

Foreign Direct Investment Inflow And Inequality In An Emerging Economy – South Africa

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Abstract: This study related the influence of foreign direct investment inflow on income inequality in South Africa. The paper applied the co-integration regression and used the FDI inflow and income inequality data in South Africa for 2005-2015 to determine. Findings from the Augmented Dickey-Fully (ADF) test showed that increase in FDI inflow has (nonetheless not significant) broadened inequality in South Africa during the period of analysis. In addition, a test for a unit root in what arising from the Engle-Granger co-integration relationship test applied the Augmented Dickey-Fuller test. The result indicates that, within the time series examined, there is no long-run relationship between income inequality and foreign direct investment inflow to South Africa. The paper recommends that further research should examine likely effect of governance on income inequality by introducing governance variable into the co-integration regression model to see whether democratic governance in South Africa may have contributed in widening income inequality. Further research might also examine the characteristics of foreign direct investment inflow into the country to see whether it possesses certain attributes such as manufacturing FDI, which could create job for local citizens.

Keywords: foreign direct investment; emerging countries; inequality; poverty; economic growth

1 Introduction

Income inequality counteracts social and economic development in developing countries; hence, one of the economic development planning initiatives of governments have centred on the reduction of income inequality and accelerated rural based development. This is very imperative as income inequality reduces growth and stagnates poverty reduction efforts (Dabla-Norris et al, 2015). Many countries have stepped up campaign for the attraction foreign direct investment (FDI) which is widely believed as one of the engines for social economic growth, skills and technology transfer (Lessmann, 2013). But the question amongst

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researchers have been whether FDI does deliver the expected influence inequality. Many research has thus emerged with different views and findings regarding the influence of foreign direct investment on inequality. Several research has found that FDI may amplify income inequality (Lessmann, 2013); others have found that increase in FDI inflow may reduce income inequality (Jensen and Rosas, 2007); accordingly, findings have remained diverse and hence the need to continue research inquisition on the income inequality and FDI relationship. Findings of this important aspect of research is vital for practical economic development policies and for furthering academic debate and research.

This paper contributes to existing literature on the topic of FDI and income inequality as it concentrates attention in an emerging market of South Africa. Specifically, the novelty of this paper and hence its unique contribution is that it examines inequality and FDI within the period of democratic dispensation in South Africa, thus with the rising inflow of FDI within the period of democracy, an investigation of this nature becomes germane to see whether FDI has influenced inequality within this period; and if not where else can economic policy makers look out to improve FDI policies to benefit the poor. Therefore, the question that underpins this paper is whether FDI during South Africa's democratic rule has influence income inequality; therefore, the core objective of the paper is to analyse how foreign direct investment has related with inequality in South Africa.

The structure of the paper is as follows, the next section following the introduction presents the theoretical background and a review of related literature. This is followed by the methods and results section; the discussion of results is presented thereafter. The final section is the conclusion.

2 Theoretical Context – FDI and Acclaimed Benefits

Alfaro and Chauv (2017) define FDI as international capital flow where a foreign firm invest in another country, therefore, maintaining control over the capital invested. According to Rye (2016) FDI can take the form of new business creations in the host countries, technology and knowledge transfers as well as mergers and acquisitions. The link between FDI distribution, poverty and inequality reduction in developing countries can best be explained by the neoclassical theory (Solow, 1956; Koopmans, 1965) and endogenous growth theory (Romer, 1986; Lucas, 1988; Romer, 1990) among others. The neoclassical growth theory argues that FDI increases economic growth of the host country which in a way improves the livelihoods of the citizens. Furthermore, the neoclassical theory alludes that it is through a high national product that incidences of poverty and income inequality are addressed fully through the multiplier effect. On the other hand, the endogenous growth theory uses technology transfer and knowledge spill over to

explain how FDI reduces welfare problems like poverty and inequality. Accordingly, spill over effects can be horizontal or vertical (Magombeyi & Odhiambo, 2017). Horizontal spill over effects takes the form of the local firm imitating the technology used by foreign firms it is in the same level with but at different technological sophistication. This normally takes the form of reverse engineering where local firms learn to reassemble technological foreign equipment before they can adopt it locally. Furthermore, horizontal spill over effects can also be in the form of local labour force acquiring new skills and techniques, which improves their earning capacity (Diyamett & Mutambla, 2015). On the other hand, vertical spill over effects takes the form of industry integration between the foreign firms and the local ones. Vertical spill over effects can be backward or forward integration. Backward integration is when the foreign big firm subcontract local firms to supply it with intermediate goods while the forward integration explains an arrangement where the foreign firm secure the market outlets for its products.

