

FOREIGN DIRECT INVESTMENT IN DEVELOPING ECONOMY WITH SPECIAL REFERENCE TO INDIA

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Abstract

Foreign Direct Investment (FDI) is the process wherein residents of one country acquire ownership of assets of a firm in another country with regard to controlling the production, distribution and other activities. In other words, FDI is an investment made by a company or an individual in one country into business interests located in another country. Since the flow of FDI may be spreaded to different nations it frames the multi-national companies (MNC). FDI has three components viz. equity capital, reinvested earnings and intra company loans. Equity capital refers to the purchase of share of an enterprise in a country by the foreign direct investors. Reinvested earnings comprise the share of the direct investors out of their earnings not distributed as dividends by affiliates to them. Again intra company loans refer to short or long term lending and borrowing of funds between direct foreign investors and affiliate enterprises.

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Introduction

Foreign Direct Investment (FDI) is the process wherein residents of one country acquire ownership of assets of a firm in another country with regard to controlling the production, distribution and other activities. In other words, FDI is an investment made by a company or an individual in one country into business interests located in another country. Since the flow of FDI may be spreaded to different nations it frames the multi-national companies (MNC). FDI has three components viz. equity capital, reinvested earnings and intra company loans. Equity capital refers to the purchase of share of an enterprise in a country by the foreign direct investors. Reinvested earnings comprise the share of the direct investors out of their earnings not distributed as dividends by affiliates to them. Again intra company loans refer to short or long term lending and borrowing of funds between direct foreign investors and affiliate enterprises.

The practice of Foreign Direct Investment (FDI) can be traced back to around 1500 BC. It has been developed from ancient trade practices to modern globalized investment flows with advancements in technology and global trade and now becoming a key component of international investment and economic development throughout the world.

Significance of Foreign Direct Investment in Developing Economy

Foreign Direct Investment (FDI) is playing a pivotal role for bringing a rapid and comprehensive

growth and development in the developing countries which are basically lagging behind development with deficiency in capital, skill and technology, expertise etc. FDI has been a suitable platform not only for the global transfer of capital, but also for improved skill and technology, expertise etc. Thus FDI creates an atmosphere of new brands of production with innovative productivity and competitiveness with new avenues of employment, stimulating economic growth and development specifically in the developing countries. Utilizing the abundant labour and environment of the developing countries at cheaper cost, FDI facilitates cost efficient production and expands the market of the parent company throughout the globe. Moreover, through the diversification of investment, FDI has been a prime source to bridge the deficiency in investment along with an access to technology and innovation in the developing countries. FDI is as well strengthening the international relations improving the flow of Global Supply, contributing to economic development of the host country.

Basically, the production units of the developing countries use outdated and traditional equipments and techniques which reduce the productivity of the workers and degrade the standard of produced goods. FDI comes forward with the weapon of up-gradation of technology providing improved technological knowledge through transferring sophisticated machineries and equipments to developing countries. By raising the level of efficiency and the standard of quality of products, FDI creates a positive impact on the export competitiveness of the host country in the global market besides expanding the local demand. Moreover, through the international linkage of multi-national companies (MNC), FDI provides better access with a new dimension to foreign market to the host country. Possibility of enhanced export contributes to the growth of the host countries by relaxing demand side constraints on growth which is utmost essential to maintain their tempo of economic growth and development.

The rationale of FDI can also be observed on the ground that it can create employment in the modern sector of developing countries. Recipients of FDI gain training of employees regarding the techniques of operation of new enterprises, which contributes to human capital formation in the host country.

Consumers of a developing country are as well benefitted from FDI through new and improved quality of goods at competitive prices. Moreover, profit generated by FDI contributes to corporate tax revenues in the host country which add revenue to government.

Thus, FDI has been developed tremendously as a major form of international capital transfer since a long period of time. It needs to be mentioned that FDI is a major source of non-debt financial resources for the economic growth and development of a country. However, the effectiveness of FDI depends on the policy framework, socio-economic and political stability as well as infrastructure of the host country.

