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The Impact of Foreign Direct Investment on Poverty Reduction: Evidence from Bangladesh

Abstract

This study aims to identify the contribution of foreign direct investment on poverty reduction in Bangladesh with a data period of 32 years starting from FY 1991 to FY 2022 with annual observations in real term. Besides foreign direct investment, gross domestic product, government expenditure on education, employment, and trade openness are used as control variables. Per capita consumption is used as a proxy for poverty reduction. The study goes for Johansen Co-integration test and then Vector Error Correction Model rather than Ordinary Least Squares Regression to avoid any spurious result as indicated by Augmented Dickey-Fuller test. This study finds that FDI has significantly negative relationship while Employment has almost indifferent effect on poverty reduction in the long run. However, other control variables, i.e., GDP, Govt. Expenditure on education and Trade openness have long run positive relationship in this regard. The short run causality of FDI toward poverty reduction is also insignificant in Bangladesh.

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1. Introduction

The primary objective of the economic development is to put forward social progress to the people, so poverty reduction is the foremost priority for any economic development effort. These economic development efforts can be facilitated through using domestic and/or foreign resources. Foreign direct investment (FDI) is one kind of foreign resources that can help reduce poverty mainly in two ways. Firstly, in an indirect approach it reduces poverty through economic growth, i.e., the higher the foreign direct investment is, the higher the technology acquisition, modernization, capital formation and industrialization are, the higher the economic growth is, the higher the employment and income potentials are, and the lower the poverty level is. Secondly, in a direct approach it reduces poverty through direct employment creation in FDI enterprises. However, the empirical findings on

the direct contribution from FDI toward poverty reduction are inconclusive. It can be seen from the following section that some researchers found positive relationship while others found negative relationship. Even some researchers found no relationship at all between these two variables. With these conflicting findings, it is necessary to examine the case of Bangladesh in this regard as the country is striving to graduate from least developed country status by 2026. This study is such an effort to help the policymakers in the formulation of the appropriate measures for FDI based on the understanding about the contribution of this kind of foreign resource in the context of economic progress of Bangladesh. Before directly going into the analysis, an extensive literature review from several countries including Bangladesh is presented in the following section. Then the methodology section

presents the empirical model extracted from prior literature along with the statistical methods that are to be used. Then in the results and discussion section the study presents an in-depth analysis based on the results obtained from different statistical tests and finally the study concludes with the intuitive findings about the link between FDI and poverty reduction.

2. Literature Review

Both foreign direct investment and poverty have always generated an intense interest among the scholars who are mainly concerned with the social progress, better living standards, and economic development. Though a lot of efforts have been seen on the indirect relationship between FDI and poverty reduction via economic growth, comparatively fewer research attempts have been carried over to identify the direct contribution of FDI toward poverty reduction across the globe (Ogunniyi & Igberi, 2014) highlighting the need for increased efforts among the scholars in this arena. In such efforts: Sharma & Gani (2004) examined the direct link between FDI and HDI in low- and middle-income countries where HDI is a common proxy for poverty reduction. This study found a positive link between these variables. In Vietnam, Hung (2005) found FDI having direct positive effect on poverty reduction via employment creation. Do, et al. (2021) also examined this direct relationship in Vietnam with a study period ranging from 2010 to 2016 and found FDI playing positive role on poverty reduction. However, Tsai & Huang (2007) found foreign direct investment having insignificant effect for reducing poverty in Taiwan. Similarly, Ali, Nishat, & Anwar (2010) also found insignificant relationship in Pakistan. But Mahmood & Chaudhary (2012) found the opposite in Pakistan between 1973 and 2003. Zaman, Khan, & Ahmad (2012) and Shamim, Azeem, & Naqvi (2014) have also found FDI contributing for reducing poverty

