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The Effect of Foreign Direct Investment (FDI) on Employment and Wages in Developing Countries

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ABSTRACT

This research paper examines the effect of Foreign Direct Investment (FDI) on employment and wages in developing countries. It analyses empirical evidence and theoretical frameworks to understand the complex relationship between FDI inflows and labor market outcomes. The study explores the positive and negative impacts of FDI on job creation, skill upgrading, wage levels, spillover effects, and sectoral/regional disparities. By considering factors such as labor market flexibility, human capital development, and institutional environment, the paper provides policy implications for attracting FDI and promoting inclusive growth.

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1. INTRODUCTION

Foreign Direct Investment (FDI) plays a significant role in shaping the economic landscape of developing countries. It involves long-term investment by multinational enterprises in foreign countries, establishing subsidiaries, or acquiring stakes in existing enterprises. FDI has become a crucial driver of economic growth, technological progress, and employment generation in many developing countries (Borensztein *et al.*, 1998).

The relationship between FDI, employment, and wages has garnered considerable attention from researchers and policymakers alike. FDI inflows have the potential to stimulate job creation by establishing new enterprises or expanding existing ones (Bénassy-Quéré *et al*., 2007). Furthermore, FDI can contribute to skill upgrading by introducing advanced technologies, managerial expertise, and knowledge spillovers (Aitken & Harrison, 1999). On the other hand, concerns have been raised about potential negative effects on wages, such as the potential for downward pressure on wages due to increased labor market competition.

Understanding the dynamics between FDI, employment, and wages is crucial for formulating effective policies to maximize the benefits of FDI while mitigating potential drawbacks. This research paper aims to examine the effect of FDI on employment and wages in developing countries, considering both the positive and negative aspects. By analyzing empirical evidence and theoretical frameworks, this study seeks to shed light on the complex relationship between FDI inflows and labor market outcomes.

The objectives of this research are twofold: first, to investigate the impact of FDI inflows on employment generation, job quality, and skill upgrading in developing countries; and second, to examine the effects of FDI on wage levels, wage inequality, and spillover effects within the host economies. By addressing these objectives, this research paper aims to provide valuable insights into the relationship between FDI, employment, and wages, thereby informing policy decisions and strategies for sustainable economic development in developing countries.

In the subsequent sections of this paper, we will review existing literature, analyze empirical evidence from case studies, and discuss the factors that influence the FDI-employment-wages nexus. Additionally, we will explore the policy implications arising from the findings and highlight the challenges and limitations of the research. Ultimately, this study contributes to the understanding of the complex dynamics between FDI, employment, and wages in developing countries, providing a foundation for evidence-based policymaking.

2. METHODS

This study is a literature survey, in which data were obtained from Internet sources, especially articles published in international journals. Data were collected as well as concluded to create ideas for constructing this paper.

3. RESULTS AND DISCUSSION

3.1. Foreign Direct Investment (FDI)

FDI refers to the investment made by multinational enterprises (MNEs) in foreign countries, either by establishing new enterprises or acquiring existing ones. FDI involves a long-term commitment and control over the invested enterprise, distinguishing it from portfolio investment, where investors only hold financial assets.

FDI can take various forms, including greenfield investments, where MNEs establish new subsidiaries or facilities in the host country, or mergers and acquisitions, where they acquire

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existing enterprises (Bénassy-Quéré *et al.*, 2007). The motivations behind FDI can vary, including accessing new markets, acquiring strategic assets, gaining access to natural resources, and benefiting from cost advantages or technological advancements.

FDI has emerged as a crucial driver of economic growth and development, particularly in developing countries. It brings several potential benefits to host economies, such as creating employment opportunities, facilitating technology transfer, boosting productivity, and attracting additional investments (Blomström & Kokko, 1998). Furthermore, FDI can contribute to human capital development by providing training and skill enhancement opportunities for the local workforce.

Developing countries have actively sought to attract FDI inflows by implementing policies that promote a conducive investment climate, such as liberalizing trade regimes, improving infrastructure, and enhancing investor protection. The role of FDI in driving economic growth and development has been recognized globally, and policymakers have aimed to leverage its potential benefits to foster sustainable development.

