



Research Paper

# How do foreign direct investments (FDIs) contribute to sustainable economic growth in developing economies?

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## I. Introduction

Foreign Direct Investments are cross-border investments made by individuals, firms or corporations into another country where the investor has the intent of creating a long-term relationship with substantial control over the management of the respective business'. Whereas portfolio investments are financial in nature and are primarily short-term, foreign direct investment generally requires an established long-term relationship and commitment to providing financial capital, providing transfers of technological capabilities and management expertise. Because of this long-term structure and commitment, Foreign Direct Investment plays an important role in the Economic Integration and Development of the World.

Foreign Direct Investment is very important for many Developing Nations due to the challenges associated with many developing economies, including, but not limited to, low levels of domestic savings, a lack of technological capability, limited industrial diversification and inadequate infrastructure. In this regard, foreign direct investment is an important external source of funding that can serve to increase economic activities, facilitate industrial development, create jobs, and create a pathway for developing nations into Global Value Chains.

In recent years, as nations focus less on purely growth-based economic models and more on sustainable development paradigms, the role of foreign direct investment is increasingly evaluated based upon financial contributions and potential to promote Sustainable Development and Green Development Practices.

Based on this, the study seeks to answer the following research questions:

- How does Foreign Direct Investment (FDI) affect the level of Economic Development in Developing Countries?
- What type of link (mechanism) exists between FDI and Sustainable Development Outcomes such as Technology Upgrading, Environmental Improvements and Progress in relation to the Social Elements of the Economy.
- What role do the quality of Institutions and Regulatory Frameworks play in determining the effectiveness of FDI in Enhancing Sustainable Economic Growth?

## II. Literature Review

### Classical growth theories

The theoretical underpinning for analysing the connection between Capital Flows, including FDI, and Economic Growth, is derived from the Neoclassical Model of Economic Growth developed by Solow. This model suggests that Capital Accumulation, Labour and Technological Advancements are the major determinants of long term economic growth (Solow, 1956). As per the Solow Model, increasing the amount of Capital (either through Domestic or Foreign sources) will lead to an increase in output per worker. However, as Capital becomes more abundant, there are limits to how much additional Capital can positively impact output because of diminishing returns; additional Capital can not support incremental long-term growth unless there is continued development in Technological advancement. Subsequently, Endogenous Growth Theory has provided the opportunity to eliminate the assumption of Exogenous Technology and introduce the mechanisms which allow for sustained growth through Increasing Returns to Scale and Knowledge Accumulation, (Romer, 1986). Thus, the development of these subsequent models allows for the conceptualisation of how FDI may be able to provide the potential for continued improvements in productivity due to Technology Transfers and Arguments.

### **How FDI contributes to growth (mechanisms)**

*The literature, both empirical and theoretical, has identified a variety of mechanisms that can facilitate growth in a host country as a result of foreign direct investment (FDI), including:*

(a) the provision of capital for the development and financing of investment projects; (b) technology transfer and the sharing of know-how (including improvements in management practices and organisational structure); (c) the transfer of productively useful resources to domestic firms through demonstration, labour turnover and suppliers; (d) the growth of exports and the integration of host-country firms into global value chains; and (e) the creation of jobs and the development of skills.

There are, however, conditions associated with these benefits. In a number of studies, it has been emphasised that for a host economy to reap the benefits of FDI, it must possess a sufficient level of absorptive capacity in order to effectively assimilate and distribute the new technologies introduced by the foreign entity. Specifically, the host economy must have a relatively well-developed human capital base and must also have an established financial market infrastructure (Alfaro et al., 2004; Borensztein et al., 1998).

### **Evidence of positive impacts**

Many studies conducted both across multiple nations, as well as those focusing on only a single country, have identified positive relationships between Foreign Direct Investment (FDI) and various development outcomes when the conditions of the host country's "institutions" and its "absorptive capacity" are favourable for FDI. According to a study by Borensztein, De Gregorio & Lee (1998), FDI generates larger impacts on economic growth than domestic investment; however, this only occurs when there is a sufficient level of human capital present within the host country's economy. Furthermore, the study conducted by Alfaro, Chanda, Kalemli-Ozcan & Sayek (2004) shows that when host countries have well-developed local financial markets, the ability of domestic firms in those countries to finance additional investments that will allow them to benefit from the FDI spillovers generated by the activities of multinational corporations is increased, thereby further augmenting the positive impact of the FDI on the local economy. In addition, studies examining rapidly-growing economies at the country level have identified, amongst other things, that there are large contributions from inward FDI in those countries. Empirical decompositions identify that FDI has made a significant contribution to the rapid industrialisation and export growth of China and individual case study analyses of India and Vietnam demonstrate how technology absorption and other policy reforms and linkages are positively impacting on the manufacturing and service sectors of both economies (see Whalley, 2006; UNCTAD, 2020).

