



MODELLING THE RELATIONSHIP BETWEEN INSTITUTIONAL QUALITY, FDI, AND ECONOMIC GROWTH IN INDIA USING STRUCTURAL EQUATION MODELLING

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ABSTRACT

This empirical investigation based on the current stage of economic development indicates that FDI has important impact on the country of destination's stable, high-quality and healthy economic growth. Any nation that is involved in the process of economic globalization is therefore trying to develop a competitive business environment in the country to draw further foreign investments. The main objective of this study is based on Institutional quality or Evidence and I selected 5 factors Institutional Metrics like Control of Corruption, Government Effectiveness, Political Stability, Regulatory Quality, Rule of Law from DPIIT website (Secondary Data) for the period 2018-2023. We are Using statistical tools like Unit root Test, ARDL Approach & SEM. This study applies Least Squares regression (OLS): The study examined the impact of institutional factors influence on the FDI flows. The study has considered the ordinary least square method to know the impact of institutional factors (independent variables) on FDI flows (dependent variable). The study found with the help of ARDL model that the Institutional indicators had are having the positive coefficient value and stated that Institutional Metrics of corruption and Govt. effectiveness are institution indicators which shown short run association with FDI flows, The study examined that Political stability f-statistic value is falling above the upper peasant table (i.e., $7.4578 > 4.16$) which states political stability has a long run association with FDI flows, Institutional Indicators such as Rule of law, Regulatory Quality and Voice & accountability had a long run association with FDI flows.

KEYWORDS: FDI, Institutional Metrics, Economy Growth, SEM Model.

JEL Codes: M18

M15

M96

M98

1. INTRODUCTION

Foreign Direct Investment (FDI) plays a pivotal role in the economic development of nations by facilitating the cross-border flow of capital, technology, managerial expertise, and market access. In today's highly globalized and competitive world, FDI has become one of the most important drivers of economic integration and growth. Unlike portfolio investments, which involve passive ownership of financial assets, FDI entails a long-term relationship and significant degree of influence over the management of an enterprise located in a host country. This unique characteristic makes FDI not only a source of financial capital but also a means of transferring knowledge, skills, and innovation across economies. For developing countries, FDI is particularly significant because it helps bridge the gap between domestic savings and investment needs. It stimulates employment, introduces modern technology, enhances productivity, strengthens global trade connections, and promotes industrial diversification. Governments across the world actively compete to attract FDI by improving infrastructure, strengthening institutional frameworks, and implementing investment-friendly policies. The volume and stability of FDI inflows are often seen as indicators of a country's economic potential, macroeconomic stability, and policy credibility. Therefore, core determinants which have the greatest impact on FDI inflows and



stability of these flows should be examined. As can be seen in the number of studies of international capital flows, the main motivation for making direct foreign investments exactly is historically the advantage of ownership, location benefit and the advantage of internationalization. It should therefore be noted that, as a favorable geopolitical location, considerable market size, abundance of natural resources has a significant effect on the attractiveness of investment in a country. In today's fierce competition to attract FDI, however, the determinants mentioned above are not sufficient to ensure that a country is competitive on a world capital market. The regulatory framework built in a nation significantly decreases shareholders' transaction cost, simplifies trade and, above all, offers safeguards and protects foreign investors. In addition, it should be noted that high institutional efficiency, together with the FDI attractiveness, is a necessary factor to draw not only FDI but also to gain potential advantages. We use institutional metrics from World Bank Worldwide Governance Metrics to evaluate the influence of organizations on FDI flows, which is the primary source for institutional empirical research. In this study the following Institutional indicators were included to know the association with the FDI flows,

- Control of Corruption
- Government Effectiveness
- Political Stability
- Regulatory Quality
- Rule of Law

At the macroeconomic level, FDI contributes directly to Gross Domestic Product (GDP), enhances export performance, and improves the overall competitiveness of the host economy. At the microeconomic level, it fosters firm-level growth through improved efficiency, innovation, and better managerial practices. However, the extent to which FDI benefits an economy depends heavily on country-specific factors such as institutional quality, regulatory environment, governance standards, and openness to trade.

