



THE ECONOMIC EFFECTS OF ATTRACTING FOREIGN INVESTMENT

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ABSTRACT:

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Foreign investment has become an important component of economic development, particularly for countries seeking additional capital, technological modernization, employment growth, and stronger integration into international markets.

This article examines the economic effects of attracting foreign direct investment (FDI) and analyzes the conditions under which foreign capital can contribute to sustainable economic growth. Particular attention is given to capital formation, productivity, technology and knowledge transfer, employment, human capital, domestic business linkages, and international competitiveness. The study applies a qualitative analytical methodology based on comparative analysis and synthesis of empirical research and international institutional reports.

Introduction

In the contemporary global economy, investment resources move across national borders in search of productive opportunities, competitive markets, skilled labor, natural resources, technological capabilities, and favorable institutional environments. Foreign direct investment has consequently become an important source of external financing and a mechanism connecting national economies with international production networks. FDI differs from short-term financial flows because it normally involves a lasting relationship between an investor and an enterprise located in another economy. International statistical standards distinguish direct investment from other cross-border financial positions through the existence of a direct-investment relationship and an investor's significant influence over an enterprise [1].

For developing and emerging economies, the importance of FDI extends beyond the amount of foreign capital received. A foreign investor may introduce new production technologies, managerial methods, quality standards, professional skills, international business networks, and access to export markets. These characteristics distinguish productive foreign investment from



financial resources that provide capital without necessarily creating similar knowledge and production linkages.

The economic importance of FDI has become particularly relevant because international investment flows to developing economies have weakened considerably. According to recent World Bank analysis, FDI inflows as a share of GDP in a typical emerging market and developing economy have declined to around 2 percent in recent years, less than half their 2008 peak of approximately 5 percent [2]. At the same time, attracting more foreign investment cannot itself be regarded as a complete development strategy. The central issue is whether the investment generates additional economic value in the host country. Therefore, the effectiveness of foreign investment should be assessed through its influence on production, productivity, employment, technological development, domestic enterprises, exports, human capital, and long-term economic growth.

LITERATURE REVIEW

The relationship between foreign investment and economic growth has been extensively examined in economic literature. One influential study by Borensztein, De Gregorio and Lee investigated FDI flows from industrial economies to 69 developing countries. Their findings suggested that FDI can function as an important channel for technology transfer and may contribute more strongly to growth than domestic investment under appropriate conditions. However, the authors emphasized that sufficient human capital is necessary for host economies to absorb advanced technologies effectively [3].

This finding is important because it challenges the assumption that every dollar of foreign investment produces an identical economic effect. The value of FDI depends partly on the ability of the recipient economy to use the technology, managerial knowledge, and organizational practices introduced by multinational enterprises. Javorcik examined another important mechanism: productivity spillovers between foreign enterprises and domestic suppliers. Evidence from Lithuania was consistent with positive productivity spillovers occurring through backward linkages, meaning that local suppliers could benefit from their commercial relationships with foreign-owned firms [4].

The development of domestic financial institutions also influences the benefits obtained from FDI. Alfaro, Chanda, Kalemli-Ozcan and Sayek found that the direct relationship between FDI and economic growth was not uniformly positive across countries; economies with more developed financial markets were better positioned to benefit from foreign investment [5].

The employment dimension represents another major research area. Foreign investment can create jobs directly within foreign-owned companies and indirectly through suppliers, distributors, and other firms connected to investment projects. A World Bank literature review notes that the employment effects of FDI are heterogeneous and may differ across foreign affiliates, domestic suppliers and customers, and competing domestic firms [6].

METHODOLOGY



This study employs a qualitative analytical methodology combining literature synthesis, comparative analysis, and interpretation of secondary empirical evidence.

The analytical framework evaluates the economic effects of foreign investment through six principal channels:

FDI → Capital formation → Production and economic growth

FDI → Technology and knowledge transfer → Productivity

FDI → New enterprises and production capacity → Employment

FDI → Worker training → Human capital development

FDI → Local supplier relationships → Domestic business development

FDI → International networks → Exports and global market integration

The study uses peer-reviewed academic literature together with evidence produced by international economic institutions. Special attention is given to the conditions under which positive FDI effects become stronger or weaker.

A simplified representation of the relationship can be expressed as:

Economic Effect of FDI = $f(\text{FDI}, \text{HC}, \text{INST}, \text{FIN}, \text{OPEN}, \text{LINK})$

where:

FDI = foreign direct investment,

HC = human capital,

INST = institutional quality,

FIN = financial-system development,

OPEN = trade openness,

LINK = linkages between foreign and domestic enterprises.

The framework implies that the volume of investment alone does not determine its economic contribution. The surrounding economic environment influences how efficiently foreign capital is transformed into productivity, employment, innovation, and economic growth.

ANALYSIS AND RESULTS

One of the most direct economic effects of foreign investment is the expansion of productive capital. When a foreign company constructs a manufacturing plant, establishes a logistics facility, introduces new machinery, or expands an existing enterprise, productive capacity may increase. For example, suppose that an international company invests **\$100 million** in a new manufacturing facility. The initial economic impact includes capital expenditure on construction, equipment, infrastructure, and services. Once production begins, additional effects may arise through wages, purchases from local suppliers, transportation services, taxation, and exports. However, the total economic effect can exceed the original investment only if meaningful linkages with the domestic economy develop.

Recent World Bank analysis provides useful evidence about this conditional relationship. Using evidence for developing economies, the World Bank reports that a 10 percent increase in net FDI inflows is associated with an approximately 0.3 percent increase in real GDP after three



years. Under stronger conditions—including better institutions, higher human capital, greater trade openness, and lower informality—the estimated effect can reach about 0.8 percent [2].

