

## IMPACT OF FOREIGN DIRECT INVESTMENT ON ECONOMIC DEVELOPMENT OF INDIA

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### **ABSTRACT**

This research examines the multifaceted impact of Foreign Direct Investment on India's economic development since the 1991 liberalization reforms. Through comprehensive analysis of historical trends, policy frameworks and sectoral distributions, the study reveals that FDI has been instrumental in India's economic transformation, with cumulative equity inflows reaching \$663 billion between 2000 and 2024. While foreign direct investment has significantly contributed to GDP growth, employment generation, technology transfer and global value chain integration, its benefits remain unevenly distributed across sectors and regions with five states capturing over 70% of inflows. The research identifies persistent challenges including infrastructure deficiencies, regulatory complexity, land and labour market rigidities and global competition for investment. The study concludes that India must evolve from simple liberalization policies to strategic integration of foreign direct investment with broader developmental goals, emphasizing targeted sectoral strategies, regional balance and strengthening domestic capabilities to ensure equitable distribution of benefits across all segments of society.

**Keywords:** FDI, Economic Development, Liberalization Reforms (1991), GDP Growth, Employment Generation, Make in India.

### **INTRODUCTION**

Foreign Direct Investment has emerged as a critical driver of economic development for emerging economies worldwide. In the Indian context, foreign direct investment has played an important role in the country's economic transformation since the liberalization reforms of 1991. As India continues its journey toward becoming a global economic powerhouse, understanding the impacts of foreign direct investment becomes increasingly important for policymakers, economists and business leaders.

This study aims to provide a comprehensive analysis of the impact of foreign direct investment on various dimensions of the economic development of India. By examining historical trends, policy frameworks, sectoral distribution and socio-economic implications, this research contributes to the broader discussion on the role of foreign direct investment in developing economies. The research is particularly relevant in the context of India's ambitious economic goals, including achieving a \$5 trillion economy and enhancing its position in global value chains.

## LITERATURE REVIEW

**Dunning (1980)**, provided a comprehensive framework for understanding foreign direct investment through ownership, location and internalisation advantages. This theoretical foundation helped in explaining why multinational enterprises (MNEs) choose to invest in specific locations like India and the resulting implications for the host country.

**Bajpai and Sachs (2000)**, investigated foreign direct investment in India, identifying key issues and problems related to the foreign direct investment regime. Their study emphasized the role of foreign direct investment in India's service sector growth and focused on sector-specific impacts.

**Chakraborty and Basu (2002)**, analysed the relationship between foreign direct investment and economic growth in India using a co-integration approach. They found a significant long-term relationship between net foreign direct investment inflows, real GDP and unit costs suggesting that foreign direct investment played a crucial role in India's economic development.

**Research by Pradhan (2002)**, highlighted the positive broader effects of foreign direct investment on domestic firms' productivity, particularly in manufacturing sectors.

**Nagaraj (2003)**, questioned the sustainability of foreign direct investment-led growth without adequate development of manufacturing capabilities.

**Kumar (2005)**, argued that several measures have been taken in order to liberalize foreign direct investment in India. He pointed out the importance of absorptive capacity in maximizing the benefits of technology transfer through foreign direct investment.

**Mukherjee (2011)**, showed that States with better infrastructure, skilled labour and business-friendly policies have attracted significantly more foreign investment, potentially deepening regional inequalities.

## OBJECTIVES OF THE STUDY

The primary objectives of this research study are:

1. To analyse the trends and patterns of foreign direct investment flows into India since economic liberalization;
2. To evaluate the impact of foreign direct investment on key economic indicators including GDP growth, employment and productivity;
3. To examine the sectoral distribution of foreign direct investment and its implications for balanced economic development;
4. To assess the effectiveness of policy reforms in attracting and channeling foreign direct investment;
5. To identify challenges and opportunities in maximizing the benefits of foreign direct investment for sustainable economic growth.

## METHODOLOGY

This research study used a mixed-methods approach, combining quantitative analysis of economic data with qualitative assessment of policy frameworks. The sources of data collection include statistics from the Reserve Bank of India (RBI), Department for Promotion of Industry and Internal Trade (DPIIT), World Bank, International Monetary Fund (IMF) and other reputable national and international organisations. The study period primarily covers 1991 to 2024, including the post-liberalization era in India.