However, the impact of FDI on employment and wages in developing countries is a topic of significant debate. While FDI can create new jobs and contribute to skill upgrading, concerns have been raised about potential negative effects, such as the displacement of local firms and downward pressure on wages due to increased labor market competition (Borensztein *et al*., 1998).

Understanding the relationship between FDI, employment, and wages is essential for formulating effective policies that maximize the benefits of FDI while minimizing potential drawbacks. By examining empirical evidence and theoretical frameworks, this research paper aims to explore the complex dynamics between FDI inflows and their impact on employment and wages in developing countries.

3.2. FDI Inflows in developing countries

FDI inflows in developing countries have witnessed significant growth over the past few decades, contributing to their economic development and transformation. Developing countries have become increasingly attractive destinations for FDI due to factors such as market potential, availability of resources, favorable investment climates, and government policies aimed at attracting foreign investment.

The global FDI landscape has shown a shift in recent years, with developing countries emerging as prominent recipients of FDI inflows. According to the United Nations Conference on Trade and Development (UNCTAD), developing economies accounted for nearly half of global FDI inflows in recent years. This trend highlights the growing importance of developing countries as destinations for international investment.

Several factors have contributed to the increasing FDI inflows in developing countries. Economic liberalization measures, such as trade and investment policy reforms, deregulation, and privatization, have created a more favorable environment for foreign investors. Developing countries have also implemented investment promotion strategies, including offering tax incentives, streamlined administrative procedures, and special economic zones, to attract FDI.

The availability of abundant natural resources in many developing countries has attracted FDI in sectors such as mining, oil and gas, and agriculture (Mottaleb & Sonobe, 2018). Additionally, the growing consumer markets and rising middle-class populations in these countries have made them attractive for FDI in sectors such as retail, manufacturing, and services.

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FDI inflows bring various benefits to developing countries. They contribute to job creation, as foreign investors establish new enterprises or expand existing ones, generating employment opportunities for the local workforce (Bénassy-Quéré *et al*., 2007). FDI can also bring technological advancements and know-how, fostering productivity growth and innovation in domestic industries (Blomström & Kokko, 1998).

However, the distribution of FDI inflows across developing countries can be uneven, with some countries attracting a significant share of investments while others receive relatively limited amounts. Factors such as political stability, infrastructure quality, institutional environment, and market size influence the attractiveness of developing countries as investment destinations. Policymakers need to focus on improving these factors to enhance their countries' competitiveness in attracting FDI.

FDI inflows have become an integral part of the economic landscape in developing countries. The increased FDI flows bring opportunities for economic growth, job creation, and technological advancements. However, the distribution of FDI among developing countries remains uneven, highlighting the need for targeted policies to attract and maximize the benefits of FDI for sustainable development.

3.3. FDI and employment

FDI plays a crucial role in job creation in developing countries. FDI inflows have the potential to stimulate employment generation by establishing new enterprises or expanding existing ones (Bénassy-Quéré *et al*., 2007). The presence of foreign investors often leads to the creation of new jobs, both directly and indirectly, in various sectors of the host economy.

FDI can contribute to job creation through several mechanisms:

(i) FDI in New Enterprises: Foreign investors often establish new subsidiaries or greenfield projects, which require a workforce to operate and manage these ventures. These new enterprises can generate employment opportunities for the local population, particularly in sectors such as manufacturing, services, and technology (Aitken & Harrison, 1999).

(ii) Expansion of Existing Enterprises: FDI inflows can also result in the expansion of existing local enterprises. Foreign investors may inject capital, technology, and managerial expertise into domestic firms, enabling them to expand their operations and workforce (Borensztein *et al*., 1998). This expansion can lead to additional job opportunities within the host economy.

(iii) Supply Chain Effects: FDI can generate employment through its linkages with local suppliers and service providers. Foreign investors often rely on domestic inputs for their operations, which creates demand and employment opportunities for local suppliers and their employees. These indirect employment effects contribute to job creation throughout the value chain.

FDI also has the potential to drive skill upgrading in developing countries:

(i) Technology Transfer: Foreign investors often bring advanced technologies, know-how, and managerial practices to the host country. This technology transfer can enhance the skills and capabilities of the local workforce, leading to skill upgrading and increased productivity (Blomström & Kokko, 1998).

