



IMPACT OF FOREIGN INVESTMENT ON GROWTH AND POVERTY: A CASE STUDY OF INDIA

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Abstract

Foreign direct investment (FDI) has been recognized as an important resource for economic development. Many people argue that the flows of FDI could fill the gap between desired investments and domestically mobilized saving. It also may increase tax revenues and improve management, technology, as well as labor skills in host countries. Additionally, FDI may help the host country to break out of the vicious cycle of underdevelopment.

All of these benefits are expected to contribute to higher economic and employment growth which is an effective tool for achieving improvement in the reduction of poverty. However, the impacts of FDI on poverty depend on many factors including the host countries' institutions and policies, the quality of the labor market, the economic environment, and the investment itself.

Although the FDI effects on the reduction of poverty have been identified, empirical research on the impact of FDI on poverty reduction in India has not been extensively conducted. Moreover, research using econometric models to evaluate the relationship among the inflows of FDI, growth, and poverty reduction in India is lacking. One of the possible reasons of this is that the availability of the data on FDI, poverty, as well as others determinants variable is limited in India. Thus, this paper will use empirical panel data across states in India to find the impact of FDI on poverty reduction. The final results will be used to recommend suitable policies to promote FDI and poverty reduction.

Keywords: *Investments, Growth, Reduction, Panel Data, Determinants.*

Introduction

Foreign direct investment (FDI) has been recognized as an important resource for economic development. Many people argue that the flows of FDI could fill the gap between desired investments and domestically mobilized saving. It also may increase tax revenues and improve management, technology, as well as labor skills in host countries. Additionally, FDI may help the host country to break out of the vicious cycle of underdevelopment.

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Literature Review

Foreign direct investment is defined by the World Bank as “investment made to acquire a lasting management in an enterprise operating in a country other than that of the investor.” In general, investment which includes at least a 10 percent ownership of an enterprise is considered as FDI.

According to Hayami (2001) and Todaro and Smith (2003), the contributions of FDI to the development of a country are widely recognized as filling the gap between desired investment and domestically mobilized saving, increasing the tax revenues, and improving management, technology, as well as labor skills in host countries. These could help the country to break the vicious cycle of underdevelopment (Hayami, 2001). Empirical studies suggest that FDI is very important because it provides a source of capital, complements domestic private investment, and generates new job opportunities as well as transfers technologies and boosts economic growth in host countries.

Foreign direct investment can have direct and indirect impacts on poverty reduction in the host country. The indirect impact of FDI on the reduction of poverty is through economic growth which results in the improvement of living standards due to the increase in GDP, improvement of technology and productivity, as well as the economic environment. The direct impact of FDI on poverty can be seen through the increase in employment and the reduction of people living below the poverty line resulting from the increase in the demand for employment, and the improvement of workforce and safety nets.

Bende-Nabende (1998) investigated the data from 5 South East Asian countries, and found a positive direct link between



FDI and economic growth. In the paper, he found that FDI for Indonesia, Malaysia and the Philippines are positively correlated with growth, while that for Singapore and Thailand are negatively related. Moreover, the result revealed that FDI stimulated economic growth in those ASEAN countries mostly through human capital and employment. Likewise, the investigation by UNCTAD (1999) found FDI has both positive and negative impacts on economic growth depending on the variables that were entered in the equation.

FDI contributes to economic growth directly by creating employment opportunities and indirectly through the creation of employment opportunities in other organizations. Indirect employment created by foreign affiliates in host countries can be large, probably larger than that created directly. With the growth of international production, the share of employment creation by foreign affiliates is growing.

Employment creation in host countries has been partly attributed to the labor-intensive nature of the economic activities established by foreign companies. There is an experience of low growth or decline in employment in foreign affiliates (OECD, 1995). Thus, this gives an indication that labor abundant countries are likely to create more employment by following an outward- looking rather than inward- looking approach.

The presence of FDI is expected to create competition that probably improves the quality of the host countries' stock of physical capital and the efficiency of investment in the countries, and thus the effectiveness of domestic investment. This increases the ratio of investment to GDP and subsequently the investment increases translate into the demand for goods and service of other sectors via multiplier and accelerator effects. Thus, it prompts higher economic growth in the host countries. Bende-Nabende (1998) found that FDI generated positive impulses on capital formation in the Philippines and Thailand. However, capital formation in turn impacted negatively on the Philippines' output and affected neutrally on Thailand's output. Finally, they concluded that spillovers were not attained via capital formation and it could generate crowding out effects in the host countries.

Furthermore, economic growth is the single most important factor affecting poverty reduction. Dollar and Kraay (2000), using the Deninger and Squire Database, found that growth tends to increase the incomes of the poor proportionately with the overall growth. FDI is a key figure for generating growth and thus it is an important ingredient for poverty reduction. In the study, they investigated this phenomenon by testing the relationship between the income of the poor (bottom 20% of the income distribution) and overall income using data on income of the poor and mean income for 80 countries over 40 years. They suggest that when overall income increases, on average incomes of the poor increase by exactly the same rate. They also found that openness to international trade and improvement in the rule of law raise incomes of the poor by raising per capita GDP but do not significantly influence the income distribution.

