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Trade Openness and the Distributional Effects of Foreign Direct Investment Cross-Country Evidence on Income Inequality

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Abstract

This study investigates the connections between trade openness, income inequality and foreign direct investment (FDI), with a specific focus on the moderating effect of trade openness on national economies. The analysis method of the study was a quantitative longitudinal research design, with country-years totaling 992 for 58 countries from 1990 to 2024. The World Bank Gini Index was used to measure income inequality, whereas FDI, trade openness, and some macroeconomic indicators were used as explanatory variables. Descriptive statistics, Pearson correlation analysis and pooled and fixed-effects panel regressions were used, with an interaction term between FDI and trade openness. The results showed that trade openness had a moderate negative correlation with income inequality ($r = -0.463$), while FDI had a weak negative correlation ($r = -0.096$). The pooled regression found a significant negative relationship between trade openness and inequality ($\beta = -0.074$, $p<0.001$). This relationship, however, was not significant statistically when controlling for country and year effects. In a similar fashion, fixed-effects estimation revealed no significant relationship between FDI and inequality. There was not enough evidence of moderation as the interaction coefficient was negative and not significant ($\beta = -0.00038$, $p = 0.629$). The results indicate that the differentials in distributional outcomes are significant and the extent of the differences depends on the country-specific economic conditions. The study highlights the need to link trade and investment policies with inclusive employment, financial development and institutional strengthening, in order to foster equitable economic development.

Keywords: Trade Openness; Foreign Direct Investment; Income Inequality; Gini Index; Panel Data Analysis.

1. Introduction

The transformation of economic relationships brought about by globalization has been manifested in various ways such as international trade, foreign direct investment (FDI) and growing integration of domestic markets. The developments have increased investment possibilities, introduced technology transfer and enhanced economic cooperation between countries. But their benefits are not equally shared by income groups and economies. The distributional effects of foreign investment are linked to domestic economic structures and labour market conditions; positive and important effects include capital accumulation, employment creation, and industrial development (Azémar & Giroud, 2023; Giroud & Ivarsson, 2020). Internationally, recent investment assessments highlight the role of institutional capacity and investment policies in supporting sustainable economic development (Development (UNCTAD), 2024; Giroud, 2024). Despite greater international integration, however, there are still significant economic divides among the world's nations. Income distribution remains unevenly distributed between countries, with disparities in productivity and structural economic issues still playing a role (but Slow & amid Divergence, 2024). Income inequality is thus a key development issue that can affect social mobility, economic stability and inclusive growth. The trend toward socioeconomic inequalities is also highlighted by the assessments of international development, which also point to the need for equitable economic opportunities and institutional cooperation (Chancel et al., 2026; Conceição, 2024).

There has been a lot of focus in international economics on the connection between foreign direct investment and income inequality. FDI can also enhance income distribution by creating jobs, boosting productivity and technological development. On the other hand, investment focused on capital-intensive industries and in skilled jobs can benefit higher income groups more. The evidence indicates that the distributional effects of FDI differ depending on the sectoral structure of FDI, and also on economic development and institutional dimensions of domestic labor markets (Hekmatpour, 2024). The forms of wage bargaining are also likely to affect the distribution of investment gains among the workers and the capital owners (Anwar & Sun, 2025). Another key factor influencing income distribution is trade openness, as international competition influences wage rates, employment arrangements and production patterns. There is cross-country evidence that it has very different distributional impacts in developed and developing economies (Dorn et al., 2022). When evaluating the implications of the distributional outcomes, research based on

trade openness using alternative measures of inequality offers a further caveat on the importance of measuring (Khoso et al., 2021). Overall, these results indicate that the analysis of trade integration and foreign investments should consider them as two interrelated economic processes. Although there have been a significant number of empirical studies, the association between FDI and income inequality has been ambiguous. Reviewing past research revealed there were significant differences in estimated impacts, which could be attributed to variations in geographic scope, methodologies and institutional contexts (Huang et al., 2020). The regional evidence also suggests that the relationships between trade and FDI and income inequality can be different in economic situations. These relationships were explored in the context of the specific conditions of development of the economies of the CIS (Khan et al., 2021). Likewise, the analysis of the South Asian economies indicates that this analysis should incorporate both trade openness and the inflow of FDI in the evaluation of inequality (Khan & Nawaz, 2019). In international discussion of investment policy, it is also acknowledged that investment facilitation and architecture of investment institutions influence the potential gains of economic integration (Facilitation, 2019). The link between FDI and income inequality, however, is not very well understood and there is a lack of research on how openness to trade shapes the relationship between FDI and income inequality between countries. This encourages more cross-country studies, based on longitudinal economic observations and interaction-based panel regression models.

