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## **Foreign direct investment, governance and political stability: A case study of India**

**Arora Diksha<sup>1</sup>, Idnani D<sup>2</sup>**

<sup>1</sup> Research Scholar, Delhi Technological University (DTU), Delhi, India

<sup>2</sup> Assistant Professor, Department of Education, SPM College, University of Delhi, Delhi, India

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### **Abstract**

This study was conducted to examine how foreign direct investment (FDI) affects political stability in India. To establish this relationship, an indirect approach is used, i.e. considering the impact of FDI on economic growth and educational development. This shows that economic development has an impact on the lev3-2-el of political stability of a country. GDP growth rate is considered an indicator of economic growth; The GER of higher education and the number of universities are considered as an indicator of educational development. Governance indicators are used to study political stability in India. The study takes into account the period 2014-2019. The results of the study show that FDI has a positive effect on political stability in India. In addition, India is advancing on the path of effective governance, political stability and political continuity.

**Keywords:** political stability, economic growth, FDI, education

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### **Introduction**

In the contemporary economic environment, it is hard to find economies that are still isolated. All the countries are working at the global level. With the presence of just a few barriers to flow of money and goods, the global economy is becoming stronger and reaching greater heights. This widens the path and scope for international investments.

Foreign Direct Investment (FDI) is an investment in the business situated in one country by the investor in another country i.e. foreign country. The investor either acquires the business assets or takes controlling interest by setting up business operations in foreign country. FDI plays a major role in promoting international economic integration. It is also linked with the Economic growth and development which further enhances the global competition and thereby attracting FDI. The importance of FDI is well recognized in the context of international-political economy. However, it plays a vital role in domestic-political economy as well.

FDI is associated with various other positive aspects like improved technology, innovation in products, expansion of markets, employment opportunities, and introduction of new skills etc. All these are reflected through the medium of economic growth. For the developing economies like India, investment has always remained to be an issue. With the globalization, the policies are liberalized by countries to welcome investment from capital rich countries. The developed countries focus on new markets where labor is readily available, scope for profits and sales is higher. In such a scenario, it becomes difficult for the emerging market to compete for FDI. FDI bridges the gap between investment and savings. Advanced technology as a result of FDI leads to promotion of efficiency and productivity. The present study is an attempt to examine the relationship between FDI inflow and Economic development which leads to political stability in India.

### **Review of Literature**

FDI inflows are a dynamic component in affecting economic development and have derived its relevance for many economic and political scholars. Amongst the literature reviewed, most of the papers talk about how political stability impacts FDI inflows positively. Only a few studies explain how FDI inflows can contribute to political stability, especially in case of India and other South Asian countries.

Most of the literature examines the impact of political stability on FDI. Shikha Singh (2019) <sup>[1]</sup> examined the optimistic spillover effects of FDI inflows. Alesina and Perotti (1993) <sup>[2]</sup> measured the socio-political instability and showed that political instability had negative impact on investment. Woodward and Rolfe (1993) <sup>[3]</sup> presented how uncertainty of foreign investment increases with political instability and restricts the flow of FDI. There are a lot of debates and contradictory findings about impact of political stability on FDI but hardly any on how FDI impacts political stability.

The economy and politics are interrelated, but there is no clear explanation. South Asia, especially India, despite being one of the fastest growing economies, lacks work on how foreign direct investment affects policy. The current literature strongly suggests how foreign direct investment inflows can promote domestic political stability. Also, how does foreign direct investment affect economic development through GDP and education, further leading to political stability or instability.

The literature review attempts to focus on three aspects mainly i.e. how FDI impacts Economic growth, how FDI affects human capital development and; the effects of growth and human capital on political stability. Shib, Tarak and Krishna (2019) suggest that only the FDI inflows in the manufacturing sector will lead to

positive impact on economic growth while FDI inflows in agricultural sector have negative impact. Zhang (2001) <sup>[5]</sup> tried to recognize how FDI and Economic Growth are related in China over the period 1992-2004. It was found that FDI in China led to direct effects like increased productivity and exports which further led to economic growth.