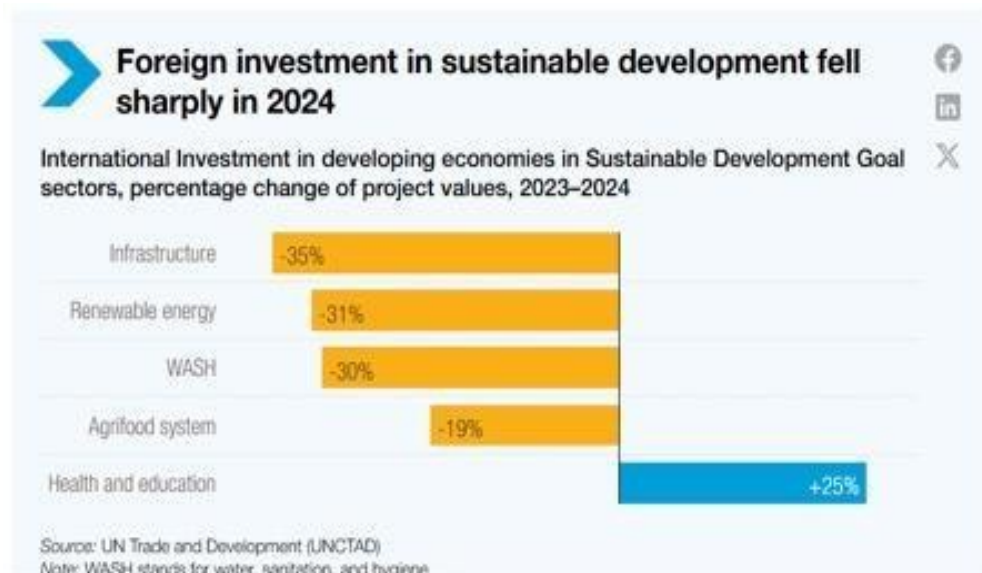
### **Studies showing mixed or negative effects**

A number of papers offer somewhat positive assessments of foreign direct investment; others have found little if any net benefit from FDI flows into an economy, particularly where the conditions of the host nation are poor. (Carkovic & Levine, 2005) state that the sporadic results from econometric studies and the control for endogeneity suggest that there is no consistent pattern of increased economic growth in any country related to FDI inflow. Volatility in the rates of foreign direct investment has also been shown to limit economic growth when examined by (Lensink & Morrissey, 2006) and other researchers. Some studies conducted across several developing countries found negative aggregate FDI effects on economic growth in certain samples, including those of (Herzer, 2012). Likewise, there is a growing body of empirical literature from Latin America and parts of Africa that documents an inability of FDI to promote significant technological transfer due to the inability of host country companies to absorb new technology and lack of effective governance and competition policies to enhance access to FDI (Blomström and Kokko, 1998).

### **Critiques and concerns**

*Many risks associated with FDI are highlighted in the literature as being an impediment to maximising the overall development effect of FDI. In particular:*

a) Foreign firms often send home a large portion of their profits as profits, which can reduce the overall economic benefits of FDI to the host economy; (b) Environmental degradation caused by FDI-related activities such as extractive industries or industries that contribute to pollution may occur if adequate regulations are not put in place; and (c) Regional imbalances that occur due to the geographic concentration of FDI in certain areas and create domestic inequalities leave a substantial number of areas behind (Blomström & Kokko, 1998; UNCTAD, 2020). The key limitations of FDI on the development effects are highlighted by the weak institutional framework, lack of good corporate governance and an underdeveloped financial sector, which limit the extent of income expansion that can occur from FDI (Hermes & Lensink, 2003; Alfaro et al., 2004).



Source: UNCTAD

### III. Methodology

Overall, this study uses qualitative research methods and is dependent on previously collected empirical data. The empirical data for this analysis comes from various international databases, which include but are not limited to, World Bank, UNCTAD, IMF and OECD, covering the period from 2000-2023, all of which represent developing countries." The analysis uses a descriptive comparison of the data and a literature synthesis method (the literature synthesis method analyses where the independent variable impacts correlativity) to interpret how FDI impacts Sustainable Economic Development. The primary limitations of this analysis are derived from problems obtained by reporting agencies for each country (cross-country inconsistencies), the limited availability for Sustainability Indicator Data and the inability to establish any direct causation without independent (primary) and/or micro-data collection.

### IV. Conceptual Framework

The purpose of this conceptual framework is to show the multiple paths through which FDI can contribute to sustainable Economic Development in Developing Countries. The framework illustrates how Technology, Economic, Social-Institutional and Environmental channels influence the long-term developmental impacts of FDI beyond traditional measures of GDP Growth.

#### A. Economic Channels

##### 1. Capital Formation

FDI represents a major external source of financing, particularly for developing countries with Capital Scarcity; Foreign Firms provide long-term capital investment in developing nations through productive sectors, thereby building the host country's stock of Physical Capital, which provides higher production capacities, greater expansion of the Industrial Sector as well as greater Macro-Economic Stability.

##### 2. Employment Generation

When multinationals (MNEs) come to a country, they create direct employment opportunities in manufacturing, service, and infrastructure sectors. However, indirect job opportunities are also created through the company's supply chain, logistics services, and ancillary industries. Stable employment increases overall income levels and decreases poverty. Employment stability leads to sustainable social development.