Adverse Effects of Foreign Direct Investment in Developing Economy

However, the blessings of FDI is not unmixed. Governments in developing countries needs to be very much careful while deciding the magnitude, pattern and conditions of private foreign investment, as it may cause a number of adverse effects on the host country. When FDI become competitive with home investment, the demand for the product of domestic industries may fall, leading to a decline in profit as well as domestic savings. It needs to be mentioned that MNCs are generally able to extract sizeable economic and political concessions from competing governments of developing countries. Therefore, the contribution of MNCs to public revenue through corporate taxes may become comparatively lower because of liberal tax concessions, investment allowances, disguised public subsidies and tariff protection provided by the host government. Consequently, private profit of these companies may exceed social benefits in real parlance.

Furthermore FDI may increase income inequalities by reinforcing dualistic socio-economic structure. Such type of investment may create a few highly paid modern sector executives diverting resources away from priority sectors to the manufacture of sophisticated products for the consumption of the local

elite, located specifically in the urban areas. It will create imbalances between rural and urban opportunities, accelerating the flow of rural people to urban areas.

Moreover excessive advertising and monopolistic market power generated through the MNCs may stimulate inappropriate consumption patterns in the host economy. The technology used by the FDI is as well generally capital intensive which does not suit the needs of more labour in the labour abundant developing economy.

Besides, in many cases continual outflow of profits through FDI may be too large, putting pressure on foreign exchange reserves. Nevertheless foreign direct investors may influence political decisions in developing countries in favour of them. In extreme cases they may bribe public officials at the highest levels to secure undue favours which basically harm the host countries.

The economic policies of the developing countries may also be jeopardized with a threat to national sovereignty by the influence of the foreign direct investors at the international level.

Foreign Direct Investment in India

The historical background of the Foreign Direct Investment in India can be traced back to the establishment of East India Company of Britain during the British regime in India (1757- 1947). Through the East India Company, British capital came to India during the colonial era. However, the initiative for Foreign Direct Investment was first introduced by the government of India in 1991 through the Foreign Exchange Regulation Act (FERA), under the monitoring of the then finance minister Dr. Man Mohan Singh. Since the policy of economic liberalization in 1991, India has been experiencing a significantly increased FDI with some fluctuations over the years.

Prior to 1991, India had a restrictive and cautious approach to foreign investment, with several restrictions and regulations to the entry of foreign capital. The economic crisis of the early 1990s caused a severe balance of payment deficit that encouraged the government to implement significant reforms, which opened up various sectors to foreign investment in India, simplifying the procedures and creating a more investor-friendly environment.

The Foreign Exchange Management Act (FEMA) of 1999 replaced the earlier Foreign Exchange Regulation Act (FERA), further rationalizing the regulations related to foreign exchange and investment in India. The Department for Promotion of Industry and Internal Trade (DPIIT) within the Ministry of Commerce and Industry is now the primary regulatory body for FDI in India.

It is observed that Singapore emerged as the largest source of FDI in India during the last fiscal year with \$ 14.67 billion investments, followed by Mauritius (\$ 8.24 billion), the Netherlands (\$ 6.5 billion), the US (\$ 4.22 billion), Cayman Islands (\$ 3.7 billion), Japan (\$ 3.22 billion), and France (\$ 1.89 billion).

Rationale of Foreign Direct Investment in India

The investment climate in India has improved tremendously since 1991 when the government opened up the economy and initiated the LPG strategies. FDI is playing a crucial role in India for bringing a rapid and comprehensive economic growth and development by the gradual expansion of her industrial base. Being a developing economy India as well experiences a deficiency between the desired investment and investment based on locally mobilized savings which has been bridged to a larger extent by the flow of FDI through the investment of the multi-national companies (MNC). With low level of per capita income and low base of locally mobilized savings, since the local capital markets of India could not often well developed, she could not meet the huge capital requirements for large investment projects before liberalization in 1991. Under such a circumstance, access to the foreign currency required to purchase sophisticated machineries from abroad which are neither available locally nor conducive. FDI has been solving both these problems simultaneously in India as it is a direct source of external capital. It is bridging the deficiency in desired investment as well as the gap between desired

foreign exchange requirements and those derived from net export earnings.

The "Make in India" initiative, launched in 2014 has also been playing a pivotal role in boosting foreign investment for spreading the scope of domestic manufacturing creating a more conducive environment of businesses for the investors.

Conclusion

Thus to conclude, the rationale of foreign direct investment (FDI) is that it plays a significant role for widening the scope of rapid economic growth and development of the developing countries. However, the governments of host countries should be very much conscious regarding the magnitude, pattern and conditions of foreign direct investment. Any venture of FDI beyond the limit may rather be a curse on the host country.

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