This present study examines the cross-country panel relationship between trade openness, FDI and income inequality. In particular, it seeks to analyse the direct relationship between FDI and income inequality, the relationship between trade openness and income distribution, and whether the relationship between FDI and income inequality is moderated by trade openness. Furthermore, this study assesses the differences in these relationships between countries and over time. The study includes interaction effects and macroeconomic control variables that are relevant to the assessment of the distributional impacts of international economic integration and thus offers empirical evidence to support the debate on inclusive investment and trade policies.

2. Materials and Methods

2.1 Research Design

The research design used in this study was a quantitative, longitudinal panel research, which aimed to explore the relationship between foreign direct investment (FDI), trade openness and income inequality at the global level. Data analysis was performed by means of descriptive statistics,

Pearson correlation and panel regression techniques. The moderating effect of trade openness on the relationship between FDI and income inequality was considered.

2.2 Data Source and Study Coverage

This study was based on a dataset on Trade Openness as a Moderator, which includes 992 country-year observations from 58 countries spanning 1990 to 2024. Annual macroeconomic indicators, such as income inequality, foreign direct investment, trade openness and economic control variables, were included in the dataset. Observations were in an unbalanced panel suitable for both cross country and longitudinal analysis (Duong, 2026).

2.3 Study Variables and Measurements

The dependent variable was the World Bank Gini index (GINI_WB) which measured income inequality. Foreign direct investment (FDI) (as a percentage of GDP) was the primary independent variable, and the moderating variable was trade openness (TO) (exports + imports as percentage of GDP). The interaction term (FDI × TO) was the moderation effect. Domestic credit (CR), population growth (POP), government expenditure (GVE), and inflation (IF) were the control variables.

2.4 Data Preprocessing

The data set was checked for consistency of variables, duplicate country-year information and missing values. The final dataset included 992 observations with no missing data on the main variables or duplications of country-year combinations. The country identifiers and year were kept to set up the panel structure. Original measurements were kept and then winsorized variables were considered for robustness analysis to minimise the impact of extreme observations.

2.5 Descriptive and Correlation Analysis

The mean, median, SD, minimum and maximum of the study variables were summarized using descriptive statistics. Pearson correlation analysis was used to analyze the linear relationships between income inequality, FDI, trade openness and macroeconomic controls. The analysis also helped to identify preliminary strong correlations between the explanatory variables.

2.6 Panel Regression Model Specification

The direct and moderating relationships between FDI, trade openness and income inequality were estimated using panel regression analysis. It was decided that pooled ordinary least squares, fixed-effects and random-effects models could be considered. One of the main regression equations was:

$$GINI_{it} = \beta_0 + \beta_1 FDI_{it} + \beta_2 TO_{it} + \beta_3 (FDI_{it} \times TO_{it}) + \beta_4 CR_{it} + \beta_5 POP_{it} + \beta_6 GVE_{it} + \beta_7 IF_{it} + \mu_i + \lambda_t + \varepsilon_{it}$$

Here, β^3 represents the moderating effect of trade openness, while μ^i, λ^t, and ε^{it} denote country effects, year effects, and the error term, respectively.

2.7 Model Diagnostics and Robustness Checks

Model reliability was assessed through variance inflation factors for multicollinearity, the Hausman specification test for model selection, and appropriate tests for heteroskedasticity and serial correlation. Country-clustered robust standard errors were specified to improve statistical inference. Robustness was assessed through alternative model specifications, winsorized variables, and alternative income inequality measures where applicable.