Chawla and Sharma (2011) <sup>[10]</sup> explained that FDI is a very important requirement for Economic development especially in case of developing countries. It contributes in the growth and human capital development. Zhuang (2008) <sup>[6]</sup> examined the relationship between FDI and Human capital accumulation in China during 1978 to 1999. It showed how FDI impacted at different levels of educational attainment over the period of time. Bohlken and Sergenti (2010) <sup>[7]</sup> examined the relationship amongst economic conditions and riots i.e. political stability. Paldam (1998) <sup>[8]</sup> observed the relationship between economic growth and political stability. It found that economic growth led to higher income levels in the economy. People with good income should be relatively happier with the government. So, growth generates stability. Shekhar Kumar Patel (2013) <sup>[9]</sup> examined the indirect relationship between FDI and political stability in South Asian countries.

### Objectives

The overall aim of the study is to find out the linkage between FDI and Political stability in India. However, the linkage is established through an indirect approach. The basic objectives of the study can be stated as following:

- To analyze the trends and establish relationship between FDI inflow and GDP growth rate in India.
- To examine the effect of FDI on Education sector in India.
- To establish a relationship among FDI and political stability in India.

### Methodology

The scope of the present study has been limited to relationship amongst FDI and Political stability in India. This relationship is to be seen through an indirect approach i.e. FDI and Economic growth, FDI and Education (Human Development), FDI and Political stability. Only secondary data has been used for the purpose of the present study. The period of the study is taken as 2014-2019 (Please see \* for details).

GDP growth rate is used as an indicator of Economic growth (data collected through World Bank). Higher Education GER and Number of universities is used as an indicator of Education development (data collected from AISHE, 2019) <sup>[12]</sup>. In order to examine political stability, indicators of governance (published by World Bank) are taken into consideration. The trend in these variables is examined through line charts created in MS Excel.

### Discussion

Economy and politics are related to each other i.e. one affects the other. Politics and economy together serve as a very important way to promote economic development. According to the basic theory that is assumed everywhere, political stability has a positive impact on FDI. However, the same is not seen in case of South Asian countries. India ranks 151 in political stability index (World Bank data, 2019). However, it was the 9<sup>th</sup> leading beneficiary of FDI in 2019 as per the *World Investment Report*.

### Foreign Direct Investment Policy since 1991

Since 1991, many policies were undertaken by the government which proved to be boon for Indian economy and the FDI sector. The policy of FDI has been liberalized gradually. The Industrial Policy Resolution of 1948 and 1956 discussed the need for foreign capital and advanced technology to promote economic growth. It was desired that the control of industries should remain in the hands of Indians. Equity holding of foreign firms was allowed only up to 40% till 1974. Foreign investment was allowed only in a few industries that too along with local restrictions. The process led to slow liberalization of government policy towards foreign investment. The foreign collaborations increased dramatically over the period of time. Technological capacity was built up in many domestic industries as a result of change in FDI policy. With the new policies of Liberalization, Privatization and Globalization; India reached new heights on the front of Economic Development.

FDI served as a source of scarce resource, technology and skills. Since 1991, FDI policy has been changed many times by Indian government. The procedures, rules and regulations have been simplified by the government of India on a regular basis to ensure that the economic environment is friendlier for the investors.

FDI doesn't impact political stability directly; rather it impacts through an indirect mechanism i.e. through GDP growth and Education development. These two together can impact the political stability (Patel, 2013) <sup>[9]</sup>.

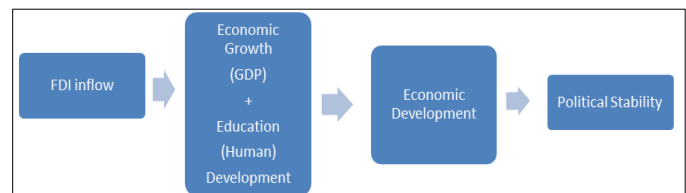


Fig 1

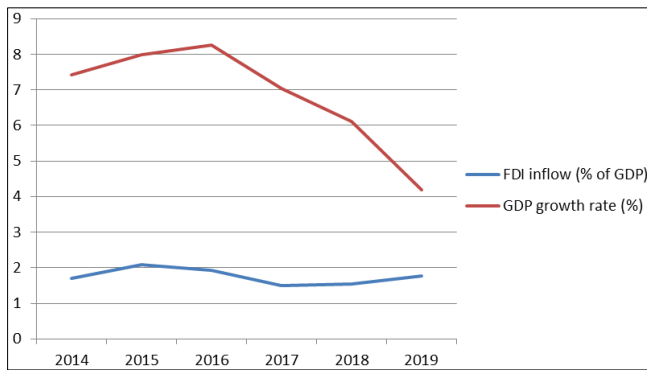
### FDI and Economic Growth

There has been a rapid improvement in the investment climate of India since opening up of the economy in 1991. India today lays amongst the top 100 in the Ease of Doing Business. In 2014-15 FDI inflows in India were \$45.15bn and have rapidly increased since then. Growth in FDI inflow was 55% from 2008-14 to 2014-2020 i.e. from \$231.37bn to \$358.39 bn. FDI inflows in India increased from \$55.56bn in 2015-16 to \$74.39bn in 2019-20. FDI inflows in India over the last 5 years accounts to be 50 % of the total FDI flows in India over last 20 years.

