conclusion due to the diversity of contexts and conditions across different countries and regions, several general observations and conclusions can be made:

FDI has the potential to contribute to economic development by bringing in capital, technology, management expertise, and access to international markets. These factors can stimulate economic growth, leading to higher incomes, increased job opportunities, and improved living standards. FDI can lead to poverty reduction by creating employment opportunities, especially in labor-intensive sectors. As new businesses and industries are established, they often hire local workers, thereby reducing unemployment and providing income to households, which in turn can help lift people out of poverty. Facilitated the transfer of advanced technologies and know-how to host countries. This can lead to improvements in productivity, innovation, and the overall competitiveness of domestic industries, further driving economic development.

The impact of FDI on poverty reduction and economic development is heavily influenced by the host country's policy framework. A conducive regulatory environment, transparent governance, and well-designed investment policies are crucial for ensuring that FDI inflows contribute positively to sustainable development and poverty reduction. Some critics argue that heavy reliance on FDI can lead to economic dependency on foreign investors and multinational corporations, potentially undermining a country's economic sovereignty and control over key sectors.
Recommendations
The impact of foreign direct investment (FDI) on poverty reduction and economic development is a complex and multifaceted topic that involves various theoretical perspectives, practical considerations, and policy implications. Here are some recommendations based on theory, practice, and policy considerations:

Theoretical Considerations
The study understands the theoretical debates surrounding FDI's impact. Dependency theory argues that FDI can perpetuate economic inequality and hinder development, while neoliberalism suggests that FDI can stimulate growth and poverty reduction through market-oriented reforms. It also examined theories of technology transfer, knowledge diffusion, and productivity spillovers from multinational corporations to local firms. Investigate how FDI can enhance human capital and technological capabilities in the host country.

Practical Considerations
The study encouraged FDI in sectors that have the potential to create jobs, enhance skills, and generate sustainable economic growth, such as manufacturing, infrastructure, and technology. Establish effective investment promotion agencies to attract quality FDI, offering incentives, streamlined regulations, and investor support services. Improve physical and digital infrastructure to create an enabling environment for FDI and ensure efficient production and distribution networks. Implement labor market policies that ensure fair wages, decent working conditions, and skill development to maximize the positive impact of FDI on poverty reduction.

Policy Implications
Tailor FDI promotion strategies to align with national development priorities. Focus on attracting FDI that contributes to sustainable development, job creation, and technology transfer. Simplify bureaucratic procedures, reduce red tape, and enhance transparency to make it easier for investors to establish and operate businesses. Enforce stringent environmental regulations to prevent FDI from causing negative environmental externalities and promote sustainable development practices. Prioritize policies that ensure the benefits of FDI are distributed equitably across society, addressing income inequality and promoting inclusive economic growth. Foster collaboration between the public and private sectors to ensure that FDI aligns with national development goals and benefits local communities.

It's important to note that the impact of FDI on poverty reduction and economic development can vary significantly based on the context of each country. Therefore, policymakers should carefully consider their country's unique circumstances, capabilities, and development goals when crafting FDI-related policies.
REFERENCES


