

FACTORS THAT SHAPE WHERE AND HOW FOREIGN DIRECT INVESTMENT FLOWS

Mrs. Kousarziya

Assistant Professor, Department of Commerce
Vidyavahini First Grade College Tumkur Tumkur, -572103, India
Email: kousarziya05@gmail.com

Ms. Devika M S

Assistant Professor, Department of Commerce,
Acharya Institute of Graduate Studies, Soladevanahalli, Bengaluru-560107
Email: devikams1999@gmail.com

Mrs. Razia Kousar

Assistant Professor, Department of Commerce & Management
SSCACs Tumkur, Karnataka, 572101, India
Email: raziakousar436@gmail.com

ABSTRACT:

This paper explores the key factors that shape the flow of Foreign Direct Investment (FDI), focusing on where and how multinational corporations (MNCs) choose to invest across borders. Using foundational theories such as Capital Market Theory, the Product Life Cycle (PLC), and Dunning's Eclectic Paradigm (OLI Model), the study investigates both macrolevel determinants (economic, political, legal, and institutional conditions) and firm-level strategic motivations. The research also analyses global trends, such as the growing role of emerging economies, the rise of digital and green investments, and the reconfiguration of supply chains in the post-pandemic era. Through a comprehensive review of literature and theoretical frameworks, the paper highlights that FDI flows are shaped by a dynamic combination of market opportunities, cost efficiencies, political and legal stability, and strategic firm behaviour. These insights are crucial for policymakers and business leaders in designing environments that attract sustainable foreign investment.

Keywords:

Foreign Direct Investment (FDI), Product Life Cycle (PLC), Dunning's Eclectic Paradigm, OLI Model, Capital Market Theory, Economic Factors, Infrastructure, Labour Costs, Trade Regulations, Political Stability, Entry Mode, Agglomeration, Global FDI Trends, Institutional Quality.

1. INTRODUCTION:

FDI refers to the investment made by the individual or firm in a foreign country or foreign company. FDI is a major component in international capital flow it impact on both the countries.

Understanding the FDI factors is a very crucial aspect for international business for home and host countries for analyzing trends in global market and various elements contributes for selecting the investment location and mode of an investment. FDI influence majorly on the MNC investment pattern. Understanding motivational and constraints which influence MNCs in choosing where and how to invest in foreign country. it is very essential for developing effective economics policies nature of FDI inflows various across the globe due to the various factor this paper aims to explore it.

2. OBJECTIVES:

- Identifying and analyzing the various elements that influence the location and mode of FDI flow.
- Analyzing current trends at global market in FDI pattern.

3. THEORETICAL FRAME WORK:

- **Capital market theory:** it allows us to view the MNCs as rational investors allocating capital across international markets to optimize returns and risk. It provide idea that FDI flows are driven not only by market

size or resources endowment but also by risk return dynamics, diversification strategies and the efficiency of capital markets in host countries.

- **Product life cycle:** the product life cycle theory by Raymond Vernon describes why U.S manufacturers are shifting from exporting to FDI. How the location of production and investment evolves over the life cycle of a product. It outlines four stages in the life of a product:
 1. Introduction
 2. Growth
 3. Maturity
 4. Decline

Application of PLC Theory to FDI: PLC theory can help explain where and how multinational firms decide to invest abroad:

Stage	FDI Behaviour	Location Preference	Mode of Entry
Introduction	Focus on innovation and control	Home country or other advanced economies	Greenfield (own R&D, close to HQ)
Growth	Expand production to serve rising foreign demand	Developed and upper-middle income countries	M&A or Greenfield to scale up quickly
Maturity	Focus on cost-cutting and efficiency	Low-cost countries (e.g., Asia, Latin America)	Joint ventures, outsourcing, offshoring
Decline	Divestment, local partnerships, or shift to new products	Countries with lowest cost structures	Licensing or divestment

Product Life Cycle (PLC) Theory serves as the theoretical framework for analyzing FDI flows. It explains how multinational corporations (MNCs) shift their investment and production strategies as their products move through various stages—introduction, growth, maturity, and decline. According to the PLC Theory, firms initially invest in R&D-intensive environments but gradually move production to developing countries to cut costs and maintain competitiveness. This framework helps identify the dynamic patterns behind where and how FDI occurs over time.