According to Diyamett and Mutambla (2015), the foreign firm vows to train the local firms to adhere to its quality standards, which improves the efficiency and productivity of local firms. Msweli (2015) remarks that FDI allows for a smooth transfer of technology and other advanced industrial skills from the foreign firms to the local labour force. Hamdani (2016) agrees and points out that FDI leads to human capital development in the host country. In addition, FDI also improves the balance of payments of the host country, which augments favourable living conditions for the citizens. FDI can affect welfare indicators like poverty and income inequality directly and indirectly (Ucal, 2014). The direct impact is achieved when FDI is labour intensive and hence, leads to an increase in employment and income growth. On the other hand, the indirect effect is achieved when FDI spurs economic growth, which consequently improves the welfare of the citizens through the multiplier effect. Ucal (2014) further alludes that it is labour intensive FDI which brings down poverty caused by unemployment compared to capital intensive FDI which target mostly skilled labour.

Rye (2016) argues that it is sagacious for host countries to clearly understand the short and long-term effects of employing FDI as a key tool to resolve socio-economic challenges like poverty and income inequality, the rightful conditions for FDI to yield intended benefits. In addition, Rye (2016) elucidates that it is key for the host country to determine which type of FDI is ideal to spur growth in their economies. FDI can only yield positive results if the host country is well positioned in terms of its institutional policies, absorptive capacity for huge investments, infrastructure and flexible labour force among others. In addition, Magombeyi and Odhiambo (2017) are of the view that it is mainly Greenfield FDI in form of new business creations, which yield more welfare benefits to the host country compared to mergers and acquisitions as they come with their own team and management. The authors of this study believe that South Africa will benefit significantly from

FDI spillovers like technology transfer and knowledge spill over and human capital development, as these will address the structural unemployment in the country, which is caused by a skills mismatch. The theories discussed above are relevant for this study as they set a discourse to understand FDI components and how it is linked to poverty and inequality reduction to host countries.

3 Review of Related Empirical Literature

There is ubiquitous literature on FDI implications on inequality and poverty. However, diverse opinions and findings have surfaced, which provides continuous impetus for more research given the importance of FDI in economic growth and development. The ensuing review is by no sacrosanct; rather, it only touches on few of the literature that provides the motivation for this paper.

3.1. Foreign Direct Investment and Income Inequality

Inequality tends to be a common phenomenon worldwide (Phillips, 2017). Rye (2016) defines inequality as a situation where power, resources and national income is concentrated on a few minorities at the expense of the majority. The Gini coefficient is commonly used in existing literature to measure income inequality. Income inequality can orchestrate conflict and pose a threat to peace if measures are not put in place to resolve it (Sharma & Abekah, 2017). The World Bank (2015) indicates that South Africa ranks high amongst the top unequal countries of the world and hence a dual economic with the rich on one side and with the highly poor on the other side. On that note, it is reported that South Africa exhibits a developed and a developing country status all at once. This causes serious income inequality as most people in marginalised areas live below the poverty datum line. A study by Keeton (2014) asserts that regardless of the social grants given to the poor, the gap between the rich and the poor remains extremely high in South Africa. Malindini (2017) concurs and adds that the richer people in South Africa continues to accumulate wealth while the poor languish in poverty. The United Nations Conference on Trade and Development, (2016) made an important remark that South Africa exhibits high levels of income inequality despite high levels of FDI inflows in the country. As such, Statistics South Africa (2016) reports that in 2014 the Gini coefficient was 0.69 considering the income data. This puts South Africa on the top countries with high-income inequality in the world (Kaulihowa, 2017). Income inequality in South Africa stems from the Apartheid regime as indicated by a Gini co-efficient of 0.58 in 1994 when the country got its independence. The literature also highlights that there is income inequality among the nine provinces in South Africa. Accordingly, the Eastern Cape and Limpopo provinces record high levels of poverty as compared to other provinces such as Gauteng (Statistics South Africa, 2017).

