Impact of FDI on Relative Return to Skill*

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ABSTRACT

Since the early 1980s, China has adopted favorable economic policies to attract FDI to facilitate technology development. Since inward FDI induces either sector or factor biased technical progress, the impact of FDI on income distribution between skilled and unskilled labor is not trivial. This paper introduces vertical product differentiation to analyze the impact of FDI on the return to skill and concludes that, for a labor abundant country, this impact depends on whether the FDI induced technology transfer is skill or labor biased regardless of which sector receives FDI. The analysis shows that FDI with relatively labor biased technology will decrease the wage gap while FDI with relatively skill biased technology will increase the profit margin of the host country’s exports as well as its wage gap. The findings provide policy insights for FDI recipient countries in balancing wage growth between skilled and unskilled workers by managing inward FDI with relatively labor biased and skill biased technologies. This is particularly important for China given the expected further increase of inward FDI following its imminent membership in the WTO.

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Key words: foreign direct investment, product quality, wage inequality

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