2.8 Statistical Analysis

Regression coefficients were evaluated based on their direction, magnitude, and statistical significance at the 1%, 5%, and 10% levels. Model estimates were compared using appropriate goodness-of-fit measures and specification tests. The moderating influence of trade openness was evaluated through the interaction coefficient and the conditional marginal effect of FDI:

$$\frac{\partial GINI_{it}}{\partial FDI_{it}} = \beta_1 + \beta_3 TO_{it}$$

This expression measures how the estimated relationship between FDI and income inequality changes across different levels of trade openness. Findings were to be interpreted as statistical associations rather than definitive causal effects.

3. Results

3.1 Dataset Characteristics and Country Coverage

Data consisted of 992 observations from 58 countries over 35 years. The panel was imbalanced, and the number of observations in each country ranged from 1 to 34. The number of observations per year ranged from 8 in 1990 to 45 in selected years, and was only 1 in 2024. In the seven main variables for the analysis, no duplicate country-year combinations or missing values were found. Table 1 provides an overview of data characteristics and reveals that the data is appropriate for longitudinal economic analysis.

Table 1. Characteristics and Coverage of the Analytical Dataset

Characteristic	Value

Total observations	992
Countries	58
Observation period	1990–2024
Distinct observation years	35
Minimum observations per country	1
Maximum observations per country	34
Median observations per country	18.5
Duplicate country-year records	0
Missing values in selected variables	0
Panel structure	Unbalanced

3.2 Descriptive Statistics of Study Variables

Descriptive analysis showed that there was a significant difference in economic conditions amongst the sampled countries. The mean Gini index was 35.624, with values ranging from 23.000 to 64.800. The average FDI inflows constituted 3.956 percent of GDP, and the average openness of trade was 79.128 percent of GDP. Trade openness and FDI were also very varied, showing heterogeneous international economic integration. The dispersion of inflation was especially large with a maximum of 2,736.971 and this justifies the application of outlier-resistant specifications. The distributions of the three main variables observed are depicted in Figure 1.

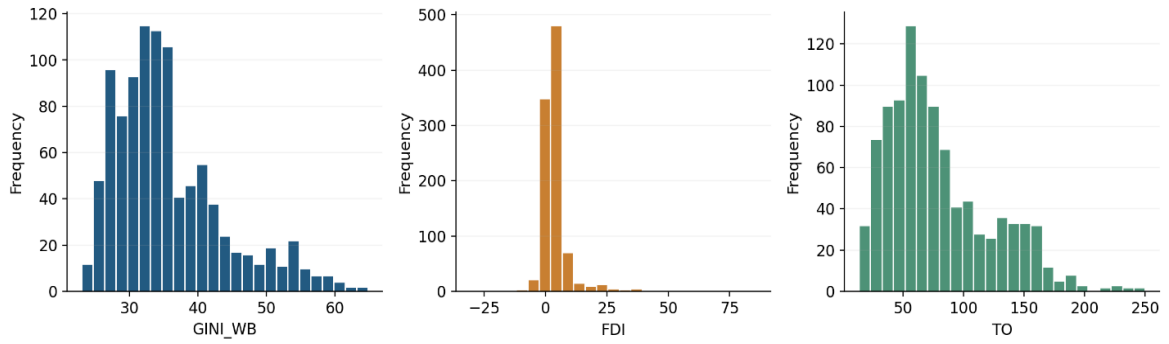

Figure 1. Distribution of Income Inequality, Foreign Direct Investment, and Trade Openness

3.3 Correlation Among Economic Variables

A moderate negative correlation (r = −0.463) was found between the two variables of trade openness and income inequality using Pearson correlation analysis. The FDI-income inequality relationship was found to be weak negative correlation (r = −0.096), while the relationship between FDI and trade openness was found to be positive (r = 0.308). Inequality (r = −0.426) was negatively correlated with government expenditures, and positively correlated with population growth (r = 0.308). As shown in Table 2, there were significant relationships between macroeconomic conditions, international economic integration, and income distribution.

Table 2. Pearson Correlation Matrix of Study Variables

Variable	GINI	FDI	TO	CR	POP	GVE	IF
GINI	1.000						
FDI	−0.096	1.000					
TO	−0.463	0.308	1.000				
CR	−0.208	0.034	0.030	1.000			
POP	0.308	−0.032	−0.171	−0.021	1.000		
GVE	−0.426	0.068	0.205	0.329	−0.299	1.000	
IF	0.168	−0.028	−0.089	−0.030	0.067	−0.016	1.000

Note: GINI = income inequality; FDI = foreign direct investment; TO = trade openness; CR = domestic credit; POP = population growth; GVE = government expenditure; IF = inflation. Correlations are based on 992 original observations.

