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The Influence of Rule of Law on Foreign Direct Investment: Evidence from India and Vietnam

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ABSTRACT

Foreign direct investment (FDI) location decisions are influenced by a combination of economic, strategic and institutional conditions. This paper examines the extent to which rule of law influences FDI attractiveness, with particular reference to India and Vietnam. Dunning's OLI framework is used to position institutional quality within the broader location advantages affecting investment decisions. Through a synthesis of existing empirical literature and comparative case studies, the analysis finds substantial evidence of a positive relationship between rule of law and FDI, although important exceptions remain. India and Vietnam both attract significant foreign investment despite continuing institutional weaknesses, suggesting that other location advantages, including market opportunities, trade integration, labour conditions and strategic positioning, can partially compensate for institutional risk. The paper concludes that rule of law can strengthen FDI attractiveness by improving predictability and reducing investment risk, but its influence is conditional and does not independently determine foreign investment flows.

Keywords: Foreign Direct Investment (FDI), Rule of Law, Institutional Quality, OLI Framework, India and Vietnam

INTRODUCTION

Foreign direct investment (FDI) is an important means of economic and financial integration of economies (OECD, 2025a). FDI can be an important and stable source of capital, especially for developing countries, and can contribute greatly to development by diversifying risk and imposing market disciplines (Jun, 1996). As a result, understanding why investors pick particular host countries is economically important. In reality, these decisions are complex and depend on several host-country characteristics such as market size, labour, infrastructure, trade access and institutional conditions.

Among these institutional determinants is the rule of law. The World Justice Project (2024) defines the rule of law as "a durable system of laws, institutions, norms, and community commitment that delivers four universal principles: accountability, just law, open government, and accessible and impartial justice". For foreign investors, a stronger rule of law can reduce risk by providing regulatory predictability, property and contract protection and effective dispute resolution. However, while theory suggests that a

strong rule of law should encourage FDI, empirical evidence is not always consistent, and some countries continue to attract substantial FDI despite institutional weaknesses. In this context, India and Vietnam offer particularly interesting case studies, as both are major developing Asian FDI destinations but have different economic structures and location advantages. Accordingly, this research paper aims to answer the following question: To what extent does rule of law influence foreign direct investment attractiveness, with reference to India and Vietnam?

Through the examples of India and Vietnam, this research paper aims to argue that a strong rule of law can increase FDI attractiveness by improving predictability and reducing institutional risk, but its influence is conditional, not independently determinative. Other location advantages can commonly compensate for institutional weaknesses.

FOREIGN DIRECT INVESTMENT: THEORETICAL DETERMINANTS AND THE ROLE OF INSTITUTIONS

FDI is defined as "the investment made by individuals or businesses from one country into the businesses of another country, granting significant influence in the foreign enterprise's decision-making processes" (Bernstein, 2023). According to UNCTAD (2026), global FDI rose 6% to $1.6 trillion in 2025. As shown in Figure 1, developing countries saw most inflows, with developing Asia being the largest recipient region, attracting $644 billion. Given the significant scale of these flows and the competition between countries to attract foreign capital, it is crucial to understand the factors that influence a firm's location decisions.

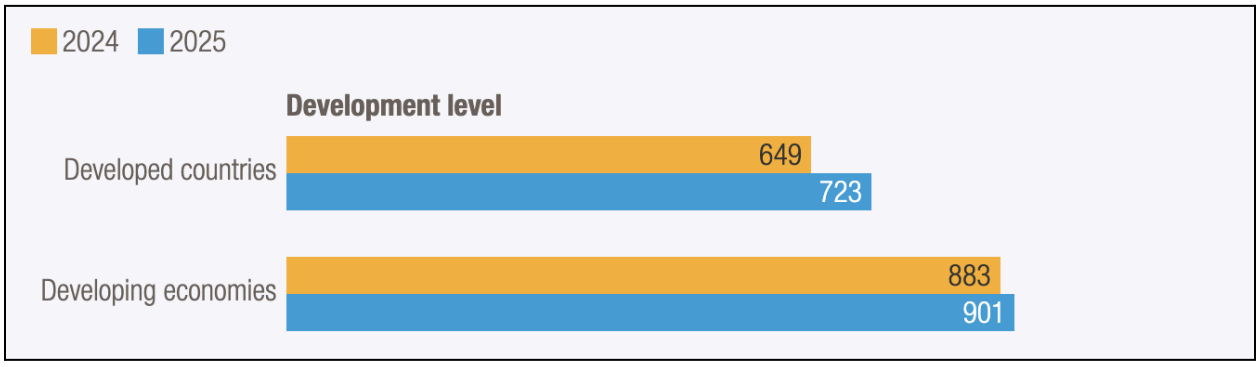

Figure 1: FDI Inflows by Development Level, 2024-2025 (UNCTAD, 2026)