Given its multifaceted importance, FDI continues to attract the attention of policymakers, researchers, and international organizations. Understanding the patterns, determinants, and impacts of FDI is essential for designing effective economic policies that maximize its benefits while minimizing potential risks.

2. REVIEW OF LITERATURE

- **Mazumdar (2020):** - The paper examined implication of capital flows in India and its implication for economic growth & argued that it was hoped that with the partial liberalization of the capital account in the- early 1990s, capital inflows would contribute towards India's economic growth. This paper reviews the role of capital flows into India and examines if such flows have in any way contributed to economic growth.
- **Mahajan and Agarwal (2020):** suggests that India can attract foreign investment by marketing. In order to make the foreign investment policy more transparent and less complex, the Government has done away with pre-equity approvals if a certain set of preconditions are met. This combines with other factors such as high economic growth in the main home and host countries, improvement in corporate profitability and higher stock valuation point would result to a recovery of FDI flows.
- **Click (2019):** examined the risk of US foreign direct investment over the period 1982-1998 in 59 host countries. The first part of the analysis built an empirical model to explain the time series and cross-country patterns of return on capital. The return on assets (ROA) has been used as a measurement of the return on capital. There are four main findings. First, the ROA in a majority of countries does not simply track the worldwide. Second, cross country differences are explained by financial risk. Third, unexplained country risk is qualitatively risk.
- **Bhaumik (2019):** - The study argued while examining the banking sector he argues that the cost efficiency and profitability of the public sector banks have improved significantly, article argues that was time to bite the bullet and privatize the public sector banks and, in the interim, to reduce the risk associated with creation of bank assets by facilitating greater securitization of credit.
- **Nagesh Kumar (20018):** The paper, "Liberalization of FDI Flows and Development-Indian Experience in the 1990's" reviews the Indian experience with FDI and its quality since 1991 & summarizes the evaluation of Indian Government policy towards FDI during 1948-2004 and examined the trends and patterns of FDI inflows in India in 1990's. The author has used only secondary data collected from the UNCTAD world investment database and the sources of Government of India.
- **Peng Hu (2017):** - "Economic Crisis on the Operation Behavior of the Firms: Case of East Asia", some Finnish Firm, depending on their industrial and financial position, saw the Asian crisis as an ideal time to



enter a new market in the region or expand existing operations there. There might be additional investment incentives available for the TNCs in the recovery phase. Altogether, the great majority of the world's largest firm kept their confidence in East Asian crisis countries as an investment destination unchanged during the Asian crisis.

- **Elissa Braum (2017):** - The study presents a review of research and policy on the links between foreign private investment and development. This work provides broad and consistent evidence for the argument that growth leads to FDI rather than FDI leading to growth. The work also underscores the importance of economic policy context for gaining development benefits from FDI. Besides keeping the production costs low to attract more qualitative FDI, countries must also have adequate domestic capacities to benefit from FDI.
- **Subramanya and Bhuma (2016):** - In the paper "Studying outward FDI by India", find that government expenses and labor outflows have significant elasticity with respect to remittances, & the level of overseas investments is closely related to the comfort level of the investors. The study contends that government expenditure to promote the tertiary education and increasing the pool of skilled man power and the number of people emerging has a direct bearing on the remittances.
- **Rajesh Narula and S. La1 (2016):** - In the edited volume, find that understanding the factors that led to an optimization of the benefits from FDI for the host country. Despite the diversity of the countries covered and methodology used, the chapters in this volume point to a basic paradox, "With weak local capabilities, Industrialization has to be more dependent on FDI. The studies here do not support the view that FDI is a sine qua non for economic development.
- **Karunagaran (2015):** - The study examined the historical perspective of foreign banks & viewed the operations of foreign banks in historical perspective, and taking a cue there from, provides an analysis of contemporary policy that has promoted their aggressive expansion.
- **Vasudevan (2015):** - The paper describes that there is no standard theoretical construct relating to portfolio flows. In the early literature, foreign investment was viewed essentially in terms of foreign direct investment (FDI), a view that was given, as economic historians would recall, policy relevance in the Leninist New Economic Policy for the erstwhile Soviet Union in 1924.