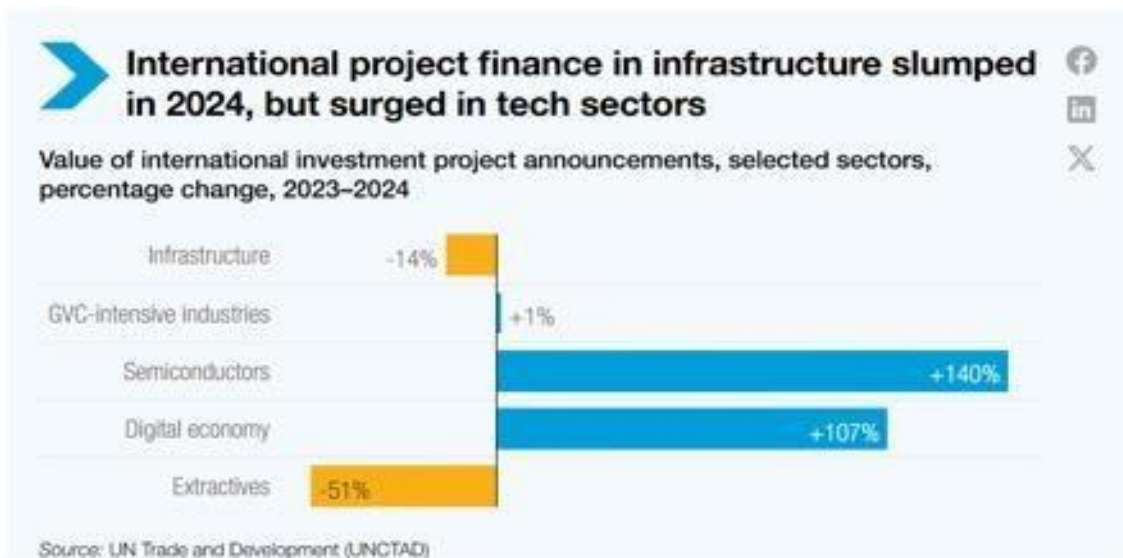
##### 3. Export Growth

Many foreign direct investment (FDI) projects offer opportunities for exporting. By creating and developing export-oriented production systems, as well as integrating into global value chains, FDI generates a more competitive export sector. The result is an improved quality of exported products and improved logistics for

shipping to overseas markets. The increase in the value of exports provides the foreign exchange necessary to establish long-term economic stability for that economy.

#### **4. Infrastructure Development**

In addition to the many other sectors, a large portion of FDI flows into the infrastructure sector: energy; transport; telecommunications; logistics; etc. These investments serve to reduce bottlenecks, decrease transaction costs, and enhance the overall environment for business to thrive. Increases in infrastructure improvements will contribute to increased production capacity for every industry, leading to the potential for long-term growth.



*Source: UNCTAD*

### **B. Technological Channels**

#### **1. Advanced Technology Transfer**

MNEs transfer cutting-edge technology, new machinery, and highly efficient production processes to host countries. As a result, these transfers result in increased productivity, industrial upgrading, and overall economic growth. Additionally, this type of transfer can accelerate growth in developing economies that have the ability to absorb this type of technology.

#### **2. Innovation Spillovers**

MNEs create innovation opportunities in domestic businesses through the development of new products or processes via demonstration effects, increased competition, and collaboration with MNEs. As domestic companies use improved product and process technology, they will generate ever-increasing rates of growth due to the resulting innovations.

#### **3. Skill Development**

FDI brings to the host country education and training programs, managerial practices based on International best practices, as well as an introduction to the standards for the industry worldwide. Through the training and educational programs offered by FDI, local workers improve both their technical and managerial skills, thereby increasing the level of Human Capital in the economy. This enhancement of Human Capital contributes to a more productive economy in the long term, thereby facilitating a transition to a more Knowledge-Based Economy.

### **C. Social & Institutional Channels**

#### **1. Better Labour Standards**

The presence of many Multinational Enterprises (MNEs) in host countries may help to improve Working Conditions, Wages, and Employee Welfare in the country where they are located, by providing a means of establishing a Standard for these types of Employment in Host Countries.

## 2. Corporate Governance Improvements

The corporate governance standards that are prevalent among many multinational enterprises (mnes) often serve as a basis for improving the quality of institutions in the host country, due to their transparency, accountability, and compliance with international regulations, which local firms adopt as a means of competing against mnes and/or as a result of their partnerships with mnes.

## 3. Increased Human Capital

Human capital development strategies are implemented through fdi in many ways. in addition to training, fdi may facilitate education-industry collaboration through developing internships and skill development programs with companies within the host country.

## D. Environmental Channels

### 1. Green Investments

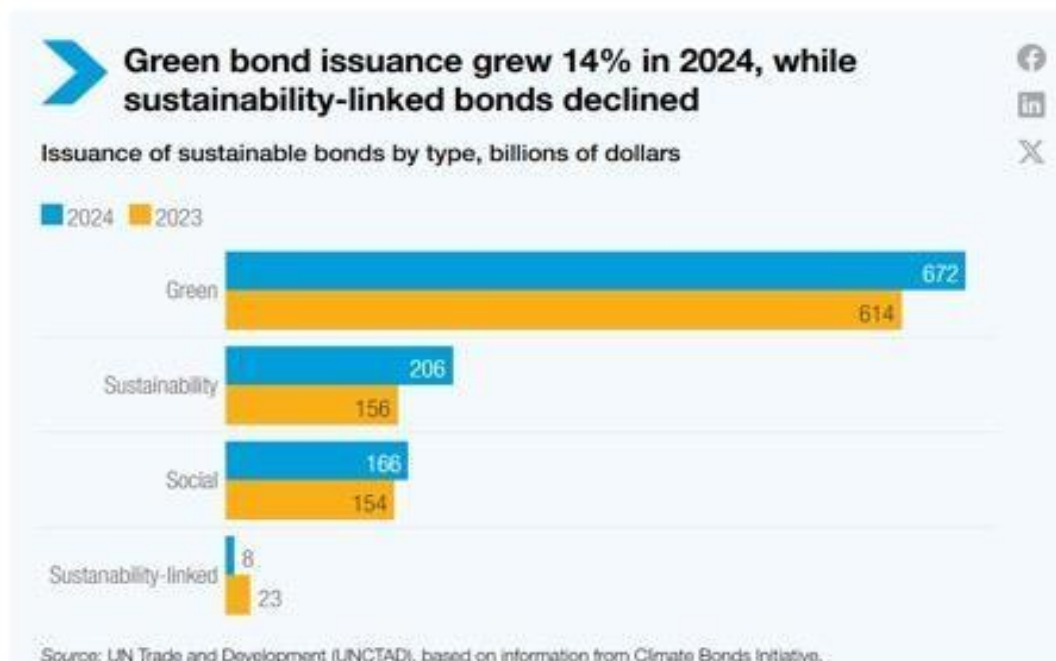
Green investments made through fdi are increasingly targeting businesses engaged in environmental management or other environmental management-focused sectors, including sustainable agriculture, circular economy, and efficient manufacturing. by introducing green investments into developing economies, fdi promotes a transition to low carbon economic growth pathways in these countries.