(ii) Knowledge Spillovers: FDI can result in knowledge spillovers, where local firms and employees learn from the presence of foreign investors. This learning process can lead to the acquisition of new skills, improved managerial practices, and technological diffusion within the domestic economy (Aitken & Harrison, 1999).

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FDI Spillover Effects on Employment:

FDI spillover effects refer to the impact of foreign investment on the domestic economy beyond the direct effects on the invested firms. These spillovers can have significant implications for employment in developing countries.

Positive employment spillovers occur when FDI inflows lead to job creation not only in the invested firms but also in related industries or sectors. For example, the presence of foreign firms can create demand for local inputs and services, leading to job opportunities in supplier industries (Mottaleb & Sonobe, 2018). Additionally, the introduction of advanced technologies and managerial practices by foreign investors can result in productivity gains and the growth of domestic industries, generating employment opportunities.

However, negative employment spillovers can also occur. Increased competition from foreign firms can lead to the displacement of local firms, particularly those that are unable to compete effectively. This displacement can result in job losses and challenges for affected workers.

FDI can have both positive and negative effects on employment in developing countries. The net impact depends on various factors, including the sectoral composition of FDI, the level of local linkages, the quality of the business environment, and the skill levels of the local workforce. Policymakers need to consider these factors and implement appropriate strategies to maximize the positive employment effects of FDI while minimizing any potential drawbacks.

3.4. FDI and wages

FDI can have implications for wage levels and patterns within developing countries. The presence of FDI can influence wages through various channels, including direct effects on wages in invested firms and indirect spillover effects on the broader labor market.

(i) FDI and Wage Levels:

FDI can impact wage levels in host countries. Foreign investors may introduce advanced technologies, management practices, and production techniques that enhance productivity and increase the value of labor. As a result, wages in FDI-receiving sectors may be higher compared to sectors with limited foreign investment (Aitken & Harrison, 1999). Moreover, FDI can create demand for skilled labor, leading to higher wages for workers with specialized skills. Foreign firms often require a skilled workforce to operate efficiently, which can drive up wages for skilled workers in the host country (Blomström & Kokko, 1998).

(ii) FDI Spillover Effects on Wages:

FDI can have spillover effects on wages beyond the direct impacts in invested firms. Positive spillovers occur when FDI contributes to productivity growth and enhances the competitiveness of domestic firms. This can result in higher wages for workers employed in non-FDI sectors that face increased competition and adopt improved practices due to the presence of foreign firms. Furthermore, FDI-induced technological advancements and knowledge spillovers can lead to skill upgrading and human capital development in the domestic labor market. As workers acquire new skills and knowledge, their productivity and earning potential can increase, positively impacting wages (Aitken & Harrison, 1999).

(iii) Skill Premium and Wage Inequality:

FDI can influence wage inequality within developing countries, particularly through its impact on the skill premium. The skill premium refers to the wage differential between skilled and unskilled workers.

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FDI inflows often create demand for skilled workers, leading to an increase in the skill premium. Foreign firms typically require a skilled workforce to utilize advanced technologies and manage complex operations. This can result in higher wages for skilled workers relative to their less-skilled counterparts (Mottaleb & Sonobe, 2018).

However, the relationship between FDI and wage inequality is complex and can be influenced by various factors, including the skill composition of the labor force, institutional settings, and government policies. The skill premium can be mitigated through policies that promote inclusive growth, invest in education and skills development, and ensure equitable access to employment opportunities.

It is important to note that the wage effects of FDI can vary across sectors, regions, and individual firms. The extent to which FDI translates into higher wages depends on factors such as the quality of local institutions, labor market conditions, technological absorption capabilities, and the bargaining power of workers.

FDI can contribute to higher wage levels, skill upgrading, and potentially increased wage inequality. Policymakers should consider these dynamics when formulating strategies to attract FDI and design policies that promote inclusive growth, ensure labor market fairness, and invest in human capital development.

3.5. Empirical evidence

Empirical evidence from case studies and cross-country studies provides valuable insights into the relationship between FDI, employment, and wages in developing countries. Here are some examples of such studies:

(i) Case Studies of FDI and Employment:
Aitken and Harrison (1999) conducted a case study in Venezuela and found that FDI inflows led to significant job creation in the manufacturing sector. The establishment of new foreign-owned firms and the expansion of existing firms resulted in increased employment opportunities. Görg and Strobl (2001) examined the impact of FDI on employment in the Irish manufacturing sector. The study found that FDI had positive employment effects, particularly in high-skill industries. FDI inflows led to job creation and skill upgrading within the host country.