4. STATEMENT OF PROBLEM

In recent years emerging countries are attracting significant FDI inflows. The economic, social development appear to the growing economies considerable making effects to attract FDIs by focusing prospective sectors, institutional settings, policy changes. Regulatory liberalization, investor guarantees, incentives and concessions etc... but India lagging behind in attracting the sizable amount of FDI. Over the past decade china doubled its FDI and India over all FDI inflows show a significant growth trend. Despite the dynamism of the country with enormous potential and increasing importance for FDI but being the amount world's top fastest growing countries (BRICS) failed to achieve the expected FDI inflows compound with other sizable economic oriented countries.

5. RESEARCH GAP

Few studies have considered investigating the policy impact on FDI flows. Few studies considered investment decisions, technological issues, economic problems related to financial mobilization through foreign direct investment. The latest development in this regard has been examined by the govt. of India to attract the FDI flows. Most of the studies had tried to look at the regulatory bottle necks in foreign direct investment area. Overall, international, national, and local studies are already being done, with the help of reasonably large samples, had not given full justice to the growth of flows, issues, and issues related to foreign direct investment. Smaller counties are able to attract larger portion of FDI successfully than India, e.g., Belgium is 100% attracting FDI and highest FDI attracting country in the world. One of the major road blocks is observed to the institutional factors which are unable to pull the funds in to India.

6. OBJECTIVES OF THE STUDY

- To study the Role of Foreign Direct investment flows in to India.
- To study the institutional environment impact on Foreign Direct investment flows in to India.

7. HYPOTHESES OF THE STUDY

H0: There is no impact of dimensions of institutional metrics on FDI flows.



H1: There is an impact of dimensions of institutional metrics on FDI flows.

8. RESEARCH METHODOLOGY

Study Period

The period of the study is between the financial year 2022-23. And the data collected from DPIIT website and Few journals.

Statistical tools to be used:

- Unit Root Test
- ARDL approach
- Least Squares regression (OLS)

9. SCOPE OF THE STUDY

To study the Impact of Foreign Direct investment flows on select sectoral growth in India and we consider Ten Institutional factors for economic growth of the country.

10. RESULT AND DISCUSSION

- To study the Role of Foreign Direct investment inflows in India.

Share of Top Five Investing Countries in FDI Equity Inflow in April 2020 to March 2025

Rank	Country	FDI Equity Flow During 2022-2023.	% Share in FDI Equity Flow During 2022-2023.
1	Singapore	1,37,374	37 %
2	Mauritius	48,895	13 %
3	USA	48,666	13 %
4	UAE	26,315	7%
5	Netherland	19,855	5%

Share of Top Five Investing Sectors in FDI Equity Inflow in April 2020 to March 2025.

Rank	Country	FDI Equity Flow During 2022-2023.	% Share in FDI Equity Flow During 2022-2023.
1	Computer Software & Hardware	74,718	20 %
2	Service Sector	69,852	19 %
3	Trading Sector	38,060	10 %
4	Non-Conventional Energy	19,977	5%
5	Drugs & Pharmaceuticals	16,654	4%

Factors Affecting Foreign Investment:

In the host country, foreign investment has so many impacts. Foreign investors are researching the obstacles of the host countries that impact foreign investors negatively because none of the companies wants a loss after investments Boopath, D. (2013)⁶. There are so many reasons for not investing in the host country as a foreign company.