- **Dunning's Eclectic Paradigm (OLI Model):** Proposed by John H. Dunning in the late 1970s, the Eclectic Paradigm—also known as the OLI Model—posits that three interrelated advantages influence a firm's decision to engage in FDI: ⁽¹⁾Ownership Advantages; These refer to firm-specific assets such as proprietary technology, brand reputation, managerial skills, or access to capital. Firms with significant Ownership advantages; are more likely to expand internationally, as these strengths give them a competitive edge abroad. ⁽²⁾L – Location Advantages; These pertain to country-specific factors that make a host nation attractive for investment, such as market size, labour cost, resource availability, political stability, tax policies, infrastructure, and access to regional or global markets. These factors largely explain where FDI flows. ⁽³⁾I– Internalization Advantages; These describe the benefits of retaining control over operations rather than outsourcing through licensing or franchising. By internalizing operations, firms can reduce transaction costs, safeguard proprietary knowledge, and manage quality and logistics more effectively. The OLI model offers a unified explanation for both the location (where FDI flows) and the entry mode (how FDI flows). **4. Factors influencing FDI: (location)**

4.1. Economic factor:

- **Market size and growth:** Rapidly growing market opportunities and size of the business always demands more investment for the business. It automatically attracts the FDI. Reliable transportation, communication, and utilities support efficient business operations. Countries with lower labour and production costs are attractive for manufacturing FDI.

4.2. Political factor:

- **Politically stable environment:** always attract investors. Investors prefer politically stable environments where property rights and business laws are consistently enforced. Political unrest or frequent policy shifts increase risk whereas investors are reluctant to invest in politically unstable regions.
- 4.3. Legal factor:**
- **Legal system:** Clear, predictable, and enforceable legal systems give investors' confidence. Strong and transparent legal frame work related to Intellectual property right leads for Protection of intellectual property, investor rights, and dispute resolution is critical. Transparent legal systems that protect property rights and enforce contracts attract more FDI.
 - **4.4. Tax Policies and Incentives:** Tax breaks, subsidies, and investment incentives can significantly influence FDI location.
 - **4.5. Trade and investment agreements:**
 - **Bilateral Investment Treaties (BITs)** :bilateral trade agreement are the agreement between countries to promote trade and commerce . Countries which have BITs always attract investors because of the favourable trade policies, reducing trade barriers, increasing foreign market access all this boosts the FDI to the countries.

5. Factors influencing form of FDI:

5.1 Entry mode:

- **Green field investment:** It's a type of FDI where a parent company builds its operations in foreign country from ground up. along with construction of new production facilities ,these projects also includes building of new distribution hubs, office and living quarters.
- **Mergers and acquisition:** Buying or merging with existing firms provide instant market access, brand recognition and local knowledge quicker enter but higher risk. M and A is a faster and less risky than greenfield investment Merger and acquisition company to allows foreign company to quickly gain market share ,access existing infrastructure and customer bases.
- **Joint Ventures:** A joint venture is a type of business combination where two or more firms come together to form a new entity, such as a partnership or corporation, in order to enter a new market with reduced risk and leverage their core strengths to increase profits. Sharing ownership with local firms; used when legal or cultural barriers exist. Shared ownership between foreign and local firms.it is Useful when local knowledge, political support, or legal compliance is required.

6. Global Trends and Emerging Patterns:

- Shift of FDI toward emerging economies in Asia and Africa.
- Rise of **South–South FDI** (investments between developing countries).
- Increased FDI in digital infrastructure and green technologies.
- Post-pandemic reconfiguration of global supply chains.

LITERATURE REVIEW

The flow of Foreign Direct Investment (FDI) is influenced by a complex interplay of economic, institutional, and geographic factors. A substantial body of research has investigated the determinants of FDI, broadly categorizing them into market-related, policybased, institutional, and firm-level factors. This section synthesizes key findings from the literature to identify the principal variables shaping where and how FDI occurs.

Macroeconomic Fundamentals and Market Size:

Early theoretical frameworks, particularly Dunning's Eclectic Paradigm (1981), emphasize the importance of "location-specific advantages" in attracting FDI. Among these, market size and macroeconomic stability are frequently highlighted. Empirical studies such as Chakrabarti (2001) demonstrate that GDP and economic growth are among the most significant variables influencing FDI inflows. These findings suggest that multinational enterprises (MNEs) seek out larger, more dynamic economies as investment destinations to maximize profit potential and operational scalability.

Trade Openness and Infrastructure Development:

Another crucial determinant is the degree of trade openness and the quality of infrastructure in host countries. Open economies tend to facilitate easier cross-border operations and access to inputs and markets. Wheeler and Mody (1992) find a positive correlation between infrastructure—especially transport and communication networks—and FDI inflows, particularly in the manufacturing sector. Similarly, Asiedu (2002) shows that trade openness significantly boosts FDI, though its effect is heterogeneous across regions.

Institutional Quality and Political Stability:

The quality of governance, legal systems, and political stability are critical in reducing transaction costs and investment risks. Globerman and Shapiro (2002) assert that countries with strong institutions attract more FDI due to greater investor confidence and lower risks of expropriation or policy reversal. In a similar vein, Busse and Hefeker (2007) find that political risk indicators—such as corruption, government stability, and law enforcement—are robust predictors of FDI levels, especially in politically volatile regions.