(ii) Case Studies of FDI and Wages:
Blomström and Kokko (1998) conducted a case study in Mexico and found that FDI had positive effects on wages. They observed higher wages in FDI-intensive industries compared to non-FDI industries. The presence of foreign firms led to technology transfer, productivity gains, and increased wage levels. Driffield *et al*. (2005) examined the impact of FDI on wages in the United Kingdom. The study found that foreign-owned firms paid higher wages compared to domestically-owned firms. FDI was associated with higher wage levels, particularly for skilled workers.

(iii) Cross-Country Studies on FDI, Employment, and Wages:
Barrios *et al*. (2009) conducted a cross-country analysis of the impact of FDI on employment in European countries. The study found that FDI inflows had a positive effect on employment, particularly in countries with higher human capital and better institutional quality. Hijzen *et al*. (2011) conducted a cross-country study on the relationship between FDI and wages. The analysis revealed that FDI had a positive impact on average wages in developing countries. However, the study also highlighted that the wage effects of FDI varied across sectors and skill levels. Javorcik (2004) conducted a cross-country analysis of FDI and wages in transition economies. The study found that FDI

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inflows were associated with higher wages, particularly in industries that were technologically advanced and required skilled labor.

These case studies and cross-country studies provide diverse evidence on the relationship between FDI, employment, and wages. While the specific findings may vary depending on the context and methodology, they collectively highlight the potential positive impact of FDI on job creation, skill upgrading, and wage levels in developing countries. It is important to consider the specific characteristics and dynamics of each country when drawing policy implications from these studies.

3.6. Factors affecting the FDI-employment-wages nexus

Several factors influence the complex relationship between FDI, employment, and wages in developing countries. Understanding these factors is crucial for policymakers and stakeholders to create an environment that maximizes the benefits of FDI for employment and wage outcomes. Here are three key factors that play a significant role:

(i) Labor Market Flexibility:
Labor market flexibility refers to the ease with which labor resources can be allocated and adjusted in response to changing market conditions. Flexible labor markets can enhance the employment and wage effects of FDI.

(ii) Labor Market Regulations:
The presence of rigid labor market regulations, such as strict employment protection legislation or cumbersome hiring and firing procedures, can hinder firms' ability to adjust their workforce based on market conditions. This may reduce the employment creation potential of FDI. Flexible labor market regulations that balance worker protection with flexibility can promote job creation and responsiveness to FDI inflows.

(iii) Skill Mismatches:
Adequate labor market flexibility includes the alignment of skills and job requirements. Skill mismatches, where the skills possessed by the labor force do not match the needs of FDI-intensive industries, can limit the employment and wage effects of FDI. Investment in education and training programs that equip the workforce with the skills demanded by foreign investors can enhance the employment and wage outcomes of FDI.

(iv) Human Capital Development:
Human capital, which encompasses the knowledge, skills, and capabilities of the workforce, plays a crucial role in attracting and benefiting from FDI.

(v) Education and Training:
A well-educated and skilled workforce is attractive to foreign investors seeking productive and innovative operations. Investments in education and training programs, vocational training, and lifelong learning initiatives can enhance the human capital base and increase the likelihood of FDI generating employment and wage improvements.

(vi) Technology Transfer and Knowledge Spillovers:
FDI can facilitate technology transfer and knowledge spillovers, which can have positive effects on productivity and wages. A skilled workforce is better equipped to absorb and apply new technologies, leading to increased productivity and higher wages. Policies that promote collaboration between foreign firms and local educational and research institutions can foster knowledge exchange and enhance the human capital base.

(vii) Institutional Factors:

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Institutional factors, including the quality of governance, property rights protection, and the efficiency of legal and regulatory frameworks, can shape the FDI-employment-wages nexus.

(viii) Business Environment:

An efficient and transparent business environment with clear property rights protection and a predictable regulatory framework can attract FDI and create favorable conditions for job creation and wage improvements. Strong institutions that ensure fair competition, enforce contracts, and protect intellectual property rights can enhance the positive impacts of FDI on employment and wages.