- **Rate of Interest/ Foreign Exchange Rate:** The disparity in the rate of interest at different locations is one of the most important reasons for foreign capital movements. Some aspects are the same, capital continues to shift from a low interest rate country to a higher one. In this situation the foreign investment movement is very slow when the exchange rate is unstable and the possibility of a decline is in future.
- **Speculation:** Speculation regarding anticipated changes in interest rates can influence the short-term capital movements. The investment portfolio in the host country market is a form of speculation. If the host country market is strong in speculation, the investment is decreased by foreign investors. As a result, foreign investment movement in the host country is small.
- **Profitability:** The motive of profit influences the private foreign capital movement. Therefore, private capital will flow to countries with comparatively higher returns on investment.
- **Costs of Production:** Lower production costs in foreign countries encourage private capital movements. Two types of cost-saving investment can be distinguished. The first is because raw materials must be



obtained in the outside world. These materials cannot be purchased at home or at very high costs, but they are important to the manufacture and sale of finished products at home or abroad. Opportunities to profit would be unexplored without them. Nevertheless, the fact that capital will enter the asset, the second cost-cutting expenditure of the product other than resources, primarily labor, is driven by large investments in the extractive industries.

- **Economic Conditions:** Private foreign investment is influenced by economic conditions, particularly market potential and infrastructure facilities. The population's size and country's income level have a significant impact on the market opportunities.
- **Government Policies:** The government policies are important factors that may affect foreign investment in a country, particularly in relation to foreign investment, foreign cooperation, transfer payments, revenues, taxations, exchange INSTITUTIONAL METRICS, tariffs and monetary incentives and other steps.
- **Political Factors:** Policy considerations such as political stability, political party structure and relations with other countries also affect movements of capital. Political influence on business practices such as tax changes and industrial policies have adverse effects on the movement of foreign investment in the country, on the other hand.

• **To study the Impact of Foreign Direct investment flows on select sectoral growth in India.**

Unit Root test with Augmented Dickey Fuller

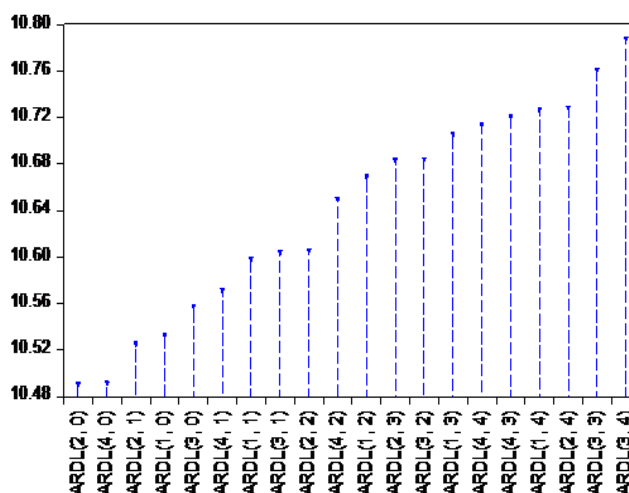
Institutional Indicators	Level	1 st Difference	2 nd Difference
Control of Corruption	0.0013*	-	-
Government Effectiveness	0.0000*	-	-
Political Right Index	0.0000*	-	-
Regulatory Quality	0.0030*	-	-
Rule of Law	0.0682	0.0000*	-

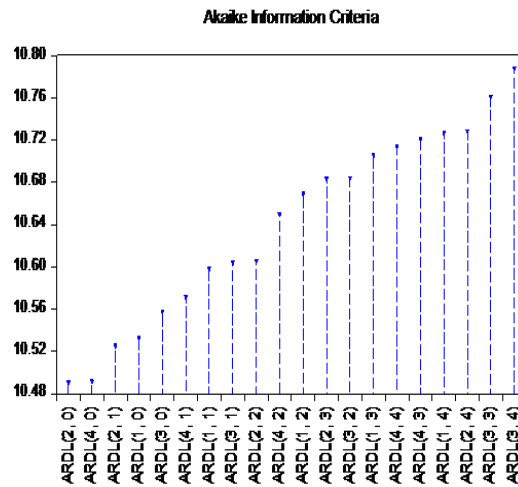
Interpretation

The table illustrates the unit root test result under the Augmented Dickey Fuller test for the sectoral investment factors of FDI are observed significant at the 5% level. The Rule of law, Civil Liberties and Women in Parliament are non-Significant at 5% level at 1st Difference and all are significant at with stationarity.