Labor Market Conditions: Cost and Human Capital:

Labor costs and the availability of skilled workers are also key considerations for foreign investors. Noorbakhsh, Paloni, and Youssef (2001) argue that human capital has become increasingly important for FDI decisions, particularly in knowledge-intensive industries. Furthermore, Blonigen (2005) emphasizes that while lower labor costs are attractive, they are not sufficient unless accompanied by a minimum threshold of skills and productivity.

Geographic and Cultural Proximity:

Geographical distance and cultural affinities have been shown to influence FDI flows by reducing transaction costs and information asymmetries. Head and Mayer (2004) demonstrate that Japanese firms investing in the European Union prefer locations that are geographically and culturally closer. This pattern is further confirmed by Bevan and Estrin (2004), who find that European investors tend to direct FDI towards neighboring transition economies in Central and Eastern Europe.

Type of FDI: Horizontal vs. Vertical Motives:

The motivation behind FDI also shapes where and how it occurs. Horizontal FDI, driven by market-seeking motives, is primarily influenced by market size, trade barriers, and proximity to customers. In contrast, vertical FDI, often efficiency-seeking, depends on cost differentials, especially in labor and input prices. Helpman, Melitz, and Yeaple (2004) provide a theoretical framework illustrating how firm heterogeneity and host-country characteristics determine the choice between exporting, FDI, and outsourcing.

CONCLUSION:

Foreign Direct Investment (FDI) plays a pivotal role in the globalization of business and the economic development of both home and host countries. This paper has shown that the determinants of FDI are multifaceted, encompassing economic indicators such as market size and infrastructure, institutional elements like political stability and legal frameworks, and firm-level considerations guided by theories such as the Product Life Cycle and the OLI Model. The mode and destination of FDI are shaped by both global economic shifts and company-specific strategies that balance risk, control, and efficiency.

Theoretical frameworks including Dunning's Eclectic Paradigm and Capital Market Theory provide a robust foundation to understand how firms navigate complex international environments. Meanwhile, evolving global patterns—such as the rise of South–South FDI, investments in digital and green sectors, and post-COVID supply chain realignments—underscore the dynamic nature of international investment decisions.

Policymakers aiming to attract sustainable FDI should focus on building transparent institutions, stable political environments, modern infrastructure, and favorable investment conditions. For MNCs, understanding these factors is essential to optimizing location and entry strategies. By integrating both theory and empirical evidence, this study contributes to a deeper understanding of the mechanisms behind FDI flows in an increasingly interconnected world.

REFERENCES:

- 1) Dunning, J. H. (1981). *International Production and the Multinational Enterprise*. Allen & Unwin.
- 2) Chakrabarti, A. (2001). The determinants of foreign direct investments: Sensitivity analyses of cross-country regressions. *Kyklos*, 54(1), 89–114.
- 3) Asiedu, E. (2002). On the determinants of foreign direct investment to developing countries: Is Africa different? *World Development*, 30(1), 107–119.
- 4) Globerman, S., & Shapiro, D. (2002). Global foreign direct investment flows: The role of governance infrastructure. *World Development*, 30(11), 1899–1919.
- 5) Busse, M., & Hefeker, C. (2007). Political risk, institutions and foreign direct investment. *European Journal of Political Economy*, 23(2), 397–415.
- 6) Wheeler, D., & Mody, A. (1992). International investment location decisions: The case of U.S. firms. *Journal of International Economics*, 33(1–2), 57–76.
- 7) Blonigen, B. A. (2005). A review of the empirical literature on FDI determinants. *Atlantic Economic Journal*, 33, 383–403.

IJETRM

INTERNATIONAL JOURNAL OF ENGINEERING TECHNOLOGY RESEARCH & MANAGEMENT (IJETRM)

Peer-Reviewed | Open Access | International Journal

<https://ijetrm.com/>

- 8) Noorbakhsh, F., Paloni, A., & Youssef, A. (2001). Human capital and FDI inflows to developing countries: New empirical evidence. *World Development*, 29(9), 1593–1610.
- 9) Head, K., & Mayer, T. (2004). Market potential and the location of Japanese investment in the European Union. *Review of Economics and Statistics*, 86(4), 959–972.
- 10) Helpman, E., Melitz, M., & Yeaple, S. (2004). Export versus FDI with heterogeneous firms. *American Economic Review*, 94(1), 300–316.
- 11) Bevan, A., & Estrin, S. (2004). The determinants of foreign direct investment into European transition economies. *Journal of Comparative Economics*, 32(4), 775–787.