Trinh (2016) notes that income inequality has worsened for the past three years worldwide despite the globalisation effect where FDI has been flowing in different countries especially developing countries. It becomes crucial to investigate if FDI is a sustainable panacea to the soaring levels of inequality in developing countries such as South Africa (Msweli, 2015). Empirical literature about the FDI and income inequality nexus is still new, scant and underdeveloped which calls for more empirical studies (Trinh, 2016; Malindini, 2017). Malindini (2017) asserts that existing literature about the effect of FDI on income inequality in developing countries is in shambles and inconclusive. The literature about the effect of FDI on income inequality is organised in the following manner; studies that found a positive relationship, negative relationship and or insignificant relationship.

Malindini (2017) analysed the effect of FDI on income inequality in South Africa using data from 1970-2012. The study made utilised Auto Regressive Distributed Lag (ARDL) model on their methodology. The study reported a significant positive impact of FDI on income inequality indicating that FDI rather worsens income inequality in the country. Asteriou, Dimelis and Moudatsou (2014) examined the impact of globalisation on income inequality using EU27 countries. The study employed an econometric approach to analyse the behaviour of the key variables. Among the variables used as globalisation indicators, FDI was established as the main factor, which perpetuates income inequality on the sample countries. Mugeni (2015) examined the effect of FDI on income inequality using 153 countries from both developing and developed countries from 1995-2010. The results showed that FDI reduces income inequality gap in the countries considered. However, the reduction effect was only established in countries where democracy prevailed. A study by Msweli (2015) investigated the nexus between FDI and inequality in South Africa from 1956- 2011. The results showed a negative relationship between FDI and income inequality. It was deduced from the study that FDI inflows decreases inequality in South Africa. Trinh (2016) examined the FDI and income inequality nexus of Vietnam's provinces between 2002-2012. The study used panel data and the pooled OLS model as well as the fixed effects model were employed on the methodology. A negative and significant relationship between the variables was established. The findings show that FDI inflows were able to diminish income inequality as a significant number of lowly low-skilled labour was sort, which improved their incomes relative to the rich. The findings are in agreement with a similar study by Farhan, Azman-Saini and Law (2014). Sharma and Abekah (2017) empirically tested the impact of FDI on inequality reduction between African countries and South American countries from 1970-2014. The results indicated that FDI has an income redistributive effect in host countries. Kaulihowa (2017) tested the link between FDI and income inequality in 16 African countries for using data from 1980–2013. The study utilised a Pooled Mean Group (PMG) to ensure consistency. The results showed that FDI had a U shaped effect on inequality.

Importantly, the findings highlighted that FDI inflows enhances equality in developing countries. Kaulihowa (2017) posited that FDI is a crucial catalyst, which fuels growth, which consequently reduces the gap between the rich and the poor.

3.2. Foreign Direct Investment and Poverty

Statistics South Africa (2017) argues that poverty level remains relatively high regardless of the perceived decline from 2006 to 2011. Over 50%, an equivalence of over 30,4 million South Africans were deeply entrenched in poverty in 2015. Kaulihowa (2017) concurs and assert that between 1990 and 2010 the number of people living in extreme poverty has risen sharply from 289.7 million to 413.8 million in Africa. Finding a panacea to this soaring problem goes a long way in resolving social unrest and conflicts between the rich and the poor in the country. Shamim, Azeem and Naqvi (2014) assert that a significant number of developing countries have started implementing policies aimed at attracting FDI hoping that it can resolve the random socio-economic challenges like poverty in the host country. Kaulihowa (2017) asserts that FDI can be a panacea towards the high incidences of poverty in Africa as it creates employment. More importantly, FDI improves existing skills of the host country labour force, which increases their earning potential. Nyuur, Ofori and Debrah (2016) support the strand of literature, which posits that FDI results in improved living standards, hence, a reduction in poverty. Extant literature posits that FDI diminishes poverty in developing countries through employment creation, technological growth and knowledge spill over effects and boost government tax which in a way can be distributed to the poor citizens (Wakyereza, 2017). The literature about the FDI effect on poverty reduction is inconclusive (Magombeyi & Odhiambo, 2017). Some studies reported a positive impact between FDI and poverty, while others document a negative impact and the rest show an insignificant impact. However, according to Rye (2016), considering the views held about the effects of FDI on income inequality in existing literature, it is important to determine which motion dominates to pave way for clear policy formulation. Soumare, (2015) empirically tested the effects of FDI on poverty reduction on North African countries using. The study used Human Development Index (HDI) and Gross Domestic Product (GDP) as measures of poverty levels. The study reported a positive impact between FDI inflows and poverty reduction.