Akaike Information Criteria Graph for Institutional Metrics-Stationarities

Akaike Information Criteria





Interpretation

The above Akaike Information Criteria graph illustrates the optimum selection criteria for the Autoregressive Distributed Lag model to check the association between Foreign Direct Investment and Institutional Metrics. The plot lines in the graph observed to have highest at lag period near to 10.7, there the independent variable (regulatory quality) seems to fit.

Reliability Analysis

S. No	Construct	Reliability Values of Initial stage	Dimension	Loadings	Reliability Values	CR	AVE	No. of dimensions
1	CC	0.816	CC1	0.816	0.816	0.903	0.654	4
			CC2	0.727				
			CC3	0.732				
			CC4	0.795				
2	EF	0.892	EF1	0.892	0.892	0.827	0.549	4
			EF2	0.856				
			EF3	0.857				
			EF4	0.836				
3	PS	0.890	PS1	0.857	0.890	0.894	0.680	4
			PS2	0.859				
			PS3	0.839				
			PS4	0.876				
4	RL	0.888	RL1	0.836	0.888	0.893	0.676	4
			RL2	0.863				
			RL3	0.875				
			RL4	0.850				
5	CV	0.893	FDI1	0.890	0.893	0.897	0.637	5
			FDI2	0.848				
			FDI3	0.877				
			FDI4	0.880				
			FDI5	0.852				
Total number of Dimensions								21

