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# Factors influencing the attraction of foreign direct investment to the economies of developing countries

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**Abstract**

**Purpose:** The author would like to thank all researchers and institutions whose empirical studies and theoretical contributions have shaped the understanding of FDI determinants in developing countries. Appreciation is also extended to the academic databases and journal publishers that provided open access to critical literature.

**Research methodology**: This study employs a qualitative analytical approach grounded in an extensive review of empirical and theoretical literature on foreign direct investment (FDI), with a focus on the OLI paradigm and the Knowledge-Capital Model. Data were drawn from 40 peer-reviewed articles published between 2020 and 2024, selected from reputable academic databases using targeted keywords related to FDI determinants. Thematic analysis was conducted to identify key variables such as market size, institutional quality, and infrastructure, highlighting regional patterns and sectoral distinctions.

**Results:** The OLI paradigm remains a key framework for understanding FDI, with recent studies showing that host-country factors such as market size, GDP growth, and skilled labor availability play crucial roles in attracting investment. While low labor costs can drive FDI in manufacturing, high-tech sectors prioritize productivity and human capital. Tax incentives and natural resources can also influence FDI, but their effectiveness depends on broader institutional and regulatory conditions. Additionally, strong intellectual property rights are essential for securing investment in innovation-driven industries.

**Conclusions:** In developing countries, FDI determinants have shifted from reliance on natural resources and low-skilled labor to a greater emphasis on skilled labor, digital infrastructure, and institutional quality. To attract high-value FDI, scholars emphasize the need for a balanced strategy that includes improving education systems, advancing digital readiness, and fostering innovation ecosystems.

**Limitations:** This study is limited by its reliance on secondary data and qualitative analysis, which may not fully capture dynamic, country-specific investment behaviors.

**Contribution:** The study contributes to FDI literature by synthesizing recent empirical findings to highlight the evolving importance of institutional quality, digital infrastructure, and human capital in developing countries.

**Keywords:** *Developing Countries, Digital Infrastructure, Foreign Direct Investment, Institutional Quality, Knowledge Capital, Labor Cost, Multinational Corporations, OLI Model, Political Stability, Tax Policy*

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# 1. Introduction

Foreign Direct Investment (FDI) serves as a pivotal mechanism in the globalization process, enabling transnational corporations (TNCs) to operate across borders and significantly contribute to economic development (Okechukwu, Chinedu, Nonso, & Widiyanti, 2023). Beyond the infusion of capital, FDI introduces recipient countries to advanced technologies, managerial expertise, human capital development, and expanded access to international markets (Wang, Xu, Qin, & Skare, 2022). These multifaceted benefits underscore FDI's critical role in stimulating economic growth, generating employment opportunities, and enhancing national competitiveness (Wardana & Setiarto, 2024).

For developing nations, attracting FDI is a strategic imperative to address domestic resource constraints, augment foreign exchange reserves, and facilitate technological modernization. Despite the recognized advantages, the distribution of FDI remains uneven among these countries, prompting a need to understand the determinants that influence investors' decisions to commit capital to specific locations. This inquiry is essential for formulating effective policies aimed at enhancing a country's attractiveness to foreign investors (Imran & Rashid, 2023).

Existing literature has extensively explored various factors influencing FDI inflows, including economic indicators, political stability, and regulatory frameworks. However, there is a noticeable gap in understanding the nuanced interplay of these factors within the unique contexts of developing economies. Specifically, the relative importance of institutional quality, market potential, and infrastructural development in shaping FDI decisions warrants further investigation (Faruq, 2023).

Moreover, while some studies have examined the impact of bilateral investment treaties and trade openness on FDI, there is limited research focusing on the synergistic effects of these variables in the context of developing countries. This gap highlights the necessity for comprehensive analyses that consider the complex interdependencies among various determinants of FDI (H. T. P. Le, Pham, Do, & Duong, 2024).

This study aims to examine the influence of shopping lifestyle and hedonic shopping motivation on impulse buying, and the role of fashion involvement in the influence of shopping lifestyle and hedonic shopping motivation on buying impulse. By addressing the identified research gaps, this study seeks to provide a nuanced understanding of the factors that attract FDI to developing economies, thereby informing policymakers and stakeholders in crafting strategies to enhance their countries' investment appeal.