Dunning's Eclectic Paradigm, or the OLI framework, based on the theory of British economist J.H Dunning, is used to analyse what makes a country attractive to FDIs (CFI, 2022). It is divided into three main factors: Ownership, Location, and Internalisation. Ownership advantage refers to a unique, valuable resource or capability that competitors cannot easily imitate. This may include technology, intellectual

property, managerial expertise or branding. Such advantages are often intangible and provide firms with a source of competitive advantage (Chen, 2019). Location advantages focus on the characteristics of the host country that make it attractive for investment. Beyond simple geographic location, these advantages also commonly include: market size and growth, legal systems, labour availability and costs, infrastructure, access to international markets, trade agreements, taxation and political stability. FDI location decisions are, therefore, inherently multidimensional. Internalisation advantage concerns how the firm should produce the product. The investing firm usually assesses the benefits of in-house production versus outsourcing before proceeding with an FDI. Of these three dimensions, location advantages are particularly relevant to understanding FDI flows between countries because they explain the factors that may attract or deter foreign investors.

Among the many location advantages, market size, labour costs and infrastructure are not the only factors that affect FDI. Firms also closely consider the host country's institutional environment. Consequently, institutional quality can be understood as another component of a country's location advantage within the OLI framework. Sabir, Rafique and Abbas (2019) describe institutions as the formal and informal rules within which economic actors operate. While good institutions can reduce transaction, manufacturing and production costs, poor institutions require firms to devote more time and resources to monitoring. Moreover, where property rights are poorly protected and contracts are difficult to enforce, risk premiums increase, potentially discouraging international investors. According to their analysis, institutional quality has a greater influence in developed countries, while other factors can play a larger role in determining FDI in developing economies.

Institutional quality is well reflected in the rule of law. As per the UN (2015), "the rule of law is a principle of governance in which all persons, institutions and entities, public and private, including the State itself, are accountable to laws that are publicly promulgated, equally enforced and independently adjudicated". The European Commission (2023) further states that the rule of law "can be defined along six principles: legality, implying a transparent, accountable, democratic and pluralistic process for enacting laws; legal certainty; prohibition of the arbitrary exercise of executive power; effective judicial protection by independent and impartial courts with effective judicial review including respect for fundamental rights; separation of powers; and equality before the law". Relevant to this paper, the Commission also explicitly reiterates the role of the rule of law in creating a predictable environment for businesses and explains that legal certainty requires clear, foreseeable rules so businesses are aware of their rights and obligations.

The World Justice Project (WJP) publishes a Rule of Law Index. It includes eight indicators: Constraints on Government Powers, Absence of Corruption, Open Government, Fundamental Rights, Order and Security, Regulatory Enforcement, Civil Justice and Criminal Justice. While this reflects the multidimensional nature of the rule of law, some factors are particularly relevant to foreign investors. For instance, under regulatory enforcement, WJP specifically assesses whether regulations are enforced effectively and fairly, whether governments avoid unlawful expropriation and whether administrative proceedings avoid unreasonable delays. Civil justice also includes whether proceedings avoid

unreasonable delays and if dispute-resolution mechanisms are accessible, impartial and effective. Even the absence of corruption, covering bribery, improper influence and misuse of public resources, is important for businesses as it reduces their exposure to arbitrary costs and improper influence. A strong rule of law should therefore make a host country more attractive for FDI by increasing predictability and reducing institutional risk. However, as OLI demonstrates that location attractiveness is multidimensional, a strong rule of law is only one potential determinant alongside the others mentioned previously.

While this section provides a theoretical basis for expecting rule of law to influence FDI, whether this relationship is consistently observed in real-life requires an examination of the existing empirical evidence.

THE RELATIONSHIP BETWEEN RULE OF LAW AND FOREIGN DIRECT INVESTMENT (FDI)

Extensive empirical research has examined the role of the rule of law in inward FDI. The table below summarises the main findings.