Table 1: FDI inflow and GDP growth rate in India

Year	FDI inflow (% of GDP)	GDP growth rate (%)
2014	1.7	7.41
2015	2.09	7.99
2016	1.93	8.25
2017	1.5	7.04
2018	1.55	6.11
2019	1.76	4.18

Source: World Bank Data, 2019



Source: Author’s own representation based on World Bank data

Fig 2

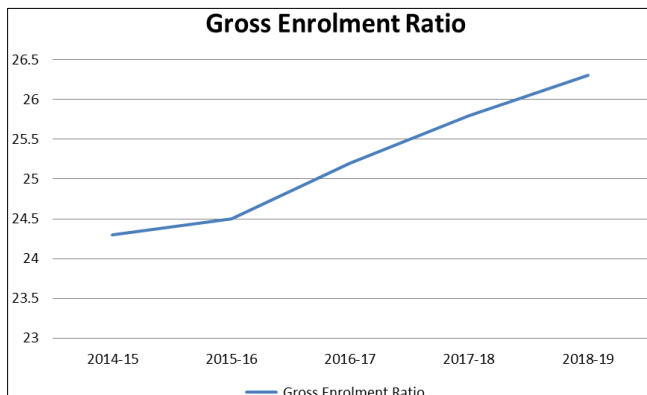
The table above shows that the FDI inflows in India have grown from 1.70% of GDP in 2014 to 1.76% of GDP in 2019. During that time period, India’s growth rate has fallen down from 7.41% in 2014 to 4.18% in 2019. This slowdown in India’s GDP can be attributed to a mix of internal and external causes such as global slowdown, demonetization, improper implementation of GST, dropping of sales in domestic automobile sector, reduced investment in construction and infrastructure.

**FDI and Education Development**

In the 21st century, education plays an important role in all areas of life. Part of the whole stage is school education, and the other part is higher education. Higher education is a springboard to a quality life. Receiving higher education can increase the chances of obtaining work and financial security, thereby improving living standards. It converts the young population into productive resources, not only earning a living for itself, but also proven to be a catalyst for economic growth. The Gross Enrollment Rate is "a measure of the percentage of students enrolled in different grades, such as elementary, middle school, elementary, middle school, high school, and higher." To find GER in higher education in this study, the age range of 18–23 years was considered.

Table 2: Higher Education GER and Number of Universities in India

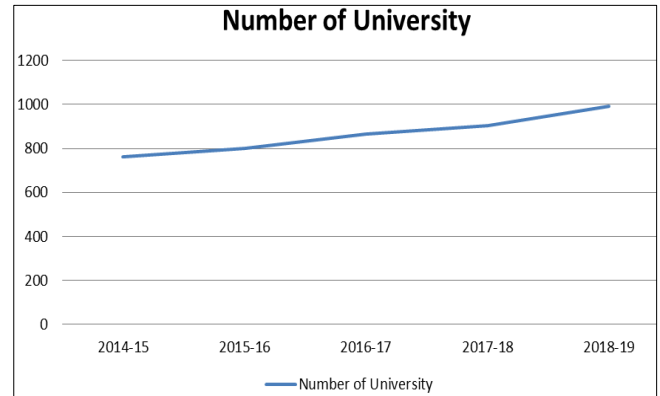
Year	Gross Enrolment Ratio	Number of Universities
2014-15	24.3	760
2015-16	24.5	799
2016-17	25.2	864
2017-18	25.8	903
2018-19	26.3	993



Source: Author’s own representation based on AISHE data

Fig 3

In the last five years, there has been an increase in the Gross Enrolment ratio. For the year 2018-19, higher education GER is 26.3. There has been an increasing trend overall. In 2014-15, GER was 24.3. From 2014 to 2019, GER has increased by 8.23% (AISHE, 2019) [12]. In spite of increasing GER on yearly basis, GER in India lacks behind other countries. Higher education GER age group is 18-22 years internationally. Indian GER is higher than Pakistan (9) and Bangladesh (21), while it is much below the levels in USA (88), Germany (77).