in Pakistan. However, Huang, Teng, & Tsai (2010) found negative relationship in twelve East Asian and Latin American countries. Quiñonez, Sáenz, & Solórzano (2018) found insignificant relationship in Latin America. Reiter & Steensma (2010) examined this relationship in 49 developing countries during 1980 to 2005. They found a positive link from FDI toward HDI (a common proxy for poverty reduction) meaning a reduction in poverty is possible through foreign direct investment. Assadzadeh & Pourqoly (2013) also found a positive relationship in 21 Middle Eastern and North African countries with a study period from 2000 to 2009. They have used HDI for measuring poverty reduction. Similarly, Fowowe & Shuaibu (2014) found strong positive relationship in some selected African countries. Fauzel, Seetanah, & Sannasse (2016) also studied the relationship over a study period 1980-2013 in Mauritius located off the eastern coast of Africa. They found FDI's contribution toward poverty reduction as positive. However, the extent of this contribution is lesser in short run than that of the long run. But Ogunniyi and Igberi (2014) examined this relationship in Nigeria where they have found an insignificant positive contribution from FDI for reducing poverty. Similarly, Anetor, Esho, & Verhoef (2020) found FDI playing negative role for reducing poverty in 29 countries from Africa during 1990 to 2017. But Uttama (2015) found a significant positive relationship in Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam during 1995 to 2011. Agarwal, Atri, & Kundu (2017) have studied the relationship in India and for comparison in SAARC countries with a study period ranging from 1981 to 2011 and found FDI inflows having positive contribution for poverty reduction in the long run. Ahmad, Draz, Su, & Ozturk (2019) have also conducted a study in ASEAN and SAARC countries. They found strong positive relationship in Asia. However, this positive relationship is stronger in SAARC

countries than ASEAN countries. Ganic (2019) has examined this relationship with a study period from 2000 to 2015 in 12 European countries by dividing these countries into two groups. One group consists of countries from Western Balkan region namely Albania, Bosnia and Herzegovina, Montenegro, Croatia, FYR Macedonia, and Serbia. The other group comprises of countries from Central European region namely Czech Republic, Bulgaria, Romania, Hungary, Slovakia, and Slovenia. He found positive relationship in Western Balkan region but a negative relationship in Central Europe underscoring the importance of FDI in emerging countries for reducing poverty. Topalli, Papavangjeli, Ivanaj, & Ferrà (2021) have also found positive relationship in Western Balkan countries. From the above literature it can be seen that the empirical findings on the FDI's contribution for poverty alleviation are yet to be settled. These findings indicate the necessity for country-by-country investigation on this relationship and this study is such an effort to find the role of FDI for poverty reduction in the context of Bangladesh.

3. Methodology

3.1 The Empirical Model

As this study aims to investigate the effect of foreign direct investment on poverty reduction, the dependent variable is Poverty reduction and the independent variable is FDI. However, to make the econometric model more robust GDP, Govt. expenditure on education as a % of government's total expenditure, Employment and Trade openness are used as control variables alongside FDI based on past literatures as mentioned below. By considering all these variables with respect to the dependent variable outlined above, the econometric model can be written as:

$$\text{Poverty reduction}_t = \beta_0 + \beta_1 \text{FDI}_t + \beta_2 \text{GDP}_t + \beta_3 \text{Govt. expenditure on education}_t + \beta_4 \text{Employment}_t + \beta_5 \text{Trade openness}_t + e_t$$

Here, β_0 is constant and $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ denote the elasticities of poverty reduction with respect to each of the respective variables. And e_t is the error term. The dependent variable, Poverty reduction, is usually measured by using the poverty headcount ratio (poverty incidence), the poverty gap ratio (depth of poverty), and the squared poverty gap ratio (severity of poverty). However, these time series data are very scant and inadequate for Bangladesh (Uddin, Kyophilavong, & Sydee, 2012; The World Bank, 2023). So, this study used per capita consumption as a proxy for poverty reduction as used by Dada & Akinlo (2021); Nguea, Noumba, & Noula (2020); Uddin, Kyophilavong, & Sydee (2012) etc. and it denotes that a reduction (increase) in national poverty means an increase (decrease) in national per capita consumption as being less poor, people will have more income to consume that they could not previously. The independent variable, FDI, denotes net inflows of FDI. In the direct approach of FDI's contribution toward poverty reduction it is expected that the higher the amount of FDI inflow, the higher the amount of investment is, which will ultimately create many jobs as well as many complementary business opportunities that will also create many employments. These opportunities will reduce poverty in turn (Shamim, Azeem, & Naqvi, 2014). The control variable - GDP denotes Gross Domestic Product which is expected to show a positive contribution for reducing poverty as the usual understanding is that growth in GDP meaning growth in economic activity reduces poverty provided that income inequality does not change with growth (Son & Kakwani, 2004). Prior literatures such as Shamim, Azeem, & Naqvi (2014); Do, et al. (2021); Hung (2005); Mahmood & Chaudhary (2012) etc. have extensively studied the contribution from economic growth toward poverty reduction. Educational development is another important factor for reducing poverty (Awan, Malik, Sarwar, & Waqas,

