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Financial Development, Income Distribution and FDI Inflow in Developing Countries: The Role of Institutions

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ABSTRACT

Attracting foreign direct investment (FDI) plays an important role for developing countries. In particular, in recent years, financial markets have begun to develop in developing countries. Especially, the institution may be impact on the relationship between financial development and foreign direct investment. Therefore, this study evaluates the impact of financial development and income distribution on FDI under the role of institutions and in developing countries. In particular, financial development is measured through two indicators: financial institution and financial markets development. The author collected data on 62 developing countries from 2011 to 2021. The panel data regression with generalized least squares (GLS) was used in this study. The results of data analysis with GLS indicate that financial markets development has a positive impact on FDI. Income distribution and financial institution have no impact on FDI. In addition, institutions have a positive impact on the relationship between financial markets development and FDI. From the result, the author gives any implications to attract more FDI in developing countries. The recommendations focus on financial markets development to reduce information asymmetry and uncertainty, consequently lowering the perceived risks for foreign investors.

1. INTRODUCTION

Foreign direct investment (FDI) plays a pivotal role in the economic development of developing countries, serving as a vital source of capital, technology transfer, and job creation. In these nations, where domestic resources are often limited, FDI provides the much-needed financial infusion that can jumpstart economic growth, modernize industries, and integrate them into the global economy [1]. Beyond the injection of capital, FDI brings along advanced technologies and managerial expertise, fostering innovation, improving productivity, and enhancing competitiveness in the global marketplace [2]. Moreover, it acts as a catalyst for creating a more skilled workforce, as foreign enterprises invest in training and development for their local employees. The ripple effects of such investments are profound, contributing to poverty reduction, infrastructure development, and overall economic resilience. The advantages of FDI are contingent upon the policies, regulatory environment, and capacity of the receiving nation to draw in and hold on to top-tier capital. Because of this, FDI is seen as more than just a financial tool; rather, it has the power to revolutionize developing nations and advance their economic growth and level of integration with the global community.

As the cornerstone of sustainable growth and the reduction of poverty, financial development (FD) is essential to the economic prosperity of emerging nations. It includes the development and effectiveness of financial markets, banks, and other financial institutions, which work together to make it easier to mobilize resources, allocate capital to its most advantageous uses, and diversify risk [1]. Businesses and entrepreneurs have better access to credit and financial services in areas with more developed financial systems, which empowers them to make investments, create new ideas, and grow. Thus, by bringing more individuals into the formal sector, this increases economic activity, opens up job opportunities, and fosters inclusion [3]. Moreover, a robust financial system enhances the efficiency of both domestic and international investment, attracting foreign direct investment that brings along technology transfer and global best practices. Financial development also supports governments in improving fiscal health and policy-making, through better tax collection systems and the efficient allocation of public resources. Consequently, the strategic development of financial systems is fundamental to transforming the economic landscape of developing countries, driving them towards higher growth trajectories and the realization of broader development goals.

Income distribution significantly influences foreign direct investment by shaping consumer markets, social stability, and workforce quality. More equitable income distribution broadens the consumer base and stabilizes social and political environments, attracting FDI, especially in consumer-focused industries [3]. It also fosters a skilled workforce by enabling

better access to education and healthcare, further appealing to foreign investors. Conversely, high income inequality can deter FDI by limiting market size to a smaller wealthy segment and increasing socio-political risks. Thus, improving income distribution in developing countries can enhance their attractiveness to FDI, promoting sustainable economic growth and development.

There were a few studies about the relationship between FD, income distribution and FDI [1, 3-6]. Some studies show that FD helps to enhance the FDI inflow [1, 3]. There are some researches that give the opposite result when FD has a negative impact on FDI inflow [7]. However, the research in Developing countries is limited. Especially, the researchers have not conducted the role of institutions.

Therefore, this study will show the impact of FD on FDI under role of institutions in developing countries. This study will address some research gap: (1) The literature review about financial development, income distribution and FDI; (2) The way to measure these factors; (3) The research model and testing the relationship among income distribution, FDI and financial development.

2. LITERATURE REVIEW

2.1 The theoretical framework

The theoretical framework for examining financial development, growth economics, and FDI inflow in developing countries can be anchored in endogenous growth theory and institutional Theory.

Endogenous growth theory emphasizes that internal factors like innovation, human capital, and financial market efficiency drive long-term economic growth. Financial development enhances the allocation of resources and reduces investment risks, which attracts more FDI [8]. As FDI brings technology and knowledge transfer, it further supports the growth process in developing countries by improving productivity and innovation.