3.4 Direct Relationship Between FDI and Income Inequality

A baseline panel regression analysis showed that there were differences between pooled and fixed-effects estimates. The pooled model indicated that FDI had a positive significant (β = 0.165, p = 0.085) coefficient at the 10% level but not at the 5% level. Nonetheless, it took the country and year effects into account, which resulted in the FDI coefficient turning negative and statistically insignificant (β = -0.012, p = 0.657). These findings indicate that the relationship between foreign investment and income inequality was susceptible to unobserved country specifics and time. Figure 2 shows the dispersion of FDI and income inequality observations in general.

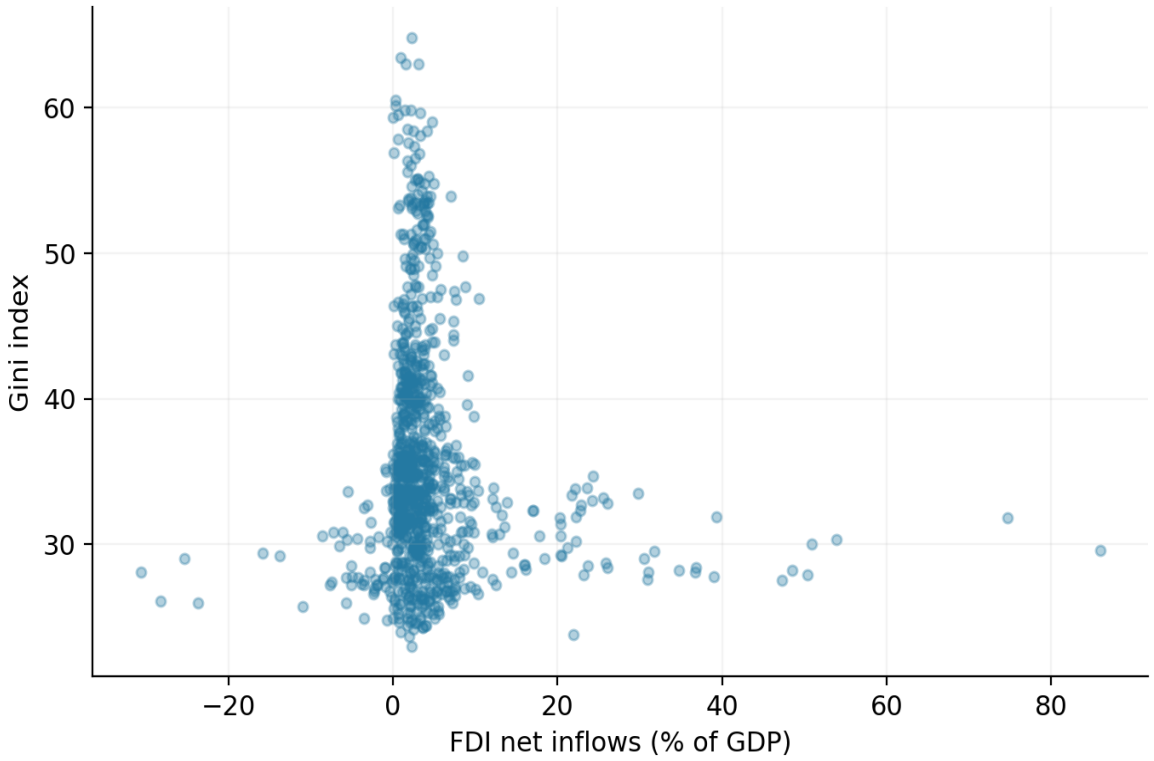

Figure 2. Relationship Between Foreign Direct Investment and Income Inequality

3.5 Relationship Between Trade Openness and Income Inequality

The pooled regression model revealed a negative significant relation between trade openness and income inequality ($\beta = -0.074$, $p < 0.001$). This relationship was no longer upheld when country and year fixed effects were added, however. The fixed-effects coefficient was positive ($\beta = 0.022$), but not statistically significant ($p = 0.165$). Table 3 shows that the baseline and interaction-model estimates indicated that the strength and direction of the trade openness relationship varied depending on the model specification.