2011) as this enables people to become more skilled and makes people more aware with respect to the income opportunities that are readily available or, that can be created by them. That is why this study also uses Government Expenditure on education as a % of government's total expenditure as a control variable which is also used as a control variable by Mahmood & Chaudhary (2012) in their study aiming to identify the role of FDI for reducing poverty in Pakistan. Employment creation is always regarded as a strong measure for poverty reduction. As employment can be generated by many other factors besides FDI, this variable is also taken into consideration as a control variable in this study to capture the sole effect of FDI on poverty reduction and this employment variable is also used as a control variable by Hung (2005); Gutierrez, Orecchia, Paci, & Serneels (2007); Babatunde, Oyeranti, Bankole, & Ogunkola (2012) etc. The variable, employment, is measured by taking square root of the number of people employed in Bangladesh. Trade openness is also used as a control variable for poverty reduction by many studies such as Fauzel, Seetana, & Sannassee (2016); Anetor, Esho, & Verhoef (2020); Dada & Akinlo (2021); Do, et al. (2021); Topalli, Papavangjeli, Ivanaj, & Ferra (2021) etc. In line with these studies, this study also includes trade openness as a control variable. The more open the economy is, the more the amount of export and import is which means more economic activities. These increased economic activities will then generate employment and income opportunities which will reduce poverty in turn. The sum of export and import as a percentage of GDP is usually used as a measure for Trade openness (Alotaibi & Mishra, 2014).

3.2 Data

This study covers a data period from 1991 to 2022 with 32 annual observations which is common to all the above variables based

on their availability. These data are collected from World Bank data repository and Bangladesh Bureau of Educational Information and Statistics (BANBEIS). This study used GDP deflator to convert the nominal variables into real term to remove the inflationary effect from the data series. Moreover, natural logarithm for per capita consumption, FDI and GDP values; and square root for the number of people employed are used which have made it easier to fulfill the time series stationarity requirement.

3.3 Econometric Approach

As the study involves analyzing time series data, it is necessary to determine whether the data are stationary or not. For this, Augmented Dickey-Fuller (ADF) test has been used. Then Johansen Co-integration test has been used instead of Ordinary Least Squares (OLS) regression to avoid any spurious findings as indicated by ADF Test. After that the study has gone for Vector Error Correction Model (VECM) to identify the long run convergence or, divergence relationship in the above-mentioned econometric model. To determine the forecasting strength and the long run viability of the model this study used some diagnostic checks on the result, i.e., the Lagrange-multiplier test has been used to identify whether there is any autocorrelation or not. To identify whether the residuals from the statistical model are normally distributed or not, the study used Jarque-Bera test for normality. White's Heteroskedasticity test has been used to identify whether the residuals are homoskedastic or not. Variance Inflation Factor (VIF) and Correlation matrix have also been used to identify the multicollinearity issues among the independent variables. This study also checked for the stability condition of the result found from VECM. All these tests are necessary to determine whether the dataset fulfills the assumptions of the applied statistical technique or not.

4. Empirical Results and Discussion

4.1 Descriptive Statistics

To get a general understanding about the distribution pattern of the variables the

descriptive statistics are determined in the following table. This understanding about the data series helps in determining the relevant statistical techniques that the study needs to go for.

Table 4.1: Descriptive Statistics

Variables	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
POVR*	2.1792	.1708	1.9771	2.6079	1.1499	3.2551
FDI**	15.4701	1.8576	10.8179	17.2521	-1.2895	3.4748
GDP***	21.2536	.3499	20.8272	21.9808	.8156	2.3929
GEEGE^	.1325	.0329	.0865	.2662	2.0117	9.5643
EMP^^	7182.49	696.41	5986.88	8423.81	.0415	2.0308
TO^^^	.3254	.0799	.1889	.4811	.4270	2.2489

Source: author's calculation

Note: *Poverty Reduction, **Foreign Direct Investment, ***Gross Domestic Product, ^Government Expenditure on Education as a % of Government's total Expenditure, ^^Employment, ^^Trade Openness

From the table 4.1, it can be seen that all the variables show different level of fluctuations in the data structure. In terms of skewness, Employment and Trade openness show nearly symmetrical pattern but GDP is slightly skewed whereas FDI, Poverty reduction, and Govt. expenditure on education are extremely skewed. Poverty reduction, FDI, and Government expendi-

ture on education are leptokurtic whereas GDP, Employment, and Trade openness are platykurtic. Due to this wide variation in the data distribution, great caution is to be considered while modeling a relationship among these variables. To address this issue, the required post-estimation diagnostic tests have been carried out as mentioned in the following sections.