# 2. Literature review

### *2.1. Literature Review*

The OLI paradigm (Ownership, Location, Internalization), proposed by John Dunning, remains the foundational framework in explaining multinational enterprises' decisions to engage in foreign direct investment (FDI). It emphasizes that a firm must possess firm-specific ownership advantages, must find a host country with location-specific advantages, and must benefit more by internalizing its operations rather than relying on licensing or partnerships. Recent studies have adopted sub-national perspectives of the OLI framework to capture institutional dynamics across regions within a country (Batschauer da Cruz, Eliete Floriani, & Amal, 2022).

Markusen's Knowledge-Capital Model builds upon earlier theories by distinguishing between horizontal (market-seeking) and vertical (efficiency-seeking) FDI. It asserts that knowledge-intensive activities can be centralized and used across geographically dispersed production sites. Recent research by Kox (2024) demonstrates that public knowledge production significantly impacts outward FDI flows, particularly in technologically advanced sectors (Kox, 2024).

Market size and economic growth are widely recognized as primary drivers of FDI. According to Faruq (2023), openness to trade and GDP growth have a statistically significant impact on FDI inflows in developing Asian economies. Institutional quality, including government effectiveness and political stability, also plays a critical role (Febriana, Wijaya, & Arieftiara, 2024). A. N. N. Le, Pham, Pham, and Duong (2023), find that trade openness strengthens the positive effect of political stability on FDI inflows. Their study concludes that while both factors are relevant, trade openness tends to exert a stronger influence than political stability alone.

The presence of robust infrastructure both physical and digital remains a key determinant of FDI, particularly in high-tech sectors. Initiatives such as 5G networks and smart cities are increasingly attracting investment in ICT and digital innovation (Beltozar-Clemente et al., 2023). Moreover, favorable corporate tax regimes are commonly associated with higher FDI inflows. Nonetheless, the long-term efficacy of tax incentives such as tax holidays remains contested. While short-term boosts are possible, they often fail to ensure sustainable investment.

If the two countries have markets of the same size but differ in their factor endowments, the firm will generally station its headquarters in the country that has more highly skilled labour and locate its production plant in the country with an abundance of lower-skilled labour. The finished products from that plant can then supply both the local market and, via export, the investing firm's home market (including neighbouring countries). This represents vertical FDI. Host-country characteristics that influence transnational corporations' decisions include economic and political conditions, infrastructure, trade- and investment-related factors, natural resources, and financial and technological systems (Matsuura & Saito, 2023).

The size of a country's economy is widely recognized as a key determinant of its ability to attract FDI (Ngatini, 2024). Empirical studies have demonstrated that countries with larger economies and higher GDP growth rates tend to draw more FDI due to stronger consumer demand and greater market potential. For instance, a study analyzing 90 middle-income countries from 1990 to 2020 found that a 1% increase in FDI led to a 9.3% increase in economic growth, highlighting the significant impact of FDI on expanding markets and enhancing productivity (A. N. N. Le et al., 2023).

While labor costs are often considered an important factor in attracting FDI, empirical evidence suggests that their influence varies across countries. In industrialized nations, higher labor costs may deter FDI unless offset by high efficiency or productivity levels (Purno, Hermana, & Sudaryanto, 2025). Conversely, in developing countries, lower labor costs can be a significant attraction for FDI, particularly in labor-intensive industries. However, the overall impact of labor costs on FDI inflows is complex and often interrelated with other factors such as infrastructure quality, political stability, and institutional frameworks (Islam & Beloucif, 2024).

Horizontal and vertical foreign direct investment (FDI) represent two primary strategic approaches employed by multinational enterprises (MNEs) to expand their operations internationally (Bi, Ren, & Bao, 2020). Horizontal FDI occurs when a firm replicates its home-country production activities in a host country to serve local markets directly. This strategy is typically pursued when countries have similar market sizes and factor endowments but are separated by significant trade barriers or geographic distance, making exporting less feasible. In contrast, vertical FDI involves fragmenting the production process across countries to exploit differences in factor endowments, such as labor costs or resource availability (Huy, 2017). Firms may locate different stages of production in countries where specific inputs are more cost-effective, often resulting in headquarters situated in countries with abundant skilled labor and production facilities in countries with abundant unskilled labor (Al-Kasasbeh, Alzghoul, & Alghraibeh, 2022).