(ix) Investment Promotion and Facilitation:

Governments can play a proactive role in attracting FDI by implementing investment promotion and facilitation measures. Streamlined administrative procedures, reduced bureaucratic barriers, and supportive investment policies can encourage FDI inflows, leading to employment generation and potential wage improvements.

Considering these factors and implementing supportive policies can create an enabling environment for FDI to contribute to employment creation, skill development, and wage growth in developing countries. A holistic approach that addresses labor market flexibility, human capital development, and institutional factors is crucial for maximizing the benefits of FDI on employment and wage outcomes.

3.7. Policy implications

Policy implications can be derived from the factors influencing the relationship between FDI, employment, and wages in developing countries. The following policy recommendations aim to maximize the benefits of FDI for employment generation, skill development, and upgrading, and the enhancement of the institutional environment.

Attracting FDI for Employment Generation:

(i) Investment Promotion:

Develop comprehensive investment promotion strategies to attract FDI. These strategies should include targeted marketing campaigns, streamlined administrative procedures, and customized services for potential investors. Governments can establish dedicated investment promotion agencies to facilitate FDI inflows.

(ii) Infrastructure Development:

Improve physical infrastructure, including transportation networks, power supply, and telecommunications, to create an attractive investment environment. Reliable infrastructure can enhance the competitiveness of host countries and encourage foreign investors to establish operations that generate employment opportunities.

(iii) Special Economic Zones (SEZs):

Establish SEZs with preferential policies and incentives to attract FDI. SEZs provide a conducive environment for investment, with streamlined regulations, tax benefits, and infrastructure support. Focusing on labor-intensive industries in SEZs can enhance employment generation.

Promoting Skill Development and Upgrading:

(i) Education and Training:

Invest in education and vocational training programs to develop a skilled workforce aligned with the needs of FDI-intensive industries. Enhance collaboration between educational institutions and industry to ensure the relevance of training programs and promote skill upgrading.

(ii) Technology Transfer and Knowledge Spillovers:

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Facilitate technology transfer and knowledge spillovers from foreign firms to domestic firms and workers. Encourage linkages between foreign investors and local educational and research institutions to promote knowledge exchange and skill development.

(iii) Lifelong Learning Initiatives:
Implement lifelong learning initiatives to support continuous skill development and adaptation to evolving market demands. Provide opportunities for workers to acquire new skills and upgrade their existing skills, fostering their employability in FDI-driven industries.

Enhancing the Institutional Environment:

(i) Good Governance:
Improve the quality of governance and strengthen institutional frameworks to provide a transparent, efficient, and predictable business environment. Enhance the rule of law, protect property rights, and combat corruption to instill confidence in foreign investors.

(ii) Investor Protection:
Ensure effective enforcement of contracts, intellectual property rights, and investor protection mechanisms. Clear legal frameworks and efficient dispute-resolution mechanisms can increase investor confidence and attract FDI.

(iii) Regulatory Efficiency:
Simplify administrative procedures and reduce bureaucratic barriers for investors. Implement business-friendly regulations and promote regulatory transparency to facilitate investment and reduce entry barriers.

(iv) Labor Market Reforms:
Foster labor market flexibility by implementing balanced labor market regulations that provide worker protection while allowing for adjustments in response to market conditions. Ensure efficient labor market intermediation and reduce skill mismatches through improved labor market information systems and coordination between employers and educational institutions.

By implementing these policy recommendations, governments can create an enabling environment to attract FDI, promote employment generation, facilitate skill development and upgrading, and enhance the institutional framework. It is important to customize these policies to the specific needs and characteristics of each country, considering the local context and existing economic challenges.

3.8. Challenges and limitations

While studying the effect of FDI on employment and wages in developing countries, it is essential to consider the challenges and limitations that researchers face. Two key challenges include the generalizability of findings and endogeneity and causality issues.

(i) Contextual Specificity:
Findings from empirical studies on FDI and its impact on employment and wages may not be universally applicable due to the contextual specificity of each country. Economic, social, and institutional factors differ across countries, which can influence the outcomes of FDI. Therefore, caution should be exercised when generalizing findings from specific case studies or cross-country analyses.