## EVOLUTION OF FDI POLICY FRAMEWORK IN INDIA

### 1. Pre-Liberalization Period (Before 1991)

Prior to economic liberalization in 1991, India maintained a restrictive stance toward foreign direct investment. The features of this period were as under:

- According to Foreign Exchange Regulation Act (FERA), 1973, foreign equity participation was limited to 40% in most sectors.
- There was selective permission for foreign investment based on technological necessity.

- The approval of foreign investment was mandatory through a complex bureaucratic process.
- The priority was on self-reliance over global integration in the import substitution industrial policy.

Foreign direct investment inflows during this period remained minimal, averaging less than \$200 million annually.

## 2. Post-Liberalization Reforms (1991-2000)

The balance of payments crisis in 1991 activated extensive economic reforms that fundamentally changed India's approach to foreign investment. During this era, the following steps were taken towards foreign direct investment:

- The industrial licensing regime was dismantled.
- An automatic approval route for foreign direct investment in designated priority sectors was introduced.
- There was gradual increase in sectoral caps for foreign equity participation.
- Foreign Investment Promotion Board (FIPB) was establishment to facilitate investment proposals.
- Currency convertibility on the current account was also allowed.

These measures marked a paradigm shift from a controlled economy to a market-oriented one. The New Industrial Policy of 1991 explicitly recognized the need for foreign capital, technology and managerial expertise to accelerate India's economic development.

## 3. Progressive Liberalization (2000-2014)

Foreign direct investment frameworks experienced substantial liberalization in the early years after 2000. This period showed the following measures to boost foreign direct investment:

- Consolidated foreign direct investment policy circular was introduced for greater clarity.
- The sectoral caps in telecommunications, insurance and civil aviation has been raised.

- 100% foreign direct investment in sectors like pharmaceuticals and single-brand retail were allowed during this period.
- Approval procedures and investment approaches were simplified.
- Bilateral investment treaties were made to provide legal protections for foreign investors.

The Foreign Exchange Management Act (FEMA) replaced the restrictive FERA in 1999, signaling a shift from control to management of foreign exchange. This period also showed the emergence of Special Economic Zones (SEZs) to attract export-oriented foreign direct investment.

#### 4. Recent Policy Initiatives (2014-2024)

During recent years, more ambitious reforms were adopted to enhance India's global competitiveness. These were:

- Make in India initiative was introduced in 2014 to transform India into a global manufacturing hub.
- Foreign Investment Promotion Board (FIPB) was abolished in 2017 and changed to ministerial approval.
- 100% foreign direct investment through automatic route were introduced in numerous sectors.
- A new scheme namely; Production-Linked Incentive (PLI) was introduced to attract foreign direct investment in manufacturing.
- Digital India and Start-up India programs were started for creating new avenues for foreign investment.
- National Single Window System was commenced for expediting the business approvals.

The emphasis has been shifted from merely attracting foreign capital to leveraging foreign direct investment for specific developmental objectives including employment generation, technology transfer and global value chain integration.

## TRENDS AND PATTERNS OF FDI INFLOWS TO INDIA

### 1. Overall Foreign Direct Investment Trends

Since liberalization, India has witnessed extraordinary growth with annual inflows expanding from just \$237 million in 1990-91 to over \$84 billion in 2023-24. The cumulative foreign direct investment equity inflows reached \$663 billion between April 2000 and March 2024, while India's global ranking as a foreign direct investment destination improved from 15th in 2013 to 7th in 2023. Foreign direct investment as a percentage of GDP has increased significantly from less than 1% in 1991 to approximately 2.5% in 2023. Despite global economic disruptions from the COVID-19 pandemic, India maintained good healthy direct investment inflows reflecting strong investors' confidence in its long-term economic potential.

### 2. Sectoral Distribution

India's foreign direct investment scene showed notable concentration in specific sectors, with computer software and hardware leading at 25% of total inflows, followed by services (financial, banking and insurance) at 16%. Telecommunications sector accounted for 7%, while the automobile industry attracted 5%. Construction and infrastructure have seen significant investment under the Smart Cities initiative. Despite their employment importance, traditional manufacturing sectors like textiles received modest foreign investment, while agriculture faced minimal foreign direct investment due to regulatory restrictions and structural challenges.