Institutional theory highlights the critical role of institutions—such as legal frameworks, regulatory systems, and governance structures—in shaping economic outcomes. Strong institutions reduce corruption, ensure property rights, and foster a stable investment climate, which is essential for both financial market development and attracting FDI [9]. In this framework, institutions act as enablers of growth, ensuring that financial markets and FDI contribute effectively to long-term economic development in developing countries. Together, these theories underscore that financial and economic growth depend on institutional strength to thrive.

2.2 Financial development

Financial development is multifaceted, incorporating the growth and efficiency of financial institutions, markets, and the range of products available to consumers and businesses. A pivotal work in this domain is by King and Levine [10], who argue that financial development plays a crucial role in determining the rates of economic growth, capital accumulation, and technological innovation. Further studies [10, 11] empirically confirm the positive relationship between financial development and economic growth. Their research suggests that financial intermediaries significantly influence long-term growth by facilitating investments, mobilizing savings, and enhancing productivity through the efficient allocation of resources. Beck et al. [11] extend this view by demonstrating that financial development not only stimulates economic growth directly but also indirectly influences growth through mechanisms such as capital accumulation and technological innovation. Focus has also been heavily placed on the function of financial markets in economic development. According to Beck et al. [11], the development of banks and stock market liquidity are both highly predictive of future rates of capital accumulation, productivity growth, and economic growth. This implies that in fostering economic progress, banks and markets work in tandem rather than in opposition to one another. The subtleties of financial development, as well as any potential drawbacks, are now being examined in recent literatures [12, 13]. The "too much finance" problem, which states that financial expansion might impede economic progress beyond a certain point, is discussed by Demirguc-Kunt [14]. This collection of research points to a complicated relationship in which the advantages of economic growth might potentially reverse.

2.3 Foreign direct investment in developing countries

FDI is a vital source of finance, technology, and management know-how for emerging nations. The abundance of research on FDI in developing nations highlights the complex effects of this type of investment on international trade dynamics, technological transfer, and economic growth [12, 13]. Fundamental to the discussion, Alfaro et al. [15] examine the direct and indirect effects of FDI on economic growth, stressing that the influence is dependent on the evolution of the financial markets of the host nation. According to their findings, the effectiveness of FDI is higher in settings with strong financial institutions and markets, rather than guaranteeing growth on its own. Blomström and Kokko [16] emphasize the importance of technology transfer and spillover effects, further elaborating on the relevance of FDI. They contend that FDI stimulates innovation and increases productivity in home businesses by introducing new technologies and management techniques in addition to capital. However, the degree of human capital and the legal system in the host nation have a big impact on how much these advantages actually materialize. Attention is also drawn to the connection between FDI and export performance in emerging nations. Borensztein et al. [17] investigate how FDI helps a nation become more export-ready by bringing in cutting-edge technology and incorporating domestic businesses into international supply chains. Their analysis indicates that FDI can be a critical driver of export diversification and competitiveness. Despite the optimistic view, the literature also acknowledges challenges and potential downsides of FDI. Critics, like Aitken and Harrison [18], point out that FDI can lead to market dominance issues, crowding out local enterprises, and may not always result in technology spillover.

2.4 The relationship between financial development and foreign direct investment, the role of institutions

Researchers are examining how the development of financial markets affects the attraction, path, and outcomes of FDI in both developed and developing economies. The relationship between financial development and FDI has attracted a lot of scholarly attention [19, 20]. This analysis of the literature explores important conclusions that outline the

complex interaction between these two essential components of economic growth. Alfaro et al. [15] made a significant contribution to this discussion by laying the groundwork for a fundamental knowledge of how financial development promotes FDI absorption and amplifies its effects on economic growth. According to their theory, FDI has a more positive impact on economic development in nations with advanced financial systems because these institutions are more adept at managing risks, mobilizing funds, and allocating resources effectively. Building on this idea, Desai et al. [21] investigate the process by which local financial markets affect multinational companies' (MNCs') decision-making. They discover that MNCs have a clear preference for locations with strong financial systems and that they are more likely to invest in nations with developed financial markets because these markets offer greater chances for risk management and capital raising. On the other hand, some research raises concern about the relationship between FDI and financial development. Durham [22] argues, for example, that although financial growth might draw FDI, excessively liberal financial markets may expose nations to erratic capital flows, which could destabilize the economic environment and make it unfavorable for both domestic and international investors. Dissecting the effects of various elements of financial development (such as stock market liquidity and the depth of the banking sector) on foreign direct investment is a recent academic endeavor. These studies, like those by Aizenman and Noy [23], highlight the complexity of the relationship between financial development and FDI flows by showing that not all characteristics of financial development have uniform effects on FDI flows.