Table 3. Panel Regression Estimates for Income Inequality

Variable	Pooled baseline β (p)	Two-way FE baseline β (p)	Two-way FE interaction β (p)
FDI	0.165 (0.085)	−0.012 (0.657)	0.002 (0.963)
Trade openness	−0.074 (<0.001)	0.022 (0.165)	0.024 (0.148)
FDI × TO	—	—	−0.00038 (0.629)
Domestic credit	−0.014 (0.334)	0.016 (0.032)	0.016 (0.030)

Population growth	1.503 (0.086)	−0.069 (0.858)	−0.062 (0.873)
Government expenditure	−0.497 (0.005)	−0.184 (0.143)	−0.181 (0.153)
Inflation	0.062 (0.566)	−0.060 (0.277)	−0.060 (0.275)
R^2	0.400	0.942	0.942
Observations	992	992	992

3.6 Moderating Effect of Trade Openness

The negative, albeit statistically insignificant, FDI × Trade Openness coefficient (β = −0.00038, p = 0.629) in the interaction-based fixed-effects regression indicated a negative FDI-TO relationship. The estimated conditional FDI coefficient decreased with expansion of trade openness; however, the estimates were not significant. The estimated marginal effect of a one-percentage-point increase in FDI/GDP was 0.0133, 0.0057, and −0.0074 Gini points at the 25th, 50th, and 75th percentile of winsorized trade openness, respectively. To show the uncertainty in the moderation relationship, the same relationship is presented as marginal effects in Figure 3 with 95% confidence intervals around these estimates.

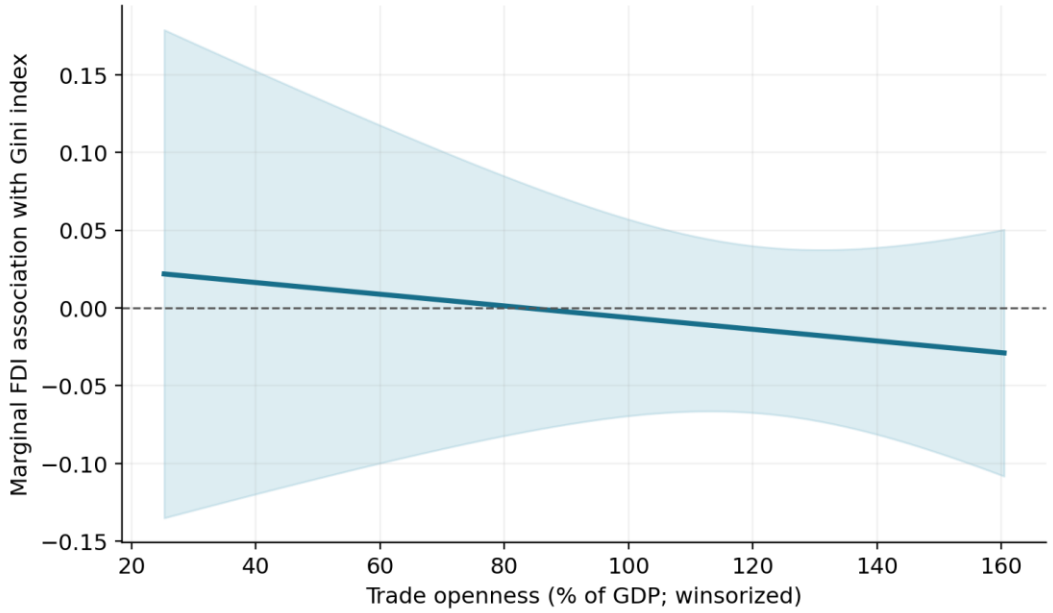

Figure 3. Marginal Effect of FDI on Income Inequality Across Trade Openness Levels

3.7 Cross-Country and Temporal Variations

The panel was unbalanced with respect to both countries and time. Fixed-effects interaction models were estimated separately for observations pre-2020 and for observations 2020 and beyond to compare the temporal differences. The pre-2020 sample had 851 observations from 58 countries, while the latter sample had 141 observations from 46 countries. The FDI and interaction coefficients were not statistically significant for both periods. Table 4 shows that there was no statistically discernible relationship between international investment, trade openness and income inequality in either of the two periods. Direct comparison is hindered by differences in sample coverage and the shorter later period.