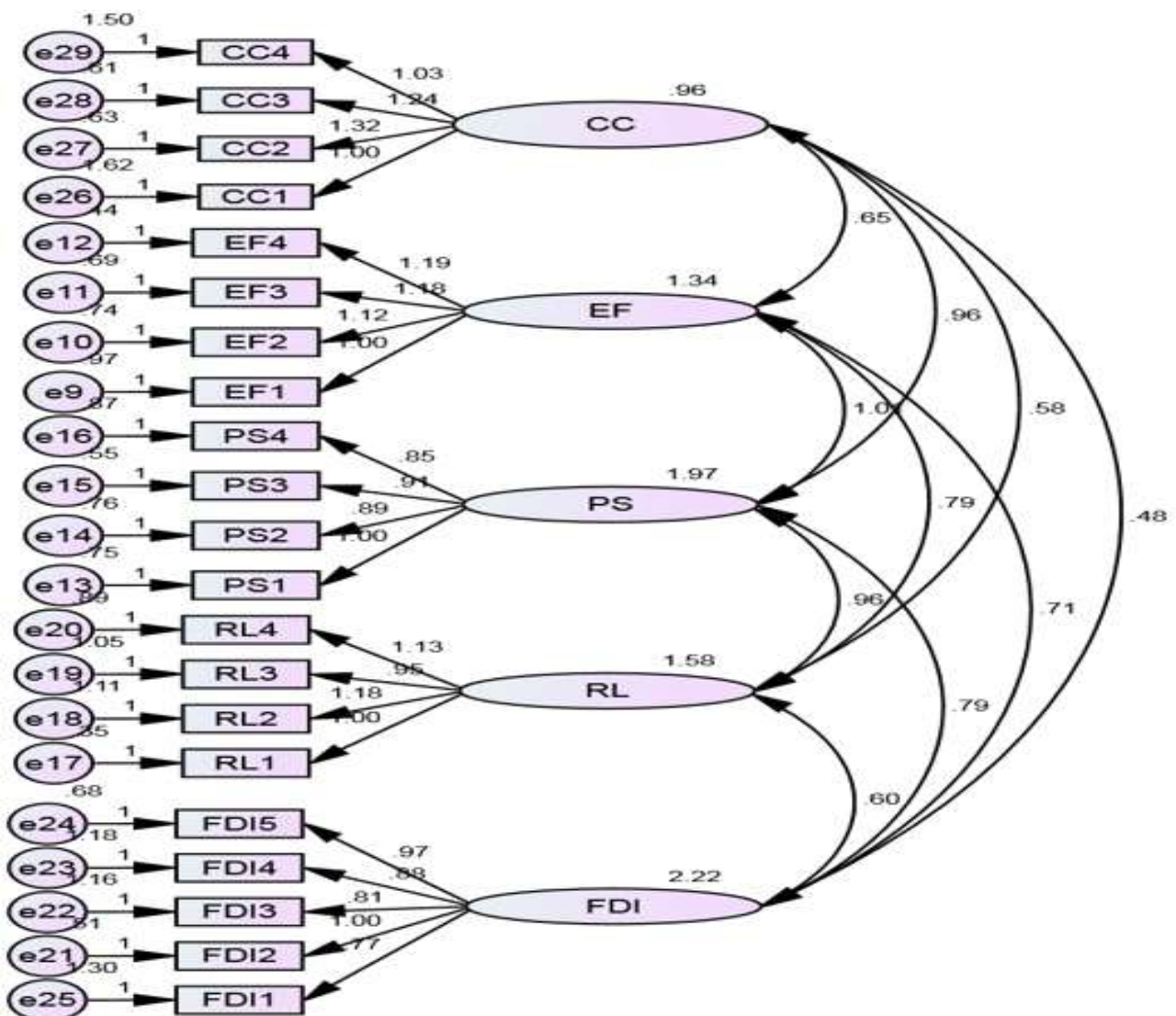
Interpretation

The construct CC demonstrates strong reliability, as evidenced by high CR and consistent factor loadings above 0.70. The AVE value of 0.654 indicates that over 65% of variance in the items is explained by the construct. Thus, CC is a valid and reliable construct for further analysis. EF displays high factor loadings and a CR above the recommended threshold. While the AVE is slightly above 0.50, it still meets minimum criteria, showing moderate to strong convergent validity. The construct is reliable and suitable for further structural analysis. PS demonstrates



excellent reliability and convergent validity. With AVE at 0.680, the construct explains a significant proportion of variance, and the high factor loadings confirm item relevance. This construct is statistically strong and stable. RL shows high internal consistency and strong convergent validity. Factor loadings well above 0.80 demonstrate that each indicator contributes meaningfully to the construct. Overall, RL is a robust and reliable measure. CV displays strong factor loadings and a high CR value, indicating strong internal consistency. The AVE of 0.637 confirms that the indicators collectively capture considerable variance of the underlying construct. This is a statistically sound construct.

CFA Overall Path Model



Interpretation:

The Confirmatory Factor Analysis (CFA) overall path model was estimated to validate the measurement structure and assess how well the observed variables represent their respective latent constructs. CFA serves as a crucial step in structural equation modeling (SEM), ensuring the reliability and validity of the measurement framework before testing structural relationships. The model specifies the expected pattern of factor loadings based on theoretical foundations and evaluates whether the collected data aligns with the hypothesized factor structure.



In the CFA overall path model, each observed indicator loads significantly on its respective latent construct, demonstrating strong measurement coherence. The standardized factor loadings exceeded the recommended threshold of 0.70, confirming that every indicator contributes meaningfully to the construct it represents. These strong loadings provide evidence of convergent validity, showing that the items for each construct share a high proportion of common variance.

Fit indices values of CFA path model

	$\chi^2(\text{df})$	χ^2/df	CFI	GFI	RMSEA
Model results	431.735(6)	284	0.927	0.979	0.035

Interpretation

The CFA overall path model confirms that the measurement model is statistically sound, theoretically consistent, and empirically valid. The constructs demonstrate strong reliability, convergent validity, and discriminant validity. This provides confidence that the measurement framework is appropriate for testing the structural relationships among the latent variables in the subsequent SEM analysis.