### 2. Renewable Energy FDI

Renewable energy investments made through fdi in the solar, wind, hydropower and other renewable energy sectors increase access to clean energy. the reduction of reliance on fossil fuels, improvement of energy security and mitigation of climate change through renewable energy projects will directly assist in achieving environmental goals.

### 3. Sustainable Production Practices

Multinational corporations adopt environment friendly production practices, which include using resource-efficient technology, emissions-reducing equipment, and effective waste management systems, which collectively have significant effects on local businesses and support the transition to a sustainable industrial future.

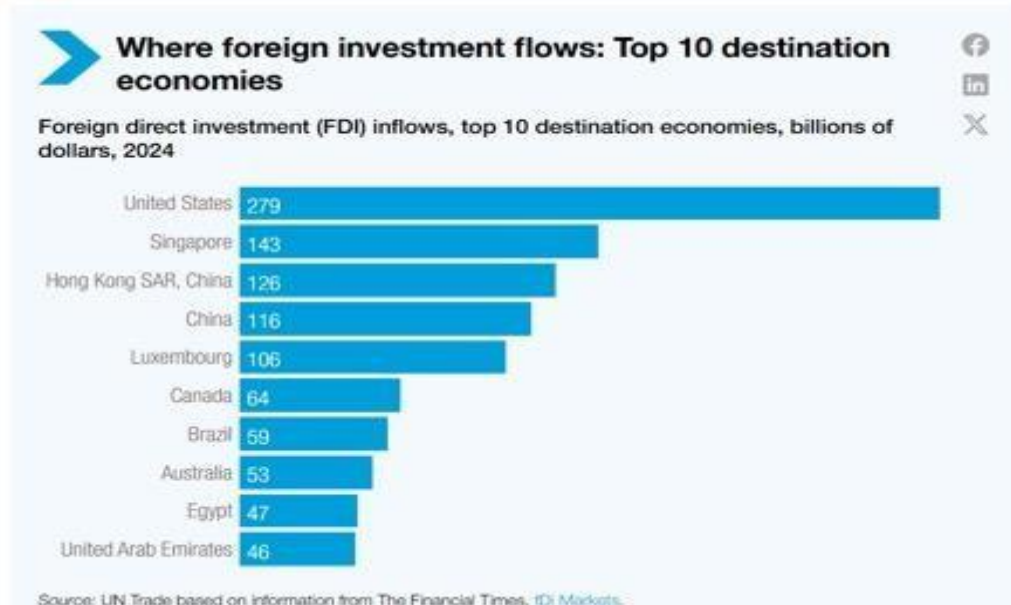


Source: UNCTAD

## V. Analysis & Discussion

### Evidence from Global Data

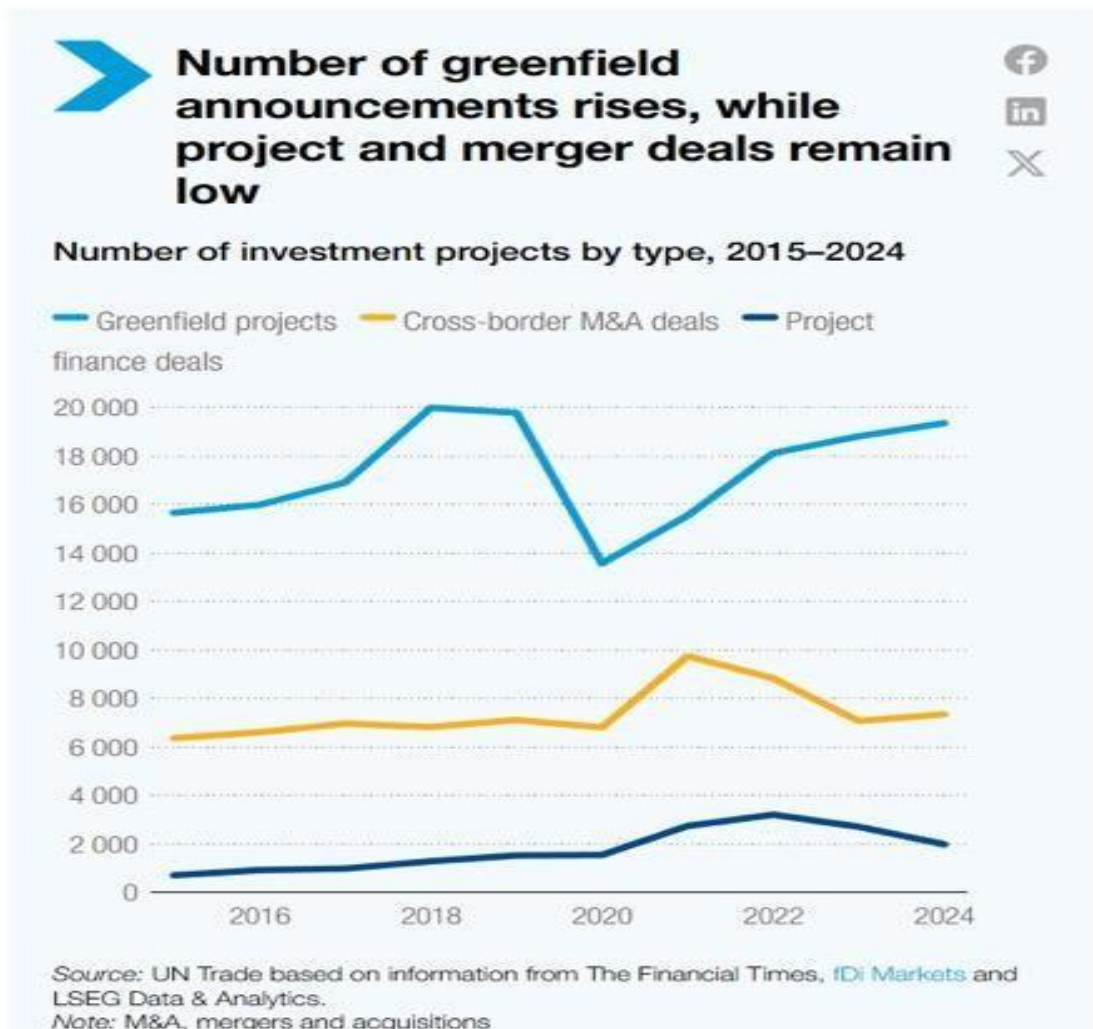
Global trends in Foreign Direct Investment (FDI) indicate that developing economies have become increasingly important destination markets for international investments since at least 2000. Data from UNCTAD show that Asia and Africa together account for more than half of all global FDI inflows and that growth in these regions has been most pronounced in manufacturing, services, and