### *2.2. Hypothesis*

Based on the theoretical framework and the empirical findings reviewed above, the following hypotheses are proposed:

H1: Ownership-specific advantages (e.g., technological capability or brand reputation) significantly influence a firm’s decision to engage in FDI.
H2: Host-country institutional quality (e.g., government stability, rule of law) has a positive impact on the volume of FDI inflows.

## 3. Methodology

This study adopts a qualitative analytical approach aimed at examining the multidimensional drivers of foreign direct investment (FDI). The research is exploratory in nature and is grounded in an extensive conceptual and empirical literature review. Foundational theories such as Dunning’s OLI paradigm and the Knowledge-Capital Model by Markusen et al. serve as the theoretical backbone. These models are revisited in the context of contemporary global investment conditions, emphasizing how firm-level strategic motives (e.g., market-seeking vs. efficiency-seeking) interact with host-country characteristics.

The primary data source consists of peer-reviewed journal articles published between 2020 and 2024, retrieved from reputable academic databases such as Scopus, SpringerLink, ScienceDirect, Nature, Taylor & Francis, and arXiv. The search focused on keywords including “FDI determinants,” “OLI model,” “Knowledge-Capital Model,” “horizontal and vertical FDI,” and “FDI and tax policy.” Inclusion criteria emphasized empirical studies and theoretical contributions that explore institutional quality, infrastructure development, labor market factors, and fiscal regimes affecting FDI location decisions. Out of over 100 initial sources identified, approximately 40 articles were selected based on methodological rigor and thematic relevance.

A thematic analysis technique was employed to synthesize and interpret the selected literature. Key variables such as market size, factor endowments, trade costs, political stability, and corporate taxation were coded and grouped into broader thematic categories. These categories were then analyzed to identify patterns, overlaps, and distinctions in how different studies conceptualize and empirically assess the determinants of FDI. Comparative interpretation across regional contexts (e.g., Asia, Latin America, Sub-Saharan Africa) further enhanced the depth of analysis and highlighted context-specific insights.

To ensure analytical robustness, the study triangulates findings from multiple empirical settings and integrates them with theoretical insights to develop a coherent understanding of FDI dynamics. The review also identifies conceptual gaps and unresolved debates in the literature, particularly regarding the role of institutional quality and digital infrastructure in shaping investment decisions. These gaps are positioned as potential areas for future empirical research, reinforcing the value of this qualitative synthesis in advancing FDI scholarship.

## 4. Results and discussions

### *4.1. Result*

The OLI paradigm (Ownership, Location, Internalization) remains a foundational framework for understanding the determinants of Foreign Direct Investment (FDI). Recent empirical studies from the past five years have provided nuanced insights into how various host-country factors influence FDI decisions. Below is an expanded analysis of these factors, supported by contemporary research findings. A country's economic size and market potential are pivotal in attracting FDI. Larger economies with robust GDP growth and substantial consumer bases offer more opportunities for foreign investors (Nastiti & Saepudin, 2023). A systematic review by Faruq (2023), highlighted that countries with expanding markets and higher GDP per capita are more likely to receive increased FDI inflows, as they present greater demand and profitability prospects for multinational enterprises (MNEs).

While low labor costs can be an incentive for FDI, their impact varies across industries and regions. In labor-intensive sectors, such as manufacturing, lower wages can attract FDI; however, in high-tech industries, the availability of skilled labor and productivity levels are more critical (Louhenapessy, Leasiwal, Hanoeboen, & Assel, 2024). A study by Yang (2024), found that labor cost differences significantly influence FDI decisions, with MNEs seeking to capitalize on cost-saving opportunities, provided that productivity standards are met.

Competitive corporate tax rates and favorable tax policies can enhance a country's attractiveness to foreign investors. However, the relationship between tax incentives and FDI is complex. While lower tax rates may encourage investment, other factors like market size and political stability often have more substantial impacts. In resource-rich countries, the presence of natural resources can attract FDI, particularly in extractive industries. However, the mere availability of resources is not sufficient; the overall investment climate, including regulatory frameworks and infrastructure, also plays a crucial role. Strong intellectual property rights (IPR) are vital for attracting FDI in knowledge-intensive industries. Robust IPR frameworks assure investors that their innovations and proprietary technologies will be protected (Ölmez, Bilgiç, & Aydın, 2024).