Source: Author’s own representation based on AISHE data

Fig 4

There has been an increasing trend in the number of Universities in India since the last five years. The number of universities was 760 in 2014-15 and 993 in 2018-19. This depicts an increase by around 30.7% over the period of time. According to the consolidated FDI policy 2017, upto 100% FDI is allowed in educational institutions under automatic route. The collaborations between Indian and foreign higher education institutions improve the education system. FDI inflows in education sector have been increasing continuously except for a fall in 2013-15. The maximum FDI in education are received in vocational and technical education.

With the increase in FDI, there has been an increase in the higher education GER and the number of universities in India. The quality of education has been improving. With the better education system, human capital formation is taking place which further serves as an asset for the nation. FDI helps in reaching higher levels of education and thus human development.

As analyzed with the help of data, FDI serves as a source for promoting Economic growth and attaining higher levels of education in the society. These two factors contribute towards Economic Development. Economic Development is further associated with political stability. The next part of this paper puts light on level of governance in India through the means of governance indicators.

**Political Stability**

Political Stability, in very basic terms is the government stability which is well depicted through the condition of the state. Political instability, on the other hand, is the likelihood of a government to fall down as a result of disagreements or because of pervasive competition amongst various political parties. Moreover, the probability of a government change leads to further increase in chance of subsequent changes.

Political instability and economic growth are interrelated. On the one hand, the unstable political environment makes the situation unpredictable. This uncertainty further reduces investment, thereby reducing the pace of economic development. However, on the other hand, poor economic performance will increase the chances of government collapse and political turmoil.

Political stability can be achieved by exploiting or owning a party that does not need to compete with other parties for re-election. In such circumstances, political stability has its favorable and unfavorable results. A peaceful environment linked to political stability is what all people long for. However, at the same time, a peaceful environment can generate favoritism and immunity. Many countries with a weak political order face these difficulties. Effectiveness of government and control of corruption plays a positive role in the attaining the situation of political stability and control on violence. Political stability is one of the dimensions of governance. Governance is associated with how the authority is exercised in a country through means of traditions and institutions. It includes "process of selection, monitoring besides replacement of government. Further, it includes the government's ability of formulating and implementing various policies. Also, the admiration of citizens and the state are also part of it".

The World Governance Index (World Bank) explains the six dimensions of governance. The first is voice and responsibility. It considers "the perception of the extent to which citizens of a country can contribute and participate in government choices." In addition to free media, it also covers other forms of freedom of expression and association.

Political stability and absence of violence expresses "a view of political instability and the possibility of politically induced violence."

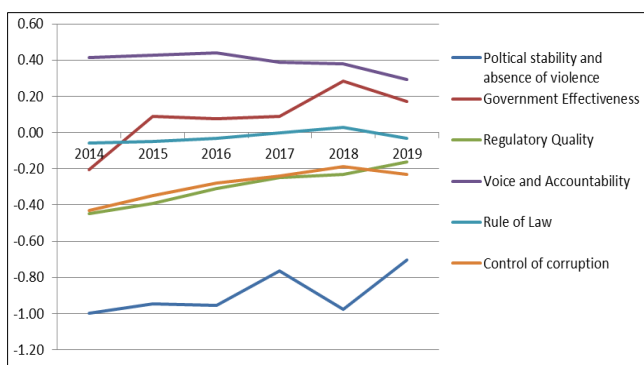
The effectiveness of the government takes into account "the perception of public services, the quality of civil servants' service and their independence from political pressure." It also involves the quality of policies and the dedication of the government.

The quality of supervision reflects "the perception of the government's ability to formulate and implement policies that regulate the private sector".

The rule of law considers perceptions of the extent to which agents comply with social rules, property rights, and courts. It also covers the possibility of crime and violence.

Corruption control measures "perceptions of the extent to which political power is said to obtain private benefits" (World Governance Indicators, 2020\*) [13].

These indicators summarize the views of citizens, companies, and interviewees in developing and industrialized countries on the quality of governance.



Source: Author's own representation based on World Bank data, 2020

Fig 5

All the indicators of governance except Voice and Accountability show an improvement over the period of five years i.e. 2014-2019. India is moving towards the path of effective governance and political stability. The values range 'from -2.5 (weak) to 2.5 (strong) governance'. Therefore, Political stability and absence of violence has moved from -1.00 to -0.70 over 2014-19 (Worldwide Governance Indicators, 2020). This is a sign of improvement. Any movement towards the positive value is an indication of positive changes.