infrastructure sectors. Additionally, FDI has increased GDP growth by making more capital available, increasing industrial capacity, and linking developing economies into the global economy. As a result of foreign companies' introduction of modern production systems and international market linkages, many countries have achieved greater diversification of their exports than they had prior to FDI.



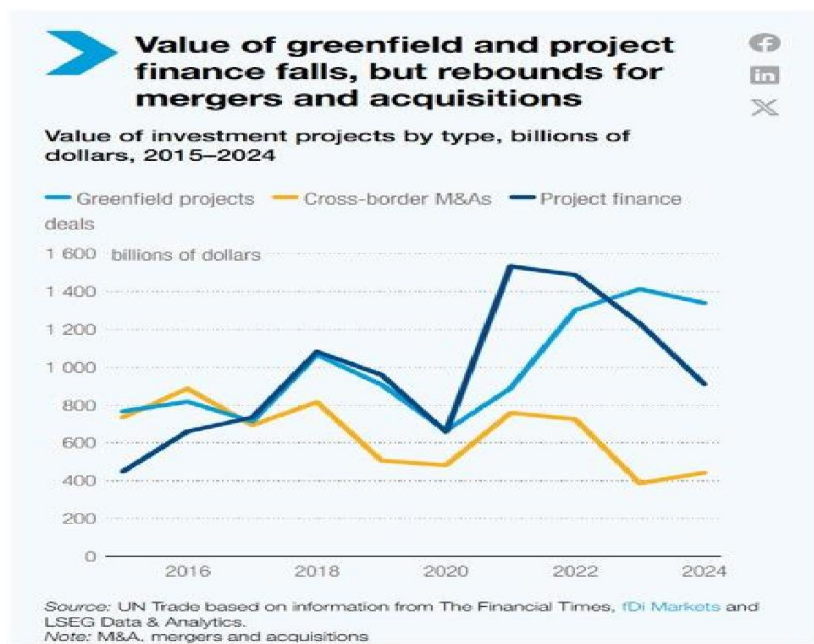
Source: UNCTAD

### Positive Impacts

FDI has created several benefits for developing nations' economies. The introduction of foreign firms into the economy has led to greater productivity as a result of modern technologies and management practices and heightened competitive pressures; this has also facilitated the rapid upgrade of technology by domestic firms through methods such as imitation, labour mobility, and supplier relationships with foreign firms. The provision of training, exposure to new technologies, and other means to support the development of skilled workers, as well as the increase in business activities leading to additional government revenues (e.g., from tax, import duties, and formal employment), have been a few of the developmental benefits FDI has created for developing countries.