One of the most important areas of research in economic literature is the complex relationship that exists between financial development, foreign direct investment, and the institutional framework in which they function. Institutions are essential in determining how financial growth affects foreign direct investment flows since they represent the legal, regulatory, and social standards of a nation. The important findings into how institutional factors interact with financial development to affect FDI are summarized in this overview of the literature. Aizenman and Noy [23] establish the foundation by indicating that although financial growth is essential for drawing FDI, the caliber of local institutions greatly influences or limits the efficacy of this development. Strong legal and regulatory frameworks along with well-developed financial markets are known to draw larger levels of foreign direct investment, highlighting the complementary effects of institutional and financial development. Adding to this, Acemoglu and Johnson [24] contend that achieving the benefits of FDI requires respect for property rights and the rule of law. They show that FDI has a more pronounced beneficial impact on economic growth, mediated through financial development, in nations with more robust property rights protections and open legal systems. Additionally, Wei [25] presents the idea of institutional voids, showing that, irrespective of the degree of financial growth, inefficiencies and holes in the institutional framework can discourage FDI. This research highlights the importance of a coherent institutional environment that supports financial mechanisms to facilitate and leverage FDI effectively. Recent studies, such as those by Aizenman and Noy [23], also explore the differential impact of various institutional qualities, such as governance standards and bureaucratic efficiency, on the relationship between financial development and FDI. These studies suggest that not all institutional aspects are equally important; certain dimensions, like contract enforceability and corruption levels, have more pronounced effects on attracting FDI through financial development channels.

Hypothesis 1: *Financial development has a positive impact on FDI.*
Hypothesis 2: *Institution has a positive impact on relationship between financial development and FDI.*

2.5 The relationship between Income distribution and foreign direct investment

The impact of income distribution on FDI in developing countries is a multifaceted phenomenon that has garnered significant scholarly attention. Empirical studies suggest that a more equitable income distribution can positively influence FDI inflows by fostering a stable socio-economic environment conducive to investment. A more equal distribution of income often correlates with a larger consumer base, which can attract FDI by offering greater market potential. Additionally, a fairer income distribution may mitigate social unrest and political instability, thereby reducing investment risks and enhancing investor confidence. Conversely, a highly skewed income distribution characterized by widespread poverty and inequality may deter FDI due to heightened social tensions, political unrest, and potential regulatory challenges. Furthermore, equitable income distribution may also facilitate human capital development and promote inclusive economic growth, which are attractive factors for foreign investors seeking long-term sustainability. However, the relationship between income distribution and FDI is complex and context-dependent, influenced by various factors such as institutional quality, governance structures, and sector-specific dynamics. Hence, further research is needed to comprehensively understand the nuanced interplay between income distribution and FDI inflows in developing countries. In this study, income distribution is measured by economics growth. Therefore, the hypothesis is presented:

Hypothesis 3: *Economics growth has a positive impact on FDI.*

3. RESEARCH METHOD

3.1 Research model

From literature review as well as the previous studies, authors give the research model:

$$FDI\ inflow = \vartheta + \beta_j FD + \beta_k Control\ variables_{it} + \varepsilon_i + u_{it}$$

The variables are described in Table 1.

3.2 Data collection

The study collected secondary data from IMF between 2011 and 2021 with developing countries. The results of 62 countries are presented in Table 2.

Table 1. Description of variables

Variables	Content	Measure
Dependent variable		
FDI	Foreign Direction Investment	FDI in flow
Independent variables		
FI	Financial Institutions	Financial Development of IMF
FM	Financial Markets Efficiency	Financial Development of IMF
INCOME	Income distribution	GDP capital

Table 2. Summary

Variables	Obs	Mean	SD	Min	Max
FDI	618	3.53	5.33	-37.17	43.91
FI	618	0.27	0.108	0.122	0.75
FM	618	0.075	0.111	0.000	0.55
INCOME	618	1870.44	1147.60	263.36	6107.45

The table shows that the mean of FDI is 3.533, minimum is -37.17 and maximum is 43.91, median of FDI is 2.339. The data shows the mean of FI is 0.279, minimum is 0.122 and maximum is 0.758, median of FI is 0.245. The table shows that the mean of FM is 0.075, minimum is 0 and maximum is 0.595, median of FM is 0.016. It shows that the mean of GDP capital is 1870.44$, minimum is 263.361$, maximum is 6107$, and median of GDP capital is 1485.197 (Table 2).

3.3 Data analysis

With data for 62 countries from 2011 to 2021, panel data analysis is appropriate in this study. Some popular models such as fixed effect model (FEM), random effect (REM) or generalized least squares (GLS).