Discriminant Validity

	FDI	EF	PS	RL	CC
FDI	0.803				
EF	0.410	0.839			
PS	0.380	0.619	0.832		
RL	0.321	0.544	0.542	0.830	
CC	0.327	0.573	0.694	0.469	0.744

Interpretation

All constructs satisfy the Fornell–Larcker criterion, demonstrating that. Each construct shares more variance with its own indicators than with other constructs. No pair of constructs exceeds the AVE square root value. The measurement model exhibits acceptable discriminant validity, confirming that FDI, EF, PS, RL, and CC are empirically distinct constructs. This supports the adequacy of the measurement model and confirms that each latent variable captures a unique conceptual domain.

Fit indices values of structural model

	$\chi^2(\text{df})$	χ^2/df	CFI	GFI	RMSEA
Model results	9.310(6)	1.551	0.886	0.812	0.068

The structural model was assessed using several widely accepted goodness-of-fit indices, including Chi-square (χ^2), Chi-square/df ratio, Comparative Fit Index (CFI), Goodness of Fit Index (GFI), and the Root Mean Square Error of Approximation (RMSEA). Accepted thresholds for a good or acceptable model fit are:

- $\chi^2/\text{df} \leq 3.0 \rightarrow$ Good fit
- $\text{CFI} \geq 0.90 \rightarrow$ Acceptable fit; $\geq 0.95 \rightarrow$ Excellent
- $\text{GFI} \geq 0.90 \rightarrow$ Acceptable fit
- $\text{RMSEA} \leq 0.08 \rightarrow$ Acceptable fit; $\leq 0.06 \rightarrow$ Excellent

Interpretation

The CFI value of 0.886 is slightly below the acceptable cutoff of 0.90.

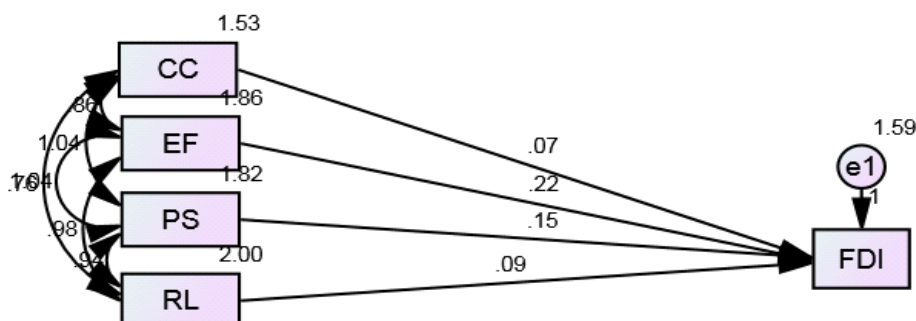
This suggests that the incremental fit of the structural model is **marginal but nearly acceptable**. While not poor, the CFI indicates that minor model improvement could be explored (e.g., refined paths or covariance adjustments). A GFI of 0.812 falls below the recommended value of 0.90.

This suggests a **moderate but not optimal absolute model fit**.

Although the model is not poorly fitted, there is room for improvement in capturing the observed variance.



Structural Analysis Model



11. CONCLUSION

The findings confirm that institutional quality significantly influences FDI inflows, reinforcing the view that transparent governance, regulatory stability, rule of law, and efficient public institutions create an enabling environment for investment. Strong institutions reduce uncertainty, minimize transaction costs, and increase investor confidence, thereby enhancing India's competitiveness in the global investment landscape. Furthermore, the analysis demonstrates that FDI has a meaningful positive impact on economic growth, supporting existing economic theories that emphasize the role of foreign investment in capital formation, technology transfer, productivity improvement, and employment generation.

Future Scope

The study of the relationship between institutional quality, foreign direct investment (FDI), and economic growth in India highlights several avenues for future research and policy exploration:

- **Regional and State-Level Analysis:**
Future research can explore how institutional quality impacts FDI and economic growth across different Indian states or regions. This may reveal regional disparities and identify areas where institutional reforms can have the greatest effect on investment and development.
- **Sector-Specific Studies:**
Examining specific sectors, such as manufacturing, services, or technology, can provide insights into how institutional quality influences FDI inflows differently across industries and which sectors benefit most from policy improvements.

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