4.2 Augmented Dickey-Fuller (ADF) Test

This test has been used to identify whether the variables (both in their level and first

difference) are stationary or not. The results for each of the variables are:

Table 4.2: ADF Test results

Variables	ADF Test with Constant & without Trend			ADF Test with Constant & Trend			Remarks
	Test Statistic	5% Critical Value	p-value	Test Statistic	5% Critical Value	p-value	
POVR	0.652	-2.986	0.9888	-0.450	-3.580	0.9853	Non-stationary
Δ POVR	-3.116	-2.989	0.0254	-3.943	-3.584	0.0106	Stationary
FDI	-2.446	-2.986	0.1293	-2.595	-3.580	0.2822	Non-stationary
Δ FDI	-3.583	-2.992	0.0061	-4.196	-3.588	0.0045	Stationary
GDP	0.846	-2.986	0.9923	-0.984	-3.580	0.9462	Non-stationary
Δ GDP	-4.405	-2.986	0.0003	-4.670	-3.580	0.0008	Stationary
GEEGE	-1.992	-2.986	0.2901	-2.939	-3.580	0.1500	Non-stationary
Δ GEEGE	-4.073	-2.992	0.0011	-3.980	-3.588	0.0094	Stationary
EMP	0.225	-2.986	0.9736	-1.721	-3.580	0.7416	Non-stationary
Δ EMP	-4.619	-2.986	0.0001	-4.548	-3.580	0.0013	Stationary
TO	-2.080	-2.986	0.2527	-1.871	-3.580	0.6695	Non-stationary
Δ TO	-4.519	-2.986	0.0002	-4.551	-3.580	0.0012	Stationary

Source: author's calculation

From the table 4.2, it can be seen that all the variables are non-stationary at level whereas at first difference all the variables are stationary. Optimal lag lengths were used for each of the variables in this unit root test. This result requires this study to go for Johansen Co-integration test rather

than OLS regression for identifying whether there is any co-integration between these variables because in the presence of unit root in the variables at level, OLS regression will produce a spurious result with a high R2 value although there is low actual relationship.

4.3 Johansen Co-integration Test

The summary results from Johansen Co-integration test are presented in the following table with these two hypotheses:

H_0 =There is no co-integration among the variables

H_1 =There is co-integration among the variables

Table 4.3: Johansen Co-integration test result

Maximum Rank	Eigenvalue	Trace Statistic	5% Critical Value	Max Statistic	5% Critical Value
0		110.6249	94.15	48.1005	39.37
1	0.79878	62.5244*	68.52	27.0562	33.46
2	0.59419	35.4682	47.21	18.5149	27.07
3	0.46053	16.9533	29.68	11.7607	20.97
4	0.32431	5.1925	15.41	4.7736	14.07
5	0.14711	0.4189	3.76	0.4189	3.76
6	0.01387				

Source: author's calculation

From the table 4.3, it can be seen that there is co-integration at rank 1. To identify whether this co-integration holds in its

equilibrium in the long run for the desired model, this study has identified the VECM.

4.4 VECM and Post-estimation Tests

The normalized co-integrating equation

along with the speed of adjustment found by conducting the VECM is:

Table 4.4: Normalized Co-integrating Coefficients from VECM

	POVR	FDI	GDP	GEEGE	EMP	TO	_cons
Co-efficient	1	.04396	-1.07205	-.27067	.00024	-.47711	18.4906
S. E.		.00441	.04259	.13925	.00001	.06877	
z		9.96	-25.17	-1.94	9.03	-6.94	
p> z		0.000***	0.000***	0.052*	0.000***	0.000***	
_ce1 L1.	-.25301; p> z =0.049**						
FDI LD.	.00534; p> z = 0.246						