The gap between expectations and reality, or the gap between needs and resources, is the root cause of political instability, especially in almost all cases (Paldam, 1987) [8]. One possible way to overcome this problem is economic development. All countries strive not only to increase GDP, but also to improve living standards, quality of life, and satisfaction. This is widely accepted in different economies, and any such problems can be solved through economic growth. It is said that economic welfare and the stability of political relations are related. Simply put, economic progress often guarantees political stability. However, in some countries such as Kenya, despite economic growth, Middle Eastern countries have experienced widespread political instability.

As far as India is concerned, economic development is a tool to promote political stability. FDI has a huge role to ensure economic development. As discussed in this document, foreign direct investment promotes economic growth and human development. Through FDI, total factor productivity is increased through positive spillover effects. Positive side effects include technological progress, advanced skills, etc. The increase in productivity has promoted economic growth. Therefore, FDI is a catalyst for increasing GDP growth rate. At the same time, the growth trend of GER in higher education and the number of universities show the positive impact of FDI on education.

India has the potential to become a knowledge superpower, this is based on positive factors such as a large population, a large proportion of young people in the total population, and a knowledge of English largely due to the educational system. Education is an important part of the Sustainable Development Goals. To improve India's higher education system, facilities must be added and the quality of education must be improved. Better allocation and efficient use of resources are very important. It is necessary to increase spending on education by increasing investment. The government wants to get spending on higher education, which requires government policies to accommodate private investment, including foreign sources. This will help close the gap between supply and demand for higher education. Furthermore, competition may even prompt local universities to improve quality. Therefore, foreign direct investment can help improve the education sector and create employment opportunities. India plans to open its regulated education sector by relaxing foreign investment rules. The share of GDP is currently around 3.1% and there is a need to increase spending on education.

## Conclusion

Due to its political stability and the predictability of its policy framework, India is on its way to becoming an "attractive investment destination." The ruling party can ensure good governance and political stability, and it can also effectively control work. All government policies aim to promote growth,



create jobs, return on investment and promote "Made in India." India is on the path of political continuity and is committed to democracy and pluralism. Extensive reforms are underway to promote business in India. Take measures to reduce bigamism. The Indian government is working hard to ensure transparency by using online platforms in almost all areas. Experts are being hired for work that can increase efficiency and reduce corruption. The only focus of Indian governance is work.

FDI and political stability are interrelated. On the one hand, increased foreign direct investment promotes political stability through indirect means that affect GDP and education and economic development. On the other hand, political stability will attract a country's FDI. As in India, the various policies India is developing to attract foreign direct investment reflect a lack of nepotism, good governance, and political stability.

Governance in India is not exclusively aimed at facilitating business, but at making life easier. Numerous public welfare policies, implemented in various ways, are a way to make people's lives more comfortable. Despite local demand, India has also met global demand for medicines. It has always been a help to meet global needs. In the current circumstances, the role of China in India has diminished, and India was once a great player. In order to solve this problem, many investments from other countries are being invited. Gujarat is becoming a very ideal investment destination. The government's planning and practice are very effectively visible through the budget. Past government policies, such as the waste of money, the implementation of goods and services tax, etc., have also helped the Indian economy. It helped overcome the black money problem. The tax structure under the goods and services tax replaced the different central and state policies previously adopted. It has attracted a lot of investment in India. Entrepreneurship, cooperation and mergers are reaching their peak. The government not only pays attention to large companies, but also considers small, medium and micro enterprises.

Despite having a Federal structure in India, the system is more or less centralized. Government is able to take care of needs of the society and plan allocation of resources efficiently. Investments are increasing at a rapid pace which is further promoting political stability in India. The Indian government believes in delivering results and focuses on every important aspect to reach heights.

### Acknowledgement

\*(The authors acknowledge the use of World Governance Indicators available at: <https://info.worldbank.org/governance/wgi/Home/downloadFile?fileName=wgidataset.xlsx>. The authors have referred to India Specific Data from the mentioned source, please see Annexure 1. Ministry of Human Resource Development, GOI. (2019, August). *All India Survey on Higher Education*. [https://www.education.gov.in/sites/upload\\_files/mhrd/files/statistics-new/AISHE%20Final%20Report%202018-19.pdf](https://www.education.gov.in/sites/upload_files/mhrd/files/statistics-new/AISHE%20Final%20Report%202018-19.pdf))

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