Study	**Scope**	**Main Finding**
Busse and Hefeker (2007)	83 developing countries covering 1984 to 2003	The rule of law, government stability, democratic rights and the absence of internal conflicts heavily influence where foreign investors commit capital.
Gani (2007)	Panel Data of countries from Asia and Latin America	The Rule of Law alongside regulatory quality, control of corruption and government effectiveness are positively correlated with attracting FDI inflows.
Alexander (2014)	Original survey of U.S. based CEOs, phone interviews, statistical analysis and a case study of China	Investors prefer countries that protect contract, property and physical integrity rights. Where the rule of law is weak, investors leverage personal relationships with business partners and government connections to reduce the uncertainty. Moreover, investors prefer personal relationships over formal rule-of-law substitutes like bilateral investment treaties and special economic zones.
Henisz (2000)	Dataset covers 461 multinational firms managing 3,389 overseas manufacturing operations	Stronger political constraints and institutions protecting the rule of law directly drive higher economic growth and mitigate political hazards for multinational corporations

	across 112 countries	
Hossain and Rahman (2017)	80 developing countries covering 1998 to 2014	A strong rule of law serves as a significant catalyst for economic growth. A one-standard-deviation improvement in rule of law was associated with a 23.1% increase in FDI under the study's pooled OLS estimation.
Staats and Biglaiser (2012)	Panel data from Latin American countries and findings from a survey of US corporations	Judicial strength and rule of law are critical independent drivers of FDI
Rodríguez-Pose and Cols (2017)	Institutional data for 22 countries in Sub-Saharan Africa	Factors such as political stability, government effectiveness, lower corruption, voice and accountability and the rule of law are important determinants of FDI. Their influence on the capacity of African countries to attract FDI is long-lasting
Panthamit and Chaiboonsri (2020)	China's OFDI activities with Greater Mekong Subregion countries, namely (Cambodia, Lao, Myanmar, Vietnam & Thailand) during 2007 and 2016.	Higher rule of law decreases the probability of being a recipient of Chinese OFDI
Wang, Du and Wang (2015)	Deal-level Chinese ODI from 2002 to 2011	China's ODI tends to avoid countries with strict legal systems. Tax evasion and resources are major motives of China's ODI.

Across different regions and samples, the majority of studies find a positive relationship between the two variables: stronger rule of law and higher FDI inflows. The primary reasons for the aforementioned are that a stronger rule of law makes a country more attractive to investors because it reduces uncertainty and investment risk through stronger protection of property rights, better judicial effectiveness, more reliable contract enforcement, lower risks of arbitrary government intervention and greater regulatory predictability. This is particularly important for FDI because, unlike short-term portfolio investment, FDI involves significant sunk costs, physical assets and long-term commitments in the host country, making investors more vulnerable to changes in regulation, government behaviour and contractual disputes. The

relationship is also economically meaningful as evidenced by Hossain and Rahman's (2017) finding that a one-standard-deviation improvement in rule of law is associated with a substantial increase in FDI.

That said, the relationship is not universal. Some studies find weak, insignificant or even negative relationships between rule of law and FDI. As Panthamit and Chaiboonsri (2020) and Wang et al. (2015) note, Chinese investors may sometimes favour countries with weaker institutional and legal environments. These contradictions may suggest that the influence of the rule of law partly depends on foreign investors' characteristics and motivations. For instance, it is possible that private firms making long-term market-seeking investments would place more value on contract enforcement, property rights and judicial reliability as these institutions reduce the risks associated with committing capital. On the other hand, state-owned enterprises, firms supported by strong bilateral political relationships or resource-seeking investors may be more willing to operate in countries with weaker legal institutions.

On the whole, the rule of law should be recognised as an important but non-deterministic influence on FDI. While stronger legal institutions can reduce investment risk and increase a country's attractiveness to foreign investors, the rule of law operates alongside other determinants of FDI, including market size, infrastructure, labour costs and taxation. A country with a weaker rule of law may continue to attract FDI if it offers sufficiently strong economic or strategic advantages. Conversely, strong legal institutions alone may prove insufficient to generate high FDI inflows where other conditions remain unattractive.

CASE STUDY I: RULE OF LAW AND FOREIGN DIRECT INVESTMENT IN INDIA

India is a major FDI destination. Data from IBEF (2026) suggests that cumulative gross FDI inflows reached $1.16 trillion between April 2000 and March 2026. FDI inflows increased by 20-fold between FY2001 and FY2026. The most recent data from FY2025-26 alone, seen in Figure 2, shows approximately $94.5 billion in total FDI inflows. India's FDI growth makes it a useful lens through which to examine how significant the rule of law is as a determinant of FDI relative to other influences.