Table 1.

Economic Effect of Higher FDI Inflows under Different Host-Country Conditions¹

Economic environment	Change in net FDI inflows	Estimated real GDP effect after three years
Average emerging/developing economy	+10%	+0.3%
Strong institutions, better human capital, greater trade openness and lower informality	+10%	Up to +0.8%

The table demonstrates a central result of the analysis: the economic return from attracting foreign investment depends substantially on domestic conditions. The same increase in FDI can be associated with a considerably stronger growth effect where institutions, skills, openness, and formal economic structures allow foreign capital to operate productively.

A second major economic benefit arises from technology transfer. Multinational enterprises may possess production technologies, management systems, logistics practices, quality-control procedures, and specialized knowledge that are not widely available in the host economy. Technology transfer may occur directly within the foreign enterprise and indirectly through relationships with domestic businesses. For example, a foreign automotive producer may require a local components supplier to meet international quality standards. To maintain the contract, the domestic supplier may invest in new equipment, train employees, improve production processes, and introduce modern management systems.

This creates a potential spillover:

Foreign investment → Supplier requirements → Technological upgrading → Higher domestic productivity.

Javorcik's empirical research provides evidence consistent with such productivity spillovers through backward linkages between foreign affiliates and local suppliers [4]. Therefore, governments seeking economic benefits from FDI should pay attention to the integration of foreign enterprises with local supply chains rather than evaluating investment projects solely according to their initial monetary value.

Foreign investment may also influence employment through both direct and indirect channels. A newly established enterprise creates **direct employment** when it hires local workers.

¹ Compiled by the author based on World Bank, *Global Economic Prospects*, June 2025 [2].



It may create **indirect employment** when local suppliers, logistics providers, construction companies, maintenance firms, and other businesses expand their activities.

Foreign-owned firms can also affect job quality. Evidence reviewed by Javorcik suggests that foreign-owned firms in developing economies often offer higher wages and more worker training than comparable domestic employers, although effects vary across contexts [7]. Consider a foreign technology company employing 500 local workers. If the company provides professional training in programming, data analysis, project management, and international quality standards, the economic effect is not restricted to 500 salaries.

Workers accumulate human capital. Some may later move to domestic enterprises, establish their own businesses, or transfer knowledge to other workers. Therefore:

FDI → Employment → Training → Skills → Labor productivity → Long-term economic benefit.

This mechanism explains why education and workforce quality are essential components of investment policy.

Foreign investment should not be analyzed exclusively through its positive effects. In some circumstances, foreign enterprises can compete with domestic businesses for financing, skilled workers, market share, or other scarce resources.

The relationship between foreign and domestic investment is therefore important.

Some studies have found complementarity, while other research has identified periods or regions in which FDI displaced domestic investment. For example, empirical research covering developing economies in Africa, Asia, and Latin America concluded that the relationship between FDI and domestic investment was not uniformly favorable and found evidence of crowding out in some cases [8].

This produces two possible scenarios:

Complementary effect:

FDI ↑ → Demand for domestic suppliers ↑ → Domestic investment ↑

Crowding-out effect:

FDI ↑ → Competitive pressure on domestic firms ↑ → Domestic investment ↓

Consequently, investment policy should seek complementarity between foreign and domestic enterprises.

Countries also need to understand why investors select particular destinations.

Political stability, predictable regulation, protection of property rights, infrastructure, workforce skills, market access, and administrative efficiency can influence investment decisions.

A World Bank investor survey involving 750 multinational investors and executives identified political stability, security, and the regulatory environment among important considerations affecting investment decisions in developing countries [7]. OECD research also demonstrates the importance of regulatory openness. An analysis covering 60 advanced and



emerging economies during 1997–2016 estimated that reforms reducing FDI restrictions by around 10 percent could raise bilateral FDI stocks by approximately 2.1 percent on average [8]. However, liberalization should not mean eliminating all economic regulation. Effective investment policy needs to combine openness with transparency, competition, environmental responsibility, labor standards, and protection of legitimate public interests.

CONCLUSION

The analysis demonstrates that foreign direct investment can make an important contribution to economic development through several interconnected channels. It can expand productive capital, introduce new technologies, improve management practices, create employment, develop human capital, strengthen domestic supply chains, and facilitate integration into international markets. Nevertheless, the economic benefits of FDI are conditional rather than automatic. The evidence reviewed in this article indicates that human capital, institutional quality, financial development, trade openness, regulatory stability, and domestic firms' absorptive capacity significantly influence the magnitude of the benefits obtained from foreign investment. The 2025 World Bank evidence provides a particularly clear illustration: a 10 percent increase in net FDI inflows is associated with an estimated 0.3 percent increase in real GDP after three years in the average emerging and developing economy, whereas the effect can rise to approximately 0.8 percent where institutions, human capital, trade openness, and formalization are stronger [2].

Therefore, the strategic objective of economic policy should not simply be **“to attract as much foreign investment as possible.”** A more sustainable approach is to attract productive investment capable of generating technological, employment, human-capital, export, and domestic-business spillovers.

From this perspective, effective foreign-investment policy requires three interconnected priorities: creating a predictable and transparent investment environment; developing domestic human and financial capital; and strengthening productive linkages between foreign investors and local enterprises.

The economic effectiveness of foreign investment should ultimately be evaluated not only by the amount of capital entering the country but by the additional productivity, knowledge, employment, domestic investment, technological capacity, and sustainable economic growth that the investment helps generate.

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