This paper contributes by analysing whether FDI has influenced inequality in South Africa. This is important as South Africa is regarded as one of the countries with high inequality despite the dismantling of apartheid. Although pitching high at 0.65 in 2005 and dropping a little at 0.62 in 2015; South Africa's income inequality is generally seen as the highest in the world and regarded as being stably high, which is an indication of inability to control income inequality (OECD, 2017).

4 Method and Results

The approach was quantitative, and we applied the co-integration statistics using observations 2005-2015 ($T = 11$) to check for possible long-run effect of foreign direct investment (FDI) inflow on inequality in South Africa. Secondary data used in the analysis was retrieved from various online archives. The GINI index was compiled from various sources (World Bank; OECD; trading economics; University of Pretoria repository). The inequality data was compiled from the online in quality data of the World Bank for South Africa. We tested for stationarity using the Augmented Dickey-Fuller (ADF) test. Experts believe that the ADF is one the best approaches for testing co-integration given its simplicity and reliability (Sjö, 2011). Furthermore, the commonly used method for analysing co-integration is the Engle-Granger co-integration test. A line graph of the two variables appear in Figure 1 and Figure 2 with the Gini coefficient and FDI inflow respectively for South Africa (2005 – 2015).

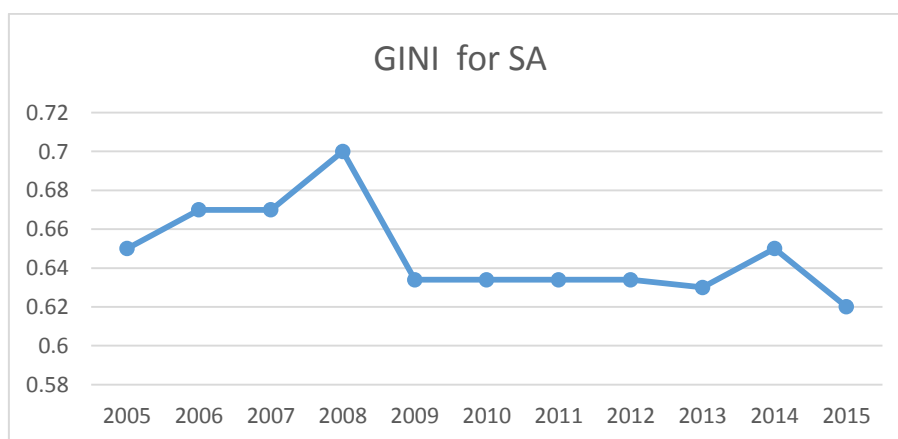


Figure 1. Gini Coefficient for South Africa (2005 – 2015)

Source: author, compiled from various sources (World Bank; OECD; trading economics; University of Pretoria repository)



Figure 2. Foreign direct investment, net inflows (BoP, current US\$) for South Africa

Source: World Bank (2017, p. 1)

The co-integration model: $y_t = \beta_0 + \beta_1 X_t + u_t$

Co-integration Results

Step 1: unit root test: ADF Test: Augmented Dickey-Fuller test

Unit test in GINI Coefficient

Null hypothesis for unit root: $a = 1$

P-value= 0.6773

Step 2: unit root test: ADF Test: Augmented Dickey-Fuller test

Unit test in FDI Coefficient

Null hypothesis for unit root: $a = 1$

P-value= 0.004258

Step 3: Engle-Granger co-integration regression

OLS with observations 2005-2015 (T = 11)