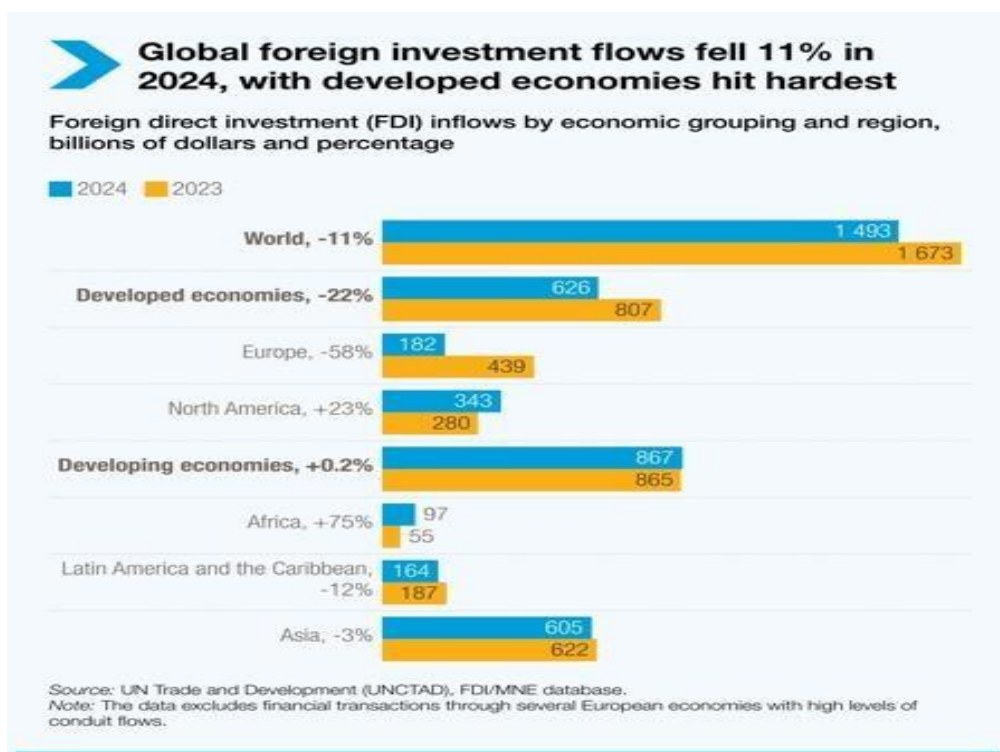
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Source: UNCTAD

### Challenges and Risks

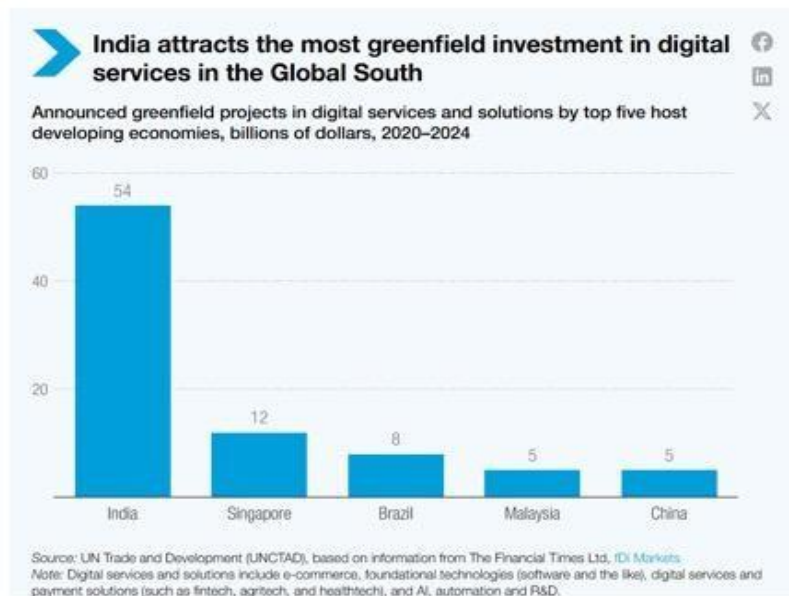
Foreign Direct Investment (FDI) offers potential economic and environmental benefits to host countries; however, FDI also poses certain economic and environmental challenges and concerns. One significant concern associated with FDI is the repatriation of profits. Repatriation of profits could limit the net long-term benefits that host countries receive from FDI. If a host country has weak environmental regulations, the potential exists for a foreign entity to contribute to the pollution or depletion of natural resources. Additionally, in some industries, foreign entities with access to superior financial resources and technology may cause local businesses to be excluded from the market. Also, excessive reliance on foreign capital leaves the host country vulnerable to global economic shocks. Finally, regional differences in the location of FDI may provide urban and industrialised areas with greater economic benefits than rural areas.



Source: UNCTAD

### Case Study 1: India

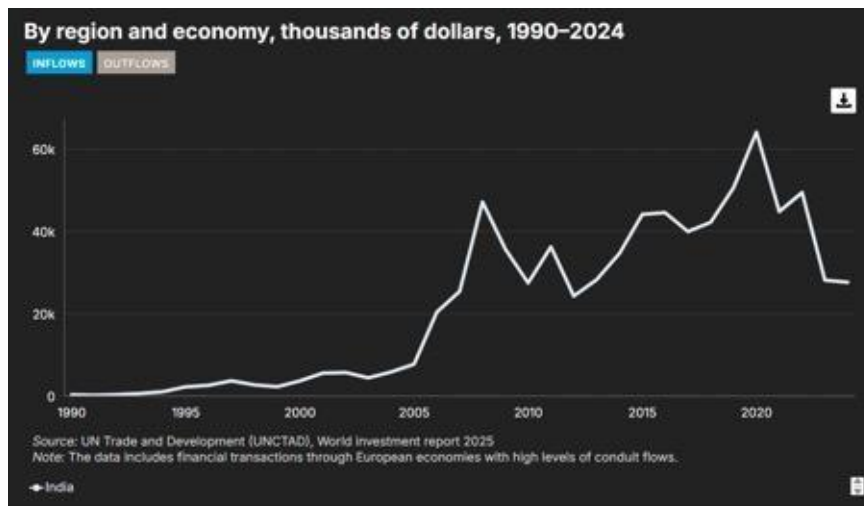
India is one of the largest recipients of FDI in the world. India attracted \$71 billion of FDI in the fiscal year 2023 and has accumulated more than \$900 billion of total FDI inflow since 2000. Service-related industries, such as information technology (IT), telecommunications, pharmaceuticals and automobile manufacturing, account for nearly 60% of total FDI in India.