Source: author's calculation

Note: *, **, and *** significant at 10%, 5%, and 1% level respectively

From table 4.4, it can be seen that all of the independent and control variables have significant long run effect on the dependent variable. The speed of adjustment is also negative and significant which means that the previous period's deviation from the long run equilibrium is corrected in the current period at an adjustment speed of 25.3%. However, foreign direct investment shows a negative relationship with the dependent variable in the long run. Moreover, the short-run causality from FDI toward poverty reduction is insignificant. This finding can be rationalized by highlighting two issues, i.e., FDI's adverse effect on low skilled workers, and insufficient amount of FDI funding going to the agricultural sectors with which most of the people of Bangladesh are directly or indirectly involved with. These two issues are more elaborated in the following section. From the control variables GDP, Govt. expenditure on education, and Trade openness show strong positive relationship with poverty reduction which is expected as outlined in the previous section. Though the expectation from employment was to have a strong positive effect on poverty reduction, the variable is found to be affecting poverty reduction negatively which is counter intuitive. However, the magnitude is close to zero. With regard to this type of finding from employment two relevant aspects are also highlighted in the following section. In the post estimation diagnostic tests, VEC model is found to be stable. The residuals are normally distributed and homoskedastic. There is also no serial correlation in the residuals. However, there is multicollinearity among the independent variables which commonly exist in the time series data. But one of the advantages of VECM is that it reduces the multicollinearity in the error correction form (Warsono, et al., 2020).

5.0 Conclusion

Though the theoretical expectation is that all of the independent variable and control variables should have positive relationship

with poverty reduction, the study found FDI having negative effect and employment having negative but close to indifferent effect toward poverty reduction in the long run. However, other control variables show long run positive relationship with poverty reduction as expected. One of the reasons behind FDI's negative relationship with poverty reduction may be that foreign direct investment usually introduces new economic activities that require new or, high skill set compared to the existing mechanism of doing things in the host countries meaning that more skilled workers instead of low-skilled workers are required by FDI which ultimately pushes the low skilled workers to be unemployed that produces more poverty (Feenstra & Hanson, 1997). Jenkins (1986) also showed that FDI usually implements increasingly capital-intensive manufacturing processes and brings advanced technologies from other countries into the host country which then pushes the low skilled workers toward unemployment that in turn increases poverty. So, the government should take timely but continuous arrangements for educating/training the workforce especially low skilled workers so that the workers' skillset does not become obsolete, rather they can become skilled in improved/newer skillset with which they can continue to remain relevant to the job market. Moreover, FDI enterprises usually invest in the profitable industries and service sectors, reaping advantage of the government incentives into these sectors where the workers from less FDI funded sectors like agriculture may not reap the benefit from FDI enterprises. So, FDI becomes unable to reduce poverty in countries mainly involved with agricultural activities (Do, et al., 2021) like Bangladesh. This can be visualized from the fact that only 1.54% of FDI net inflows was funneled toward agriculture and fishing sectors of Bangladesh (Bangladesh Bank, 2023). So, the policymakers should take this issue into consideration by implementing such policies that will funnel sufficient FDI

inflows into these sectors which may in turn create a wider but positive effect on poverty reduction as most of the people in Bangladesh are directly or indirectly dependent on these sectors for their livelihood. This point also highlights the potential for further research to identify: whether there is any sectoral concentration of FDI inflows, the resulting risk and the required mitigating measures to ensure a more diversified shock resilient economic development. In the case of employment having close to indifferent effect on poverty reduction, two important aspects are to be highlighted. Firstly, after giving a closer look into the employment data it can be seen that the level of employment with respect to labor force is around 95% or more and constantly rising in a stable fashion throughout this study period which raises a concern for the reliability of the data series (a common phenomenon in the developing countries) especially if we look into the real life employment scenario of Bangladesh. Secondly, per capita

consumption is used as a proxy for poverty reduction which is not a perfect substitute and it serves as a limitation of this study besides having a short study period of 32 years over 1991 to 2022 (a common data period for each of the variables based on their availability). Per capita consumption is being responsive to many economic and noneconomic factors. If the headcount statistics could be used for poverty, then the actual relationship could be identified. But unfortunately, there are very few data points corresponding to HIES (Household Income Expenditure Survey) years of 2000, 2005, 2010, 2016, and 2022, and HES (Household Expenditure Survey) years of 1991-92, and 1995-96 for poverty headcount ratio in this study period (Poverty & Equity Brief, 2023; World Bank, 2023). So, when more and more data will be available in the future, the actual relationship running from all the above-mentioned independent variables including employment toward poverty reduction can be identified.

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