The FEM is a method of estimating multiple regression models used in economics. This model helps estimate the impact of independent variables on the dependent variable in a proportional panel data model [26]. The FEM model solves the problem of independence of observations in a panel data model. It uses fixed effects for each object in the data, such as time or geographical units. The use of these fixed effects helps to completely eliminate unimportant factors in the model and focus only on estimating the impact of independent variables on the dependent variable. Specifically, the FEM model will assume that each object in the model has a fixed effect, that is, each object has a separate effect value and does not change over time. For example, in an economic model of income, each person would have a separate fixed effect value. The model would estimate the impact of the independent variables on the dependent variable based on comparing the average values of different subjects over a specific period of time. One of the advantages of the FEM model is that it completely eliminates unimportant factors in the model, such as fixed factors of each subject. This helps reduce the complexity of the model and increase the accuracy of the estimates [26]. In addition, the FEM model also helps to overcome the problem of endogeneity in the data, that is, the influence of independent variables on the dependent variable is not independent of other factors in the model.

The REM is one of the commonly used models in panel data analysis. Unlike the FEM, the REM assumes that the constant factors not only vary across individuals in the panel, but also are random. In other words, the REM assumes that each individual has a separate and random constant value for the unobserved independent variables, and the model will estimate the impact of the independent variables on the dependent variable based on the random differences between individuals [26]. The REM model was developed to overcome some limitations of the FEM model. First, in the FEM model, removing the constant factor between individuals reduces the variation in the explanatory variable, but at the same time reduces the precision of the estimate. Meanwhile, the REM model allows for the retention of inter-individual constants, which reduces the loss of information and increases the precision of the estimates. Second, in the FEM model, the effects of the independent variables are determined based on the differences between individuals. However, if an independent variable has significant inter-individual variation, the FEM model will not be able to estimate the effects of this variable. Meanwhile, the REM model allows for the estimation of the effects of independent variables that vary between individuals, as long as the variable is random and uncorrelated with unobserved variables [26].

GLS are also used in this study. This research model is different from previous research which only illustrated the relationship between financial development and FDI. Additionally, the GLS will address the heteroskedasticity issue. The variables will be made robust by using weight to address the heteroskedasticity phenomenon.

4. DATA ANALYSIS AND RESULTS

4.1 The regression with financial development and FDI

The results show that FM has a negative impact on FDI (beta <0 and significant at 5%). Besides, the FI has not impact on FDI. These results show that when FM increases, which will make FDI decrease. This result is similar with the studies by Desbordes and Wei [3] and Lutfi et al. [19]. Additionally, when FI or income change which don't make FDI changes (Table 3).

Table 3. Regression FD and FDI

Variables	(1) OLS	(2) FEM	(3) REM	(4) GLS
FI	-0.0380	-1.080	-0.796	-0.0380
	(0.626)	(1.332)	(1.006)	(0.624)
FM	-1.344***	-0.508	-1.112	-1.344***
	(0.457)	(2.033)	(0.952)	(0.455)
INCOME	0.126	-0.227	0.122	0.126
	(0.100)	(0.395)	(0.192)	(0.1000)
Constant	0.0604	2.876	0.302	0.0604
	(0.626)	(2.711)	(1.260)	(0.624)
Observations	561	561	561	561
Number of i		62	62	62

Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

4.2 The regression with the interaction of institution

The result shows that institution increases the impact of FM on FDI. The country has high institution so the impact of FM on FDI will stronger (Table 4).

The efficiency of financial markets plays a pivotal role in enhancing foreign direct investment in developing countries, fostering a cascade of positive impacts that drive economic growth and development. Effective financial markets greatly lower the risks connected with information asymmetry and

market manipulation by providing investors with a transparent, equitable, and predictable environment [3, 19]. Because they are confident in the long-term economic potential of these projects, this confidence motivates foreign investors to allocate more capital to emerging economies [20]. Additionally, efficient markets allow these foreign resources to be allocated more effectively, directing them toward industries where they may yield the largest profits. This increases the influence of FDI on economic growth and fosters innovation, competitiveness, and the assimilation of emerging nations into the international economy. Consequently, the virtuous cycle initiated by efficient financial markets and bolstered FDI can lead to substantial improvements in employment, infrastructure, and overall living standards in these economies, setting a solid foundation for sustained economic progress.