### 3. Source Countries

India's foreign direct investment inflows primarily originated from a selected group of nations, with Mauritius (27%) and Singapore (23%) leading due to favourable tax considerations. Other significant investors include the US, Netherlands, Japan, UK and Germany with UAE, South Korea and France showing increased activity recently. The substantial investments via Mauritius and Singapore highlighted tax planning's importance in foreign direct investment decisions, though recent treaty amendments aim to reduce treaty shopping and round-tripping practices.

### 4. Regional Distribution

Foreign direct investment in India showed regional concentration with Maharashtra, Karnataka, Gujarat, Delhi NCR and Tamil Nadu capturing over 70% of inflows, while north-eastern states and others like Bihar received minimal investment. Economic corridors such as the Delhi-Mumbai

Industrial Corridor have become investment magnets with state policies, infrastructure quality and business environment significantly influencing foreign direct investment distribution. This geographical imbalance has raised concerns about equitable economic development across India, underscoring the necessity for targeted policies to direct investments toward less-developed regions.

## **ECONOMIC IMPACT ANALYSIS**

### **1. Impact on Economic Growth**

Foreign direct investment has been a key driver of India's economic growth with studies indicating that a 1% rise in foreign direct investment inflows corresponds to a 0.4 to 0.7% increase in GDP growth. Beyond providing macroeconomic stability by financing current account deficits and supplementing domestic savings during financial constraints, foreign direct investment has created multiplier effects through sectors like IT services. However, its impact varies on different sectors. Service sector foreign direct investment showed strong positive correlation with growth, manufacturing foreign direct investment depicted mixed results highlighting the importance of supporting factors such as infrastructure and human capital development.

### **2. Employment Generation**

Foreign direct investment has created approximately 4.5 to 5 million direct jobs in India with indirect employment through linkages potentially 2 to 3 times higher. While service sector foreign direct investment generated high-skilled positions with limited absorption capacity, manufacturing foreign direct investment showed greater potential for mass employment despite automation challenges. Labour-intensive sectors such as food processing, textiles and leather goods demonstrated particularly strong employment effects. Foreign firms generally offered superior wages and working conditions as compared to domestic companies, though overall employment impact varies significantly by sector and investment approach.

### **3. Technology Transfer and Innovation**

Foreign direct investment has been instrumental in transferring technology to India through multiple channels including advanced production methods, workforce training and R and D partnerships. The automotive sector demonstrated this transformation with modern manufacturing techniques significantly enhancing competitiveness. Similarly, in pharmaceuticals, foreign direct investment has facilitated evolution from generic production to innovative drug development. While high-tech

sectors have effectively absorbed these technological benefits, traditional industries have experienced less uniform effects, creating an uneven view of innovation across the Indian economy.

#### **4. Export Performance and Global Value Chain Integration**

Foreign direct investment has significantly boosted India's export competitiveness with foreign-invested enterprises contributing 35 to 40% of merchandise exports while driving service export growth in IT and business process outsourcing. This investment has facilitated India's integration into global value chains across electronics, automobiles and pharmaceuticals improving the country's balance of payments. The nature of foreign direct investment has evolved from targeting low labour costs to increasing market seeking investments aimed at India's growing domestic market, raising questions about the sustainability of export-led growth strategies.

#### **5. Domestic Industry Development**

Foreign direct investment has diverse effects on domestic industry, driving efficiency improvements through competitive pressure and spread of knowledge. It has also enabled access to global markets through joint ventures and strengthening local supplier networks via backward linkages. However, concerns remain about potential crowding out of domestic firms, particularly in sectors like pharmaceuticals where foreign acquisitions have led to consolidation, raising questions about maintaining national self-sufficiency in critical industries.

### **CHALLENGES AND CONSTRAINTS**

#### **1. Infrastructure Deficiencies**

Despite notable progress, India's infrastructure limitations such as transportation bottlenecks, power supply irregularities, land acquisition hurdles, digital infrastructure gaps and inadequate urban development continue to hamper foreign direct investment potential by increasing costs and delaying projects. The government has responded with initiatives like the National Infrastructure Pipeline and PM Gati Shakti to coordinate development efforts and streamline implementation processes.