Source: UNCTAD

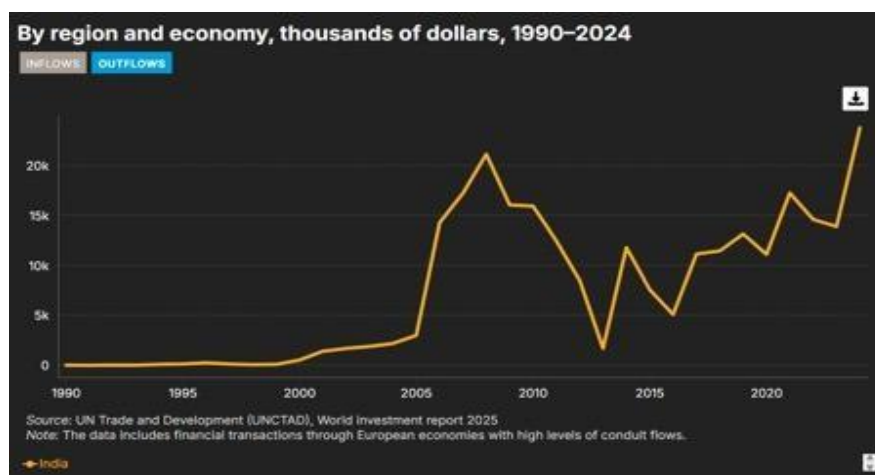
Foreign Direct Investments have supported India's economic growth; estimates indicate that FDI adds between 2% and 3% to India's GDP each year through capital formation and productivity enhancement. Many of the largest multinational corporations in the world have established research and development (R&D) centres in India. Approximately 1,400 foreign-owned R&D facilities are located in India, placing India in the top tier. Despite these positive developments, challenges remain (i.e. delays in receiving regulatory approvals to establish a business in India, inadequate infrastructure, and varying levels of environmental compliance within India). Many companies have increased their investment in renewable energy (especially solar) through FDI; however, pollution remains a significant issue in many of the manufacturing clusters in India.

### Foreign Direct Investment Inflows



Source: UNCTAD

## Foreign Direct Investment Outflows



Source: UNCTAD

### Case Study 2: China

As the largest developing country in the world for foreign direct investment (FDI) at \$189 billion in 2022 and cumulative influxes exceeding \$3 trillion since China's market reforms began. FDI has been critical to China's emergence as a manufacturing powerhouse whereby FDI-funded companies account for approximately 40% of the country's export revenue, particularly from the sectors of electronics, machinery, and advanced manufacturing. Special Economic Zones, such as Shenzhen, have attracted massive FDI and allowed China to integrate into the global value chain. In recent times, China has redirected its FDI from being a manufacturer of low-cost consumer products (think Walmart) to a producer of products and services that are sustainable and environmentally sustainable during the next decade, with the percentage of new investments allocated to renewable energy, electric vehicles, and other green technology exceeding 30%; that has been analyzed by experts; therefore, the results suggest that there are positive gains from FDI related to sustainable development in China with demonstrated improvement in environmental performance, energy efficiency etc. Despite positive developments in relation to FDI investment by China into environmental/sustainable development industries, inequality remains a problem because the coastal provinces account for almost 70% of total FDI, while inland provinces continue to be significantly less developed than the coastal provinces. Therefore, there is an opportunity for China to show that by developing and implementing policies through targeted strategic government infrastructure, future investment programs and focused investment on strong, effective institutions, FDI can be used to create positive economic and environmental returns for both China and investors.

### Case Study 3: Vietnam

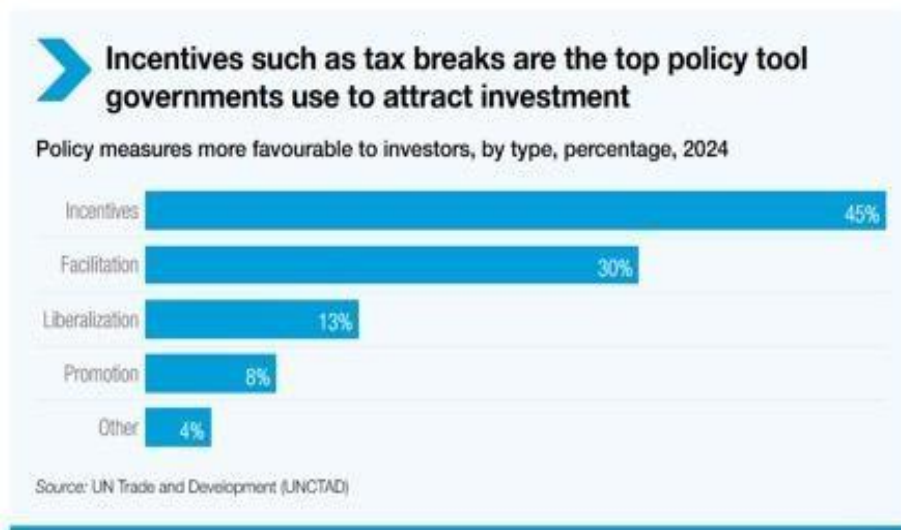
During 2022-2024, Vietnam attracted an estimated US\$36 to US\$39 billion worth of FDI annually with realisation amounts ranging from approximately US\$23 to US\$27 billion per year. More than 72%-75% of the total exports from Vietnam come from foreign companies, particularly in areas such as electronics (phones, computers), textiles, and machinery. The manufacturing industry has attracted over 55% of all foreign direct investment when considering companies such as Samsung, Intel, LG and Foxconn. FDI is also a significant source of employment in Vietnam with nearly 35% of formal sector employment being created by firms that are foreign-owned. Approximately 25% of foreign-owned companies have engaged in R&D as compared to roughly 15% of domestically owned businesses. Although there is concentration of foreign investment around Hanoi and Ho Chi Minh City creating regional discrepancies in these areas, rapid industrialisation has created increased pressures on the environment.