### *4.2. Discussion*

This analysis shows that the drivers of foreign direct investment (FDI) are complex and mutually interdependent. Traditional determinants such as labour costs or natural resources now carry decisive weight only in specific sectors. Contemporary FDI flows depend far more on knowledge capital, digital infrastructure and the political-legal environment. At the same time, a host country’s institutional capacity, education system and innovation climate emerge as central factors. Empirical evidence indicates that reforms combining economic growth with effective governance improve the investment climate. This analysis demonstrates that the determinants of foreign direct investment (FDI) are multifaceted and increasingly shaped by the interaction of economic, institutional, and technological factors. While classical variables such as labor costs, access to natural resources, and market size continue to influence investment decisions, their relevance has become sector-specific. For instance, low labor costs remain a key consideration in manufacturing and textile industries, while the availability of natural resources drives investment in extractive sectors. However, in knowledge-based and high-tech industries, these traditional advantages play a diminished role, giving way to new determinants rooted in intellectual capital and innovation.

Contemporary FDI flows are more strongly influenced by the quality of a country’s digital infrastructure, the availability of skilled labor, and the protection of intellectual property rights. Countries that invest in 5G networks, smart city initiatives, and advanced research and development ecosystems are better positioned to attract investment from multinational enterprises (MNEs) operating in technology-intensive sectors. Moreover, the ability to integrate into global value chains depends not only on physical logistics but also on digital readiness and cybersecurity capabilities, which are increasingly viewed as prerequisites by international investors.

Political and legal stability also plays a critical role in shaping the investment climate. Empirical studies consistently show that countries with transparent legal frameworks, low levels of corruption, and effective regulatory institutions tend to receive more sustained and higher-quality FDI. Institutional capacity including the effectiveness of public administration, enforcement of contracts, and protection of investor rights directly impacts investor confidence. Reforms aimed at enhancing governance, strengthening the rule of law, and simplifying regulatory procedures are thus seen as strategic levers for boosting a country’s attractiveness to foreign investors.

Finally, the synergy between a strong education system and a vibrant innovation ecosystem has emerged as a decisive factor in FDI attraction. Countries that produce a steady pipeline of technically skilled graduates and support university–industry collaboration in R&D are more likely to become innovation hubs. As global investment increasingly targets sectors like artificial intelligence, biotechnology, and clean energy, the ability of a host country to foster innovation will be central to its competitiveness. Empirical evidence supports the notion that structural reforms combining economic liberalization with investments in human capital and institutional effectiveness can significantly improve the FDI landscape and create long-term economic resilience.

## 5. Conclusions

In developing countries, the determinants of FDI have evolved markedly over the past twenty years. Although natural resources and low-skilled labour were historically dominant, today investors' decisions are influenced more strongly by the availability of skilled labour, robust digital infrastructure and institutional quality. A review of the literature makes it clear that relying on a single factor cannot yield optimal results; long-term attractiveness to investors is achieved by developing a balanced mix of determinants. Most researchers agree that, to attract high-value FDI, developing countries must devote greater attention to upgrading their education systems, enhancing digital infrastructure and fostering innovative ecosystems.

### *5.1 Limitations and Future Study*

This study is primarily based on qualitative analysis and a review of secondary sources, which may not capture the full scope of country-specific nuances or real-time investor behavior. The reliance on recent academic literature, though methodologically robust, may exclude insights from unpublished data, government policy documents, or firm-level case studies. Additionally, the generalizations drawn from diverse developing economies may overlook the contextual heterogeneity that exists across regions. As such, the findings should be interpreted with caution and not assumed to apply uniformly across all developing countries.

Future research could benefit from incorporating mixed-method approaches that combine macro-level econometric analysis with micro-level case studies of multinational enterprises operating in diverse sectors. A country-comparative framework could be especially useful in understanding how different combinations of determinants influence FDI inflows. Moreover, longitudinal studies assessing the impact of recent reforms in digital infrastructure and education policy on investment patterns would offer valuable insights. Further investigation into emerging factors such as environmental sustainability, ESG standards, and geopolitical risks may also help to refine the contemporary understanding of FDI determinants.

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