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Foreign Direct Investment and Growth in Low-Income Economies: A Literature Review

Eka Nur Yulianti[1]

[1] Sekolah Tinggi Ilmu Ekonomi Widya Wiwaha, Yogyakarta, Indonesia

Abstract

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This study reviews the recent literature on the relationship between Foreign Direct Investment (FDI) and economic growth in Low-Income Countries (LICs). While FDI is widely regarded as a driver of development through capital inflow, technology transfer, and integration into global markets, its effectiveness is far from guaranteed. Findings from recent empirical and theoretical works suggest that FDI only significantly contributes to growth when supported by strong institutional quality, strategic sectoral allocation, and high absorptive capacity, particularly in education and infrastructure. Moreover, investments in manufacturing and service sectors offer more substantial spillover effects compared to extractive industries, which often provide limited benefits to the broader economy. The review highlights the critical role of complementary conditions, such as macroeconomic and political stability, in ensuring FDI leads to sustainable and inclusive development. Thus, policymakers in LICs must focus not only on attracting foreign investment but also on creating enabling environments to maximize its developmental potential.

1. Introduction

Foreign Direct Investment (FDI) has long been considered a catalyst for economic growth, especially in developing and low-income economies. Through capital inflows, technology transfer, managerial expertise, and integration into global value chains, FDI is expected to support industrial development, infrastructure enhancement, and employment generation (Alfaro & Chauvin, 2019). In the context of low-income countries (LICs), the role of FDI becomes even more critical, as these nations often face constraints in mobilizing domestic investment and accessing international markets. Despite the theoretical consensus on the positive role of FDI, empirical findings remain mixed and context-dependent. Several studies indicate that FDI contributes to economic growth only when certain absorptive capacities, such as human capital development and institutional quality, are present (Henok & Kaulihowa, 2022; Gizaw et al., 2023). This suggests that the benefits of FDI in LICs may not be automatic but contingent on complementary factors such as macroeconomic stability, regulatory frameworks, and infrastructure.

Moreover, the recent shifts in global investment patterns driven by geopolitical tensions, pandemic-related disruptions, and changes in multinational strategies have further complicated the FDI-growth nexus in low-income economies (Giroud et al., 2023). As a result, it becomes imperative to re-examine the existing literature to understand the evolving dynamics and identify under what conditions FDI effectively contributes to growth in LICs. This literature review aims to synthesize recent empirical and theoretical studies published over the last five years, focusing on the relationship between FDI and economic growth in low-income economies. By doing so, it provides an updated overview of key findings, identifies gaps in the current research, and offers insights for policy formulation in developing contexts.

2. Literatur Review

Foreign Direct Investment (FDI) is often viewed as a key driver of economic growth in low-income economies due to its potential to supplement domestic savings, transfer technology, and create employment. However, recent studies highlight that the impact of FDI on growth is not universally positive and is influenced by various moderating factors (Herzer, 2022). One critical determinant is the quality of institutions in host countries. Countries with stronger governance and regulatory frameworks are more likely to convert FDI inflows into productive investments that foster long-term growth (Adegboye et al., 2020). Conversely, weak institutional environments may lead to inefficient allocation of foreign capital or limit potential spillovers to domestic firms.

The sectoral composition of FDI also matters. Investments in manufacturing and services tend to have more favorable growth outcomes compared to extractive sectors, which are often characterized by limited domestic linkages and environmental challenges (Opoku et al., 2019). Furthermore, the ability of a country to absorb and utilize foreign technology shaped by education levels and infrastructure quality has been identified as a crucial factor in determining the real benefits of FDI (Gupta et al., 2022). The literature suggests that while FDI can contribute to growth, its effectiveness in low-income economies depends on complementary conditions, including institutional quality, sectoral focus, and absorptive capacity.

3. Methods

This study adopts a qualitative literature review approach to examine the relationship between Foreign Direct Investment (FDI) and economic growth in low-income economies. The review aims to provide a comprehensive understanding of how FDI contributes to or hinders growth under varying structural and institutional conditions. Relevant academic literature was collected from scholarly databases such as Google Scholar, Scopus, and ScienceDirect, focusing on publications from last five years to ensure the inclusion of recent and relevant findings. Search keywords included terms such as "FDI and economic growth," "FDI in low-income countries," "institutional quality and FDI," and "sectoral impact of FDI."

The inclusion criteria were: peer-reviewed journal articles, published between 2018 and 2023, focused on low-income or developing countries, and containing theoretical or empirical analyses on the FDI growth nexus. Articles that addressed high-income countries or lacked clear methodological foundations were excluded from the review.

The selected studies were analyzed using a thematic synthesis approach. Findings were grouped into key themes such as institutional quality, sectoral distribution of FDI, and absorptive capacity, which allowed for the identification of common patterns, divergences, and research gaps across the literature. This approach supports a structured understanding of the dynamics shaping FDI effectiveness in promoting economic growth in low-income economies.

4. Results and Discussion

The review suggests that although Foreign Direct Investment (FDI) is widely considered a catalyst for economic development in low-income countries (LICs), its actual contribution to growth is highly dependent on several enabling conditions. One of the most significant factors is institutional quality. Countries with transparent legal systems, stable regulatory environments, and low levels of corruption are better positioned to translate FDI into productive investment. Paul and Jadhav (2020) emphasize that institutional strength not only attracts FDI but also enhances its positive externalities on domestic economies. Furthermore, the sectoral destination of FDI plays a crucial role in determining development outcomes. Investments in manufacturing and high-value service sectors are more likely to generate technology transfers and employment compared to those in extractive industries, which often have limited linkages with the broader economy and may worsen governance issues (Feulefack & Ngassam, 2020).

In addition, a country's absorptive capacity, especially in terms of education and infrastructure, influences the extent to which foreign capital results in sustainable development. Without adequate human capital, the potential for technology spillovers remains limited, as highlighted by Xie et al. (2020), who argue that FDI promotes growth only when a country meets a minimum threshold of educational attainment. Macroeconomic and political stability also play an essential role in encouraging long-term investment. Countries with low inflation, sound fiscal management, and stable political conditions tend to foster investor confidence and ensure that FDI contributes more effectively to structural transformation (Awad, 2020). In light of recent global disruptions such as trade tensions and post-pandemic realignments, it becomes increasingly important for LICs to focus not only on attracting FDI but also on strengthening domestic capacities to absorb and utilize it effectively. Thus, the overall evidence suggests that the developmental impact of FDI is not automatic; it depends heavily on institutional readiness, strategic sectoral focus, and the broader economic environment.

5. Conclusion

This review underscores that the impact of Foreign Direct Investment (FDI) on economic growth in low-income countries (LICs) is not inherently positive, but rather conditional upon a set of structural and institutional factors. Institutional quality, sectoral distribution of investment, and absorptive capacity particularly in education and infrastructure emerge as the most critical enablers of FDI effectiveness. Robust institutions help channel FDI into productive sectors and ensure its alignment with long-term development goals, while weak governance often leads to inefficiencies or even harm. Moreover, FDI directed toward manufacturing and service sectors has been shown to yield greater spillover benefits compared to investments in extractive industries, which are frequently isolated from the broader economy. A country's ability to absorb and utilize foreign technologies, in turn, depends heavily on the level of human capital development and infrastructure readiness. Consequently, fostering an enabling environment through macroeconomic stability, political coherence, and strategic policy frameworks is essential. Only by strengthening these foundational elements can LICs ensure that FDI serves not merely as an inflow of capital, but as a meaningful contributor to inclusive and sustainable economic development.

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