Regardless, Vietnam has become an obvious example of how properly directed FDI can lead to accelerated industrial upgrades as well as continued economic growth and transformation.

## VI. Policy Recommendations

By implementing an effective mix of regulatory, institutional, and capacity-building elements, developing economies can optimize the contribution of FDI toward facilitating long-term economic growth through sustainability. Strengthening both the labour and environmental regulations will ensure that global companies that operate via FDI will help to facilitate long-term economic growth and development without

causing damage to the environment or creating conditions for labour exploitation.

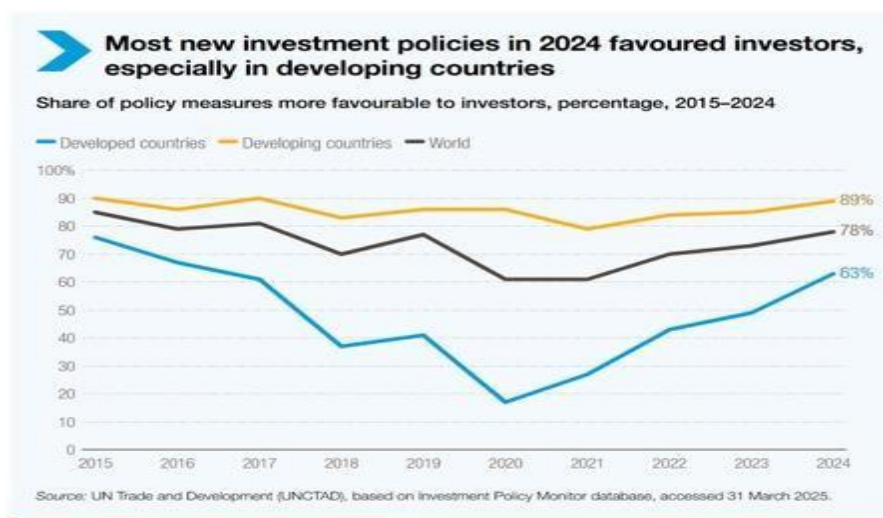


Source: UNCTAD

Governments can encourage "Green FDI" by providing targeted incentives for the development of renewable energy, the manufacturing of clean products, waste reduction technologies, and climate change resilient infrastructure. By creating an improved environment for conducting business, increasing the efficiency of the approval process for business startup, creating transparency in governance, and creating a digital administrative (e-administration) system will encourage more investor confidence and reduce the bureaucratic delays that usually are a deterrent to a responsible investment.

Another area that should be emphasized is that many small and medium-sized enterprises (smes) can benefit from improved finance resources, technology transfer, and the absorption of management expertise, all of which can be primarily achieved via targeted investment strategies, supplier development initiatives, and innovation grants for smes. Creating human capital development strategies through vocational education and training, competency-based training, and the development of stem (science, technology, engineering, and mathematics) educational programs, will allow the exponential growth of technology transfer and productivity opportunities from multinational corporations.

Lastly, policies to encourage FDI investment into sustainable industry sector opportunities such as renewable energy, information technologies, advanced manufacturing products, and environmental services, while supporting national development goals and global climate change objectives. Collectively, these strategies will enable developing nations to achieve economic growth with inclusion of sustainable economic development, environmental protection, and resilience to climate change



Source: UNCTAD

## VII. Conclusion

The purpose of this research was to investigate how Foreign Direct Investment (FDI) has been used as a tool for promoting Sustainable Economic Development in Developing Countries. The investigation was based on global statistics, theories and theories, as well as case studies from countries. The results indicated that FDI provides significant economic growth through capital formation, technology transfer, job creation and participation in the global value chain.

However, it should also be noted that these advantages do not occur automatically. For FDI to have a positive impact on long-term sustainable development, Developing Nations must have strong institutions, regulatory systems that provide transparency and stable regulatory systems, as well as effective policy structures that lead to investing in long-term national goals instead of short-term goals.

The conclusion of this research demonstrated that sustainability, which includes economic, social and environmental sustainability, must be an integral component of a country's FDI strategy. Merely having access to foreign capital or investment is insufficient to guarantee inclusive development outcomes for an economy. The type of FDI will affect the ability for long-term benefits to accrue. Countries that are able to direct a majority of the FDI into green technologies, and education and research will have a stronger potential for both equity and resiliency in growth than those countries that do not pursue those avenues of investment.

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