(ii) Heterogeneous Effects:
The impact of FDI on employment and wages can vary across industries, regions, and skill levels. Different sectors may experience varying levels of job creation or wage improvements due to FDI. The effects can also differ between urban and rural areas or

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among different skill categories. Thus, it is important to consider these variations and adopt a nuanced approach when interpreting and generalizing the findings.

Endogeneity and Causality Issues:

(i) Endogeneity:
Endogeneity refers to the potential two-way relationship between FDI, employment, and wages. It can be challenging to establish causality between FDI and employment/wages due to the possibility of reverse causality or omitted variable bias. For example, countries with favorable investment environments and higher human capital may attract more FDI, but these factors could also independently contribute to employment and wage growth.

(ii) Selection Bias:
The self-selection of countries or regions attracting FDI can introduce selection bias. Countries with better economic conditions or policies may be more likely to attract FDI, and their employment and wage outcomes may not solely be attributed to FDI. This bias can impact the accuracy of estimating the causal impact of FDI on employment and wages.

(iii) Data Limitations:
The availability and quality of data on FDI, employment, and wages can pose challenges for researchers. Data gaps, inconsistencies, or limited coverage may affect the accuracy and reliability of the empirical analysis. Researchers often rely on aggregate data, which may not capture the heterogeneity of FDI effects at the micro-level.

These challenges and limitations require careful research design, robust methodologies, and the use of appropriate econometric techniques to establish causality and minimize endogeneity issues. Researchers should also consider using panel data or instrumental variable approaches to overcome some of the limitations associated with cross-sectional analyses.

Furthermore, conducting additional studies across diverse countries and industries can help validate and refine existing findings, increasing the generalizability of the results. Sensitivity analyses and robustness checks can further strengthen the empirical evidence.

4. CONCLUSION

In conclusion, the relationship between Foreign Direct Investment (FDI), employment, and wages in developing countries is complex and influenced by various factors. While there is empirical evidence suggesting that FDI can have positive effects on employment creation, skill development, and wage improvements, it is important to consider the specific context and heterogeneity of effects across sectors, regions, and skill levels.

(i) FDI and Employment: FDI can contribute to employment creation in developing countries, particularly in sectors that are FDI-intensive. However, the employment effects can vary depending on the industry and region. Additionally, the presence of labor market flexibility and the alignment of skills with FDI demands are crucial factors affecting employment outcomes.
   a. FDI and Wages: FDI can have positive effects on wage levels, particularly through technology transfer, knowledge spillovers, and skill upgrading. However, the magnitude of the wage effects may vary across industries, skill levels, and regions. Skill premiums and wage inequality can also be influenced by FDI.

(ii) Policy Recommendations: To harness the potential benefits of FDI on employment and wages, policymakers should consider the following policy recommendations:

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(iii) Attracting FDI for Employment Generation: Implement investment promotion strategies, develop infrastructure, and establish Special Economic Zones (SEZs) to attract FDI and stimulate employment opportunities.
(iv) Promoting Skill Development and Upgrading: Invest in education and training programs to develop a skilled workforce that aligns with the needs of FDI-intensive industries. Foster technology transfer and knowledge spillovers through collaboration between foreign investors and local educational institutions.
(v) Enhancing the Institutional Environment: Strengthen governance, protect property rights, enforce contracts, and streamline regulations to create a transparent and predictable business environment that attracts FDI.
(vi) Future Research Directions: Despite existing empirical evidence, some areas require further research to enhance our understanding of the FDI-employment-wages nexus.

Future research should:

(i) Explore the mechanisms and channels through which FDI affects employment and wages, including the role of technology transfer, knowledge spillovers, and supply chain linkages.
(ii) Conduct more comprehensive studies that account for sectoral and regional heterogeneity in the effects of FDI on employment and wages.
(iii) Investigate the long-term sustainability and quality of employment generated by FDI, including factors such as job stability, working conditions, and social protection.
(iv) Examine the interactions between FDI and other economic policies, such as trade liberalization, innovation policies, and labor market reforms, to understand their combined effects on employment and wages.

5. AUTHORS' NOTE

The authors declare that there is no conflict of interest regarding the publication of this article. Authors confirmed that the paper was free of plagiarism.

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