Roemer and Gugerty (1997) indicate that on average the poor do benefit from the growth because their study shows that an increase in the rate of GDP per capita leads to a one for one increase in the average income of the poorest (bottom 40% of income distribution). Nelson and Pack (1999), and Kakwani (2000) agree that the positive effects of FDI tend to outweigh the negative effects, resulting in economic growth and poverty reduction. Furthermore, Roemer and Gugerty (1997) suggest that on average the poor do benefit from economic growth. An increase in the growth rate per capita GDP strongly correlates with average incomes of the poor.

Foreign direct investment mainly promotes growth and affects the quality of growth especially poverty reduction and thereby reduces income poverty. It may reduce the adverse shock to the poor from financial instability and improve the capacity management of the government. It also increases the safety nets for the country and through government led programs to redistribute assets and income (Klein et al. 2001).

Nordstrom et al. (1999) suggest that economic integration is generally a positive contributor to poverty alleviation, by allowing people to exploit their productivity potential, promoting economic growth, and helping the country to prevent the unexpected shocks. Although they found no direct links between FDI and poverty reduction, they concluded that the scale effects which are the impact of FDI on growth via economic activities, and employment outweighed the quality effects which are the direct impact of FDI on poverty reduction, level income of poor, and skill improvement.

Objectives

1. Assessing the impact of FDI inflows in each state on the economic growth of the states.



2. Finding the impact of FDI inflows on the number of poor people who live below the poverty line in the state.

Research Methodology

For meeting the above objectives the study is based on the secondary data, Data on FDI is collected from the department of industrial promotion and policy (DIPP) official website, state gross domestic product (SGDP) figures are extracted from the handbook of Indian Statistics published by the Reserve Bank of India (RBI) and finally the number of people living below poverty line is taken from the report published by the government of India, Planning Commission.

Since the objective is to access the impact of FDI on growth and poverty, top ten states have been selected for analysis and since the data on state basis is not published the proxy is used in selected the states on the basis of the RBI regional office and the state in which regional office is located is selected for analysis.

For arriving at the results the study applies the cross section data for the years 2004-05 and 2011-12. Two regressions are run one for finding out the impact of FDI on state gross domestic product and second for findings its impact on the poverty.

Findings

Table 1.1 shows the growth in the FDI, SGDP and fall in the population below poverty line. For the states selected the FDI growth is positive for all the states except New Delhi followed by Andhra Pradesh and Chandigarh. So far SGDP is concerned all the selected states have registered a positive growth in the SGDP and finally for the fall in population below poverty line all the states except Chandigarh have seen fall in the population below poverty line.

Table 1.2 shows the results of the two regressions that were run against SGDP and Poverty for the year 2009 and 2012. Although the effect of FDI alone on SDGP is not statistically significant for the two dependent variable for both the years but as expected the sign are positive and negative respectively and from 2009 to 2012 the value of r squared has increased for SGDP as well as Poverty.

Conclusion

Thus from the above study it can be concluded that the FDI inflows have the positive impact on both i.e. SGDP and poverty. But the effect of FDI on poverty is very negligible. This study has brought forward the impact that FDI may have on the selected variables. If the independent variables are increased then the value of the r squared will increase.

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| Table 1.1: Growth in FDI, SGDP and fall in population below poverty line for the year 2009-12. | | | |
|--|---------------------------|--------------------------|---|
| States (including UT) | % Growth in FDI 2009-2012 | % growth in SGDP 2009-12 | % Fall in Population below Poverty Line(+ implies increase) |
| Maharashtra | 13.33 | 18.06 | -28.98 |
| New Delhi | -19.04 | 19.36 | -30.28 |
| Karnataka | 38.31 | 15.50 | -11.44 |
| Tamil Nadu | 98.06 | 21.51 | -33.92 |
| Gujarat | 22.03 | 19.38 | -27.83 |
| Andhra Pradesh | -29.26 | 18.24 | -56.40 |
| West Bengal | 242.18 | 12.74 | -25.09 |
| Chandigarh | -39.88 | 32.57 | 136.96 |
| Madhya Pradesh | 123.14 | 19.77 | -13.90 |
| Kerala | 540.56 | 18.32 | -40.83 |
| Source: Authors Calculation | | | |

| Table 1.2: Regression Results | | | | | |
|--|-------|---------|--|-------|---------|
| Regression Results 2009 for FDI Impact on SGDP and Poverty | | | Regression Results 2012 for FDI Impact on SGDP and Poverty | | |
| | SGDP | Poverty | | SGDP | Poverty |
| FDI | 0.201 | -0.013 | FDI | 0.381 | -0.12 |
| _cons | 10.65 | 3.06 | _cons | 9.24 | 3.78 |
| R-squared | 14.3 | 0.003 | R-squared | 16.32 | 0.066 |
| Source: Authors Calculation | | | | | |