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Article

Foreign Direct Investment Law in Developing Economies

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Abstract: Foreign Direct Investment (FDI) is a critical driver of economic development in the Global South, delivering not only capital but also technological spillovers, export growth, and employment. However, the legal and regulatory frameworks that govern FDI in developing economies vary significantly in terms of openness, investor protections, and institutional efficiency. This article examines the current landscape of FDI law in developing countries as of 2025, focusing on entry restrictions, legal safeguards, incentive structures, and administrative hurdles. Drawing on global data and national examples—particularly India—it evaluates how regulatory frameworks affect FDI inflows and their contribution to economic growth. The article highlights global trends toward protectionism, increasing use of investment treaties, and the role of institutional quality in maximizing FDI benefits. It also discusses emerging challenges including unequal FDI distribution, environmental risks, and the rise of regulatory nationalism. Finally, it outlines key policy reforms such as easing equity caps, digitalizing regulatory processes, and strengthening dispute resolution. With visuals illustrating sectoral restrictions and long-term inflow patterns, the article underscores the importance of predictable, transparent, and balanced FDI regimes to attract sustainable investment and achieve inclusive development outcomes.

Keywords: Foreign Direct Investment, FDI law, developing economies, investment regulation, equity ceilings, automatic route, sectoral restrictions, legal framework, investment promotion, institutional quality,

INTRODUCTION

Foreign Direct Investment involves a foreign entity acquiring an ownership stake or substantial influence in the operations of a business in another country. For developing economies, FDI is vital not only as a source of external capital but also for its spillover effects such as productivity gains, technology diffusion, enhanced exports, and improved governance. However, the regulatory environment for FDI varies widely, influencing both the quantity and quality of inbound investments.

FDI REGULATORY STRUCTURES IN DEVELOPING ECONOMIES

1. Entry and Establishment Requirements

Most developing countries impose specific regulations governing the entry of foreign investors. These include:

- **Equity ceilings:** Limits on the maximum shareholding allowed for foreign investors in certain sectors.
- **Sectoral routes:** "Automatic" vs. "government approval" routes (e.g., India distinguishes sectors where FDI can proceed without approval and those requiring regulatory vetting)[1][2].
- **Prohibited sectors:** Sensitive industries such as defense, media, and resources may be fully/partially restricted.

- **Screening mechanisms:** Pre-approval processes to assess national interests and security implications.

[image:1]

Fig 1: Prevalence of FDI entry restrictions in developing economies, by sector (2025)

2. Legal Protections for Foreign Investors

- **Protection against expropriation:** Laws and treaties guarantee compensation in case of state expropriation.
- **Dispute settlement mechanisms:** Access to international arbitration (e.g., ICSID) and strong domestic recourse.
- **Guarantees on capital transfers:** Provisions allowing free repatriation of profits, dividends, or liquidation proceeds.

3. Incentives and Promotion Measures

- **Tax holidays, reduced tariffs, R&D support**
- **Special Economic Zones (SEZs) with streamlined rules**
- **Targeted sectoral incentives:** Especially for export-oriented or high-tech investments

4. Compliance and Regulatory Barriers

- **Complexity of licensing and registration**
- **Local content, employment, or technology transfer mandates**
- **Opaque legal processes and discretionary administration**

TRENDS AND EVOLUTION IN FDI LAW (2023–2025)

- FDI flows to developing economies fell to $435billion in 2023, their lowest since 2005[3][4].
- Over half of all FDI-related policy measures in 2025 have been restrictive, reflecting global trends toward protectionism and economic nationalism[3].
- Market openness, investment climate improvements, and bilateral/multilateral treaties are strong drivers for increased FDI. Countries with investment treaty coverage see over 40% greater FDI inflows[3].

Selected Country Example: India

India has liberalized its FDI regime—over 90% of inflows now enter under an automatic route—with notable increases in sectoral caps (insurance raised to 100% in 2025)[5][1]. Key authorities include the Department for Promotion of Industry and Internal Trade (DPIIT), RBI, and various sectoral regulators. Prohibited sectors and nationality screening remain in place for sensitive areas[1].

THE IMPACT OF FDI LAWS ON ECONOMIC OUTCOMES

Positive Outcomes

- **Capital Formation:** FDI adds directly to domestic capital stock.
- **Job Creation:** Foreign enterprises create jobs, raise wage levels, and enhance skill transfer.
- **Technology Diffusion:** Foreign firms transfer advanced technology and managerial practices.
- **Export Growth:** FDI promotes export-led industrialization and integration into global value chains[6][7][8].

Negative/Challenging Aspects

- **Unequal distribution:** FDI is often concentrated in a handful of large developing economies (China, Brazil, India)[3].
- **Sectoral imbalance:** Natural resources and low-value manufacturing still dominate in lower-income states.
- **Regulatory uncertainty:** Frequent changes and opacity undermine investor confidence.
- **Environmental and social risks:** Lax enforcement allows negative externalities in host communities[6].

Institutional Quality and FDI Effectiveness

Enhancements in government effectiveness, regulatory quality, and the rule of law significantly boost the impact of FDI on economic growth[7]. Conversely, weak institutions dilute these benefits.

Institutional Dimension	Influence on FDI Inflows	Influence on FDI Spurred Growth
Government Effectiveness	High	Strong
Regulatory Quality	High	Strong
Rule of Law	Medium-High	Strong
Control of Corruption	Medium	Moderate

Global Patterns and Data (2025)

[image:2]

Fig 2: FDI inflows to developing economies, 2008–2024

- 10 countries accounted for two-thirds of all FDI received by developing economies, with the poorest 26 countries capturing just 2%[3].
- Openness to trade and robust legal frameworks increase FDI by 2–3% of GDP over 10 years, while restrictive policies cause inflows to shrink[9][3].

Policy Priorities and Reform Trends

- **Easing investment restrictions:** Removal of equity caps, facilitating "automatic" entry, and expanding allowable sectors.
- **Improving business climate:** Transparent regulation, digitalization, anti-corruption efforts, and faster dispute resolution.
- **Enhancing institutional quality:** Strengthening rule of law, government effectiveness, and regulatory predictability[7].
- **Leveraging international agreements:** Bilateral investment treaties, trade agreements, and regional compacts foster confidence[9][3].

Challenges Ahead

- **Investment protectionism:** New barriers may further reduce flows in a fragile global landscape[3][4].
- **Geopolitical risks:** Political instability or conflict quickly undermines FDI.
- **Environmental and social safeguards:** Balancing investor incentives with responsible, sustainable economic development is a continuing struggle[6].

CONCLUSION

The regulatory climate for FDI in developing economies remains a powerful tool for shaping investment inflows, sectoral priorities, and economic outcomes. As global capital becomes scarcer and competition increases, developing economies must navigate the delicate balance of openness, investor protection, and national interests. Ongoing reforms, especially those improving institutional quality and legal predictability, are essential to harness FDI for sustained and equitable growth.

Figures & Graphs

- Fig 1: Prevalence of FDI Entry Restrictions in Developing Economies, by Sector (2025)
- Fig 2: FDI Inflows to Developing Economies, 2008–2024

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