Table 4. Regression with the interaction of institution

Variables	(1) LnFDI	(2) LnFDI	(3) LnFDI	(4) LnFDI
FI	-0.813	-0.936	-0.794	-0.813
	(1.367)	(2.659)	(2.068)	(1.358)
FI*Institutions	0.0245	-0.0076	0.000877	0.0245
	(0.0243)	(0.0420)	(0.0333)	(0.0241)
FM	-6.432**	-1.540	-2.522	-6.432**
	(2.882)	(4.125)	(2.995)	(2.863)
FM*Institution	0.104*	0.0261	0.0298	0.104*
	(0.0555)	(0.0607)	(0.0532)	(0.0551)
INCOME	0.0298	-0.0361	0.166	0.0298
	(0.113)	(0.469)	(0.210)	(0.112)
Constant	0.589	1.481	-0.0986	0.589
	(0.696)	(3.244)	(1.377)	(0.692)
Observations	476	476	476	476

Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1

Financial institutions have a complex role in establishing investment landscapes; to claim otherwise would be to ignore their lack of influence on FDI in poor nations [23]. Financial institutions play a critical role as middlemen, managing risks, distributing capital effectively, and mobilizing savings to foster an environment that is favorable to investment, especially FDI. Their nonexistence or ineffectiveness may result in higher transaction costs, elevated risk, and an absence of the financial infrastructure required to back major investments. Foreign investors, who depend on financial institutions for a variety of services like currency exchange, asset management, and financing choices to reduce risks connected with their investments, would probably be discouraged by this climate. Moreover, robust financial institutions can signal to foreign investors that a country has a stable economic environment, further attracting FDI. While other factors such as political stability, regulatory framework, and market potential are also critical in attracting FDI, the role of financial institutions in facilitating investment flows, providing financial services, and enhancing investor confidence cannot be understated, suggesting that their impact on FDI in developing countries is indeed significant and multifaceted.

The income distribution may not significantly impact FDI inflows. Some scholars argue that income distribution may be endogenous to the level of development and industrialization within a country. As countries progress economically, income distribution patterns may naturally evolve due to structural changes in the economy, technological advancements, and policy interventions. Therefore, income distribution may be a result of economic development rather than a determinant of FDI inflows.

5. CONCLUSIONS

5.1 Conclusion

This study answers the research questions. Firstly, the author summarizes the literature review about financial development, income distribution, and foreign direct investment. It can be seen that financial development is a basic condition to the foreigner investor interested in countries. Secondly, the author created the research model to conduct the relationship between financial development, income distribution and foreign direct investment. The financial development is measured by two indicators: Financial institution and financial markets efficiency. Income distribution is measured by GDP per capital. Finally, through GLS model shows that only financial markets efficiency has a positive impact on foreign direct investment. However, income distribution and financial institution have not impact on foreign direct investment. From these results, the authors give any implications. While income distribution remains an important socio-economic indicator, its direct impact on FDI in developing countries may be less pronounced than commonly assumed, with other factors playing a more dominant role in shaping investment decisions.

5.2 Theoretical implication

This study makes a significant theoretical contribution by showing that endogenous growth theory and institutional theory can explain well for the relationship among financial development, growth economics, and FDI inflow in developing countries with the role of institutions. According to endogenous growth theory financial development enhances the allocation of resources and reduces investment risks, which attracts more FDI. At the same time, according to institutional theory, institutions act as enablers of growth, ensuring that financial markets and FDI contribute effectively to long-term economic development in developing countries.

5.3 Practical implication

Firstly, efficient financial markets reduce information asymmetry and uncertainty, consequently lowering the perceived risks for foreign investors. This risk reduction is pivotal in encouraging FDI inflows as investors are more inclined to allocate capital to countries where they can expect stable returns. Second, by directing money to the most advantageous uses, effective financial markets improve capital allocation and increase the attractiveness of the host nation to investors. Furthermore, easier access to capital in well-functioning financial markets makes it easier for foreign businesses to finance their operations, which promotes FDI. Additionally, the ease with which foreign investors can enter and leave ventures due to the liquidity of well-functioning financial markets adds to the allure of investing in emerging nations. By increasing the economic viability of investment prospects, financial markets that are efficient and have lower transaction costs are also important in luring foreign direct investment. Moreover, investor trust is bolstered by the openness and regulatory framework inherent in efficient

financial markets, which indicate a stable investment climate. Last but not least, the development of infrastructure and better corporate governance that result from efficient financial markets foster an environment that welcomes foreign direct investment.

5.4 Limitations and future research

Although this study obtained the research objects when shows the relationship among financial development, income distribution and FDI. However, the research has some limitations such as: (1) the study only focuses on the developing countries, the developed countries have not considered yet; (2) the endogeneity has not dealt with. From these limitations, the authors give some recommendation: (1) the future research can collect data on developed countries; (2) the model can address the endogeneity through generalized method of moments (GMM) or two stage least square (2SLS).

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