DV: Gini Coefficient (GINI)

Table 1. Co-integration regression

	coeff	SE	t-ratio	p-v
const	0.637214	0.0174263	36.57	4.24e-011 ***
FDI	1.71943e-06	2.93989e-06	0.5849	0.5730

Md var	0.646364	S.D. Var	0.024606
SSR	0.005833	S.E. of R	0.025458
R-squared	0.036615	Adjusted R ²	-0.070428
Log-likelihood	25.87347	Akaike	-47.74693
Schwarz	-46.95114	Hannan-Q	-48.24857
RHO	0.292649	Durbin-Wat	1.385443

Step 4: unit root test in uhat

Augmented Dickey-Fuller test for uhat

Null hypothesis for unit root in uhat: $a = 1$

p-value 0.815

5 Discussion of Results

We first tested for the presence of unit root in both variables – to see that the series for each variable is integrated of order 1. Hence, the null hypothesis for unit root was not rejected in one of the variables GINI. Thus, the existence of unit root provided the condition to proceed to a long run co-integration relationship test. Following the co-integration regression test, we tested for a unit root in uhat arising from the co-integration relationship test using the Augmented Dickey-Fuller test. The unit root in uhat produced a P value of 0.815, which is higher than 0.05, this means that the null hypothesis could not be rejected. The implication is that, within the time series examined, there is no long-run relationship between FDI inflow into South Africa and inequality. However, we could deduct from the co-integration test that a positive relationship does manifest in the regression co-efficient although. It is also noteworthy to highlight the implication of the positive coefficient, which indicates (although not significant), that foreign direct investment inflow may exacerbate inequality if the FDI is not equitably managed. This finding seems to concur with previous research findings that FDI may amplify income inequality (Lessmann, 2013). An apparent lesson from here is that a well-managed FDI must benefit the population without segregation; it should provide employment to the local population, and this means it should strive to be manufacturing in nature so as to employ, produce and export. Practically, this means that FDI attraction should be focussed on those that would build industries locally. The tax accruable from such FDI induced industries and/or manufacturing based FDI's would contribute to the spreading of social services to the citizens. The employment income to the local citizens would contribute to the reduction of income inequality in the country. This

means that initiatives on the attraction of industry based FDI must emphasize the employment of local citizens against a situation where FDI are allowed to come with their own labour force, this might vitiate the important role of FDI in growing the host country economy. Further research is imperative regarding the extent with which FDI into developing countries contributes to the boosting of industrialisation.

6 Conclusion

This paper examined the relationship between foreign direct investment (FDI) and income inequality in South Africa, it sought to determine whether FDI during the democratic period has influenced reduction of income inequality. Applying the co-integration regression, it used FDI inflow and income inequality data in South Africa between 2005-2015 to determine if a long run relationship exists between FDI and income inequality in South Africa. The findings from the Engle-Granger co-integration relationship test, mimic some previous research; a positive relationship is seen in the FDI regression coefficient which signifies that increase in FDI has (though not significant enough) broadened inequality in South Africa. A test for a unit root in what arising from the co-integration relationship test applied the Augmented Dickey-Fuller test. The result showed that a unit root in what test produced a P value of 0.815, which is far higher than alpha value of 0.05, this shows that the null hypothesis could not be accepted. This suggests that, within the time series examined, there is no long-run relationship between foreign direct investment inflow into South Africa and inequality. The authors suggest that further research should examine likely effect of governance on income inequality by introducing governance variable into the co-integration regression model to see whether democratic governance in South Africa may have contributed in widening income inequality. Further research might also examine the characteristics of foreign direct investment inflow into the country to see whether it possesses certain attributes such as manufacturing and technology transfer, which could create job for local citizens. It is important to examine in future research, whether corruption has influenced FDI benefits to tilt towards certain sections of the population more than others. These suggestions are equally vital for policy makers to consider corruption, governance and FDI characteristics in FDI attraction strategies and the benefit distribution.

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