Table 4. Temporal Comparison of Fixed-Effects Interaction Models

Indicator	Before 2020	2020 onward
Observations	851	141
Countries	58	46
FDI coefficient	−0.0374	−0.0112
FDI p-value	0.443	0.880
Interaction coefficient	−0.000295	0.000065
Interaction p-value	0.726	0.952
Significant moderation at 5%	No	No

3.8 Model Diagnostics and Robustness Results

The regression analysis revealed that it was very sensitive to panel specification. The pooled model interaction coefficient was -0.00277(p=0.292) and after considering country and year fixed effects, the interaction coefficient was -0.00038(p=0.629). Neither estimate showed statistically significant moderation. The variance inflation factors were between 1.19 and 3.64 for the explanatory variables, which implies that there is no serious multicollinearity based on the traditional thresholds. The large effect size of country and year indicators in the high fixed-effects model R2 was mostly attributable to the explanatory power of these variables. The interaction coefficients and their 95% confidence interval are compared in Figure 4 between pooled and fixed-effects specifications.

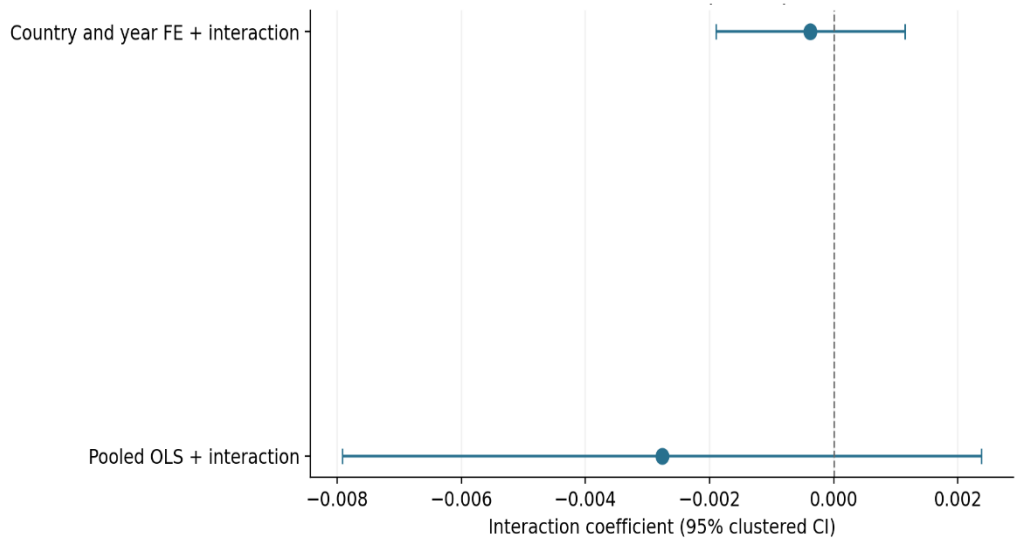

Figure 4. Robustness Comparison of Interaction Effects Across Panel Models

The results overall showed negative raw correlations between trade openness and income inequality, but trade openness was not found to have statistically significant moderating effects on income inequality, after controlling for country and year effects. The results of this study indicate that the distributional relationships observed are model-dependent and country-specific.

4. Discussion

The study analyzed the relationship between foreign direct investment (FDI), trade openness, and income inequality in 58 countries, with 992 observations from the period 1990 - 2024. The results showed that there was a moderate negative correlation between trade openness and income inequality and FDI showed a low degree of negative correlation. But these associations were not statistically significant when country-specific and temporal effects were considered. The findings suggest that international economic integration is complex and its distributional effects vary, similar to studies which have indicated the differences in the distributional impacts of economic integration across different economic environments. (Khoso et al., 2021).