#### **2. Regulatory and Administrative Challenges**

Despite simplification efforts, foreign investors in India continue to face significant regulatory complexity including multi-layered approval processes, frequent policy changes, contract enforcement difficulties and inconsistent regulatory interpretations across government departments.

Implementation gaps at the state level are continue despite central policy reforms contributing to India's moderate performance on global ease of doing business indicators, even as the country has shown notable improvement in recent years.

### **3. Land and Labour Market Rigidities**

Land and labour market rigidities significantly impact investment decisions through several structural challenges. Complex land acquisition processes delayed projects, while fractured labour laws increased compliance costs for businesses. The mismatch between educational outcomes and industry needs created workforce gaps, compounded by inadequate business exit mechanisms and regional disparities in labour quality and availability. Though recent labour laws reforms attempted to address these issues, still their implementation is incomplete.

### **4. Global Competition for Foreign Direct Investment**

India faced strong global competition for foreign direct investment from several sources. ASEAN nations like Vietnam and Thailand provided attractive manufacturing environments, while China's diversification strategy created both challenges and opportunities. Emerging African economies with Western market access are becoming competitors and the global economic slowdown is limiting overall investment flows. Additionally, advanced economies are increasingly bringing production back home. This competitive scene requires India to innovate its policies to remain an attractive investment destination.

## **RECOMMENDATIONS**

### **1. Enhancing Institutional Framework**

Strengthening the foreign direct investment institutional ecosystem requires streamlining approval processes through expanded automatic routes establishing sector-specific facilitation agencies and creating strong dispute resolution mechanisms for foreign investors. Improved coordination between central and state-level investment promotion bodies, coupled with transparent monitoring frameworks, would effectively bridge the persistent gaps between policy announcements and implementation realities.

## 2. Targeted Sectoral Strategies

Foreign investment strategies should target specific sectors like labour-intensive manufacturing (textiles, food processing and electronics), supported by matching skill development programs and dedicated industrial parks with ready infrastructure. Emphasis should also be placed on emerging industries such as renewable energy and electric vehicles. This focused approach would help to correct unbalanced foreign investment patterns and better align external capital with broader economic development goals.

## 3. Regional Development Focus

Regional development requires focused strategies to address geographic disparities. This means creating special investment zones with better incentives in underdeveloped states, building infrastructure that connects remote areas to economic centres, customizing skill training programs to match local industrial needs, strengthening state institutions to develop area-specific investment approaches and implementing city-cluster strategies that take advantage of urban concentration benefits. These combined efforts would help in spreading the advantages of foreign direct investment beyond the few states that currently dominate.

## 4. Strengthening Domestic Capabilities

To maximize benefits from foreign direct investment, a country must develop its absorptive capacity through strategic investments in R and D infrastructure and workforce skills. This approach requires fostering stronger connections between academic institutions, industry and research centres while simultaneously supporting small and medium enterprises to create strong supply chains. Finding the right balance between protecting intellectual property and encouraging technology sharing is crucial, as is developing financial markets that enable domestic capital to complement foreign investments. These coordinated efforts help local businesses to capture more value from international investments and spread technological advancements throughout the broader economy.

## CONCLUSION

This research study demonstrated that foreign direct investment has played a transformative role in India's economic development since liberalization, contributing significantly to capital formation, technological advancement, employment generation and global economic integration. The impact

has been particularly pronounced in sectors like information technology, automotive manufacturing, telecommunications and services.

However, the benefits of foreign direct investment have been unevenly distributed across sectors and regions, with significant concentration in a few states and industries. Moreover, the developmental impact varies substantially based on factors such as mode of entry, sectoral characteristics, policy frameworks and domestic absorptive capacity.

As India guides the complex global economic view characterized by geopolitical tensions, technological disruptions and sustainability imperatives, its approach to foreign direct investment must evolve from simple liberalization to strategic integration with broader developmental goals. The country must create policies that not only attract valuable investment but also ensure these benefits reach all parts of India and all segments of society. This strategic approach balances growth with equity in an increasingly complex global economy.

Future research should aim to create better ways to measure the quality of foreign direct investment, beyond aggregate inflow values. It should also explore how different types of foreign direct investment affect economies in different ways and examine how foreign direct investment interacts with major global trends like digital transformation, efforts to combat climate change and progress toward sustainable development goals.

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