The fixed effects regression showed that there was a negative, but not statistically significant association between FDI and income inequality. This means that foreign investment cannot be relied upon to improve income distribution in countries, after controlling for country and year effects. The results of investments can vary based on the types of sectors invested in, employment structure, and economic conditions in the country. The results for the previous evidence from the Asian economy also suggest the heterogeneous distributional impacts of foreign investment

(Yuldashev et al., 2023). International investment trends may also vary based on investment destinations and arrangements of special economic zones (Ozocakli & Khanalizadeh, 2022).

The pooled regression model showed a significant negative relationship between trade openness and income inequality. But it became positive and statistically insignificant under fixed-effects estimation. This difference indicates that the observed relationship is partly due to the structural differences between the cross countries. Previous studies have found direct and indirect pathways of how international trade affects income distribution, notably in developing economies (Ouedraogo et al., 2025). Thus, trade liberalization need not necessarily be understood as an inequality-reducing mechanism.

The effect of the interaction of FDI and trade openness was negative yet statistically insignificant ($\beta = -0.00038$, $p = 0.629$). The results did not support a consistent moderating relationship with estimated marginal effects decreasing as countries became more open to trade. International integration can contribute or not contribute to inclusive economic benefits depending on the institutional context. Prior studies find that institutional quality is a key moderator of the trade openness–inequality relationship (Nam et al., 2024). Therefore, some national complementary attributes may be necessary to determine the distributional effects of trade openness.

The results are largely in line with those of studies indicating a heterogeneous distributional impact of globalization. Sub-Saharan Africa has seen studies on the links between trade openness, FDI and income inequality from a regional economic perspective (Xu et al., 2021). There are also indications from India that globalization and financial development can affect inequality in different ways via economic pathways (Sethi et al., 2021). The present study builds on these discussions by analyzing interaction effects in a larger longitudinal sample.

The results indicate that if foreign investment and trade liberalization are desired to have an equitable income distribution, additional complementary domestic policies are needed. Workforce development, employment opportunities, institutional effectiveness and inclusive investment strategies should be top priorities for governments. Industrial policies also feature prominently in international investment policy assessments in relation to investment in order to focus foreign investment on other development goals (Trade & Development, 2018). The dynamics of wages should be given more attention, as wage differences can affect the distribution of economic gains between income groups (ШТУНДЕР & ШКУРОПАДСЬКА, 2025).

Secondary macroeconomic data were used, which could include variations in national statistical measurement and reporting practices. The estimates may be affected by unequal country/year coverage and unobserved institutional conditions. Fixed-effects models took into account time-invariant country characteristics and common year effects, but potential endogeneity, reverse causality, and time-varying omitted variables preclude causal interpretation. However, the post-2020 subsample is rather small, making temporal comparisons somewhat limited.

Institutional quality and labour market characteristics, as well as education and sector-specific FDI indicators should be included in future studies to explore further institutional distributional mechanisms. Other inequality indexes, e.g., those based on disposable income or on market income, could give additional information. Weaker causal identification strategies and country-specific investigations and regional comparisons would help to clarify when international economic integration is conducive to more equitable income distribution.

5. Conclusion

In this study, using longitudinal panel data of 58 countries (992 observations), the relationship between trade openness and foreign direct investment (FDI) and income inequality was examined. The results revealed a complex association between international economic integration and the income distribution in national economies. Pearson correlation analysis revealed that there was a modest negative correlation between trade openness and income inequality while the correlation between FDI and income inequality was weak. Pooled regression results showed that there was a significant negative relationship between trade openness and inequality, but this relationship was not significant when country-specific and temporal effects were controlled. In the same vein, FDI did not show any significant effect on income inequality in the fixed effects estimation. We found that the FDI–inequality relationship was not systematically moderated by trade openness because the interaction term between FDI and trade openness had a negative, but statistically insignificant coefficient. These results highlight the role played by national economic structures, institutional conditions and macroeconomic characteristics in distributional outcomes. Inclusive employment, financial development, workforce development, and effective institutional frameworks are key policy elements that complement trade liberalization and foreign investment promotion. The study provides cross-country empirical evidence, but recognizes the limitations that come with observational data, differences between countries and possible endogeneity. Future studies should include additional factors, such as institutional quality, investment in the sector, alternative

inequality measures, and more robust causal identification methods, to better understand the distributional impact of international economic integration.

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