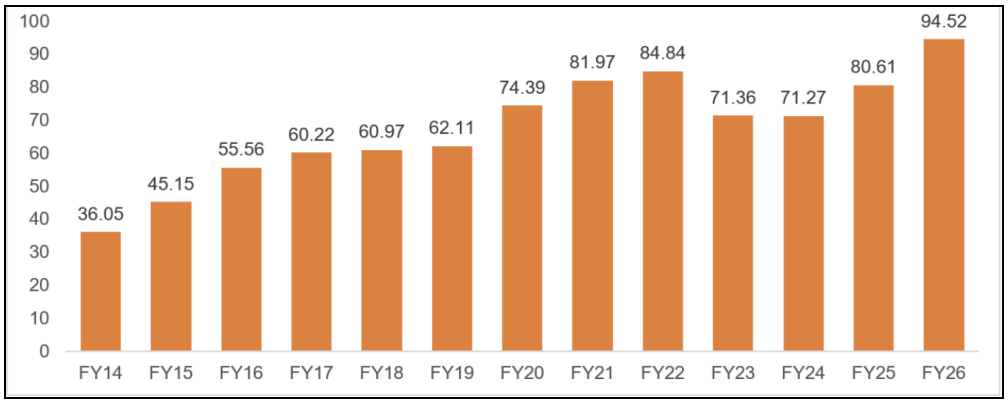

Figure 2: India's FDI Inflows (US$ billion) (IBEF, 2026)

Under the 2025 WJP Rule of Law Index, India's score is 0.49, and its global rank is 86 out of 143. Although FDI inflows have been increasing, interestingly, as seen in Figure 3 below, the country's score has fallen over the years. Of the WJP factors relevant to foreign investors, India scores lowest on absence of corruption (0.4), regulatory enforcement (0.48) and civil justice (0.42).

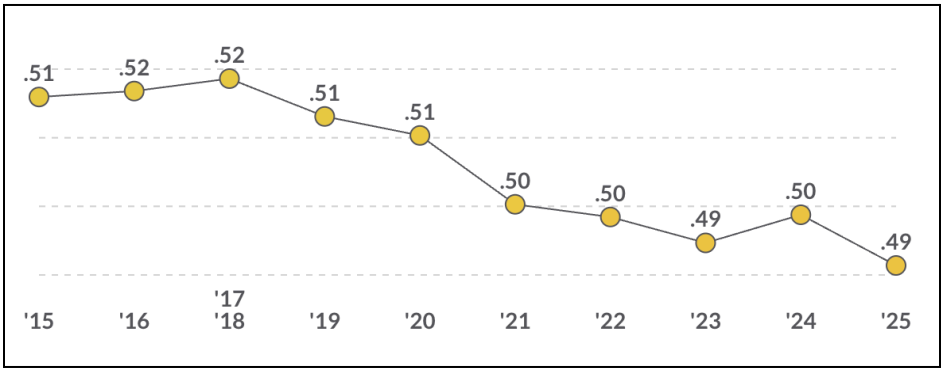

Figure 3: India's Overall Rule of Law Score Over Time, 2015 - 2025 (WJP, 2025a)

As Sachdev (2006) notes, predictability is particularly important in the FDI context and is largely linked to intelligible and enforceable commercial/contract law, property-rights protection and an impartial and efficient judiciary. However, in India, bureaucracy, lengthy approval processes and red tape repeatedly arise as investor concerns. Based on a historical analysis, he concluded that India's FDI governance was comparatively convoluted and lengthy procedures could deter investment. However, this study is from 2006 and more recent research, such as that from NITI Aayog (2026), may provide a more accurate picture of the present scenario. The 2026 Investment Friendliness Index explicitly evaluates regulatory ease and institutional environment as components of state investment friendliness. Its assessment includes: contract enforcement, land allotment, permits and clearances, access to commercial courts and business closure. The findings suggest that even Karnataka, recognised as one of the country's leading investment destinations, has scope to improve contract enforcement, access to commercial courts, permits and land approvals. According to NITI, improvements in contract enforcement and commercial-court

access can bolster investor confidence significantly. These findings indicate that weaknesses in regulatory enforcement may constrain India's investment attractiveness as uncertainty, difficulties in dispute resolution and delays can all increase the costs and risks of committing long-term capital.

That said, the government has actively changed legal arrangements in order to improve India's investment attractiveness. As per Dentons, reforms have played an important role in streamlining previously bureaucratic elements of the regulatory system. For instance, since September 2024, foreign companies looking to undertake certain 'reverse flip' mergers no longer need to get approval from the National Company Law Tribunal. This has reportedly reduced the relevant process time from a minimum of 12-18 months to around 3-4 months (McBirnie and Das, 2024). In addition, IBEF (2026) acknowledges easier FDI norms and efforts to improve ease of doing business in the country, including the introduction of GST to simplify the tax framework and increase transparency. This highlights how India's own policy direction supports the proposition that institutional and legal quality matters for FDI attractiveness.

An important question remains: If India’s rule-of-law environment continues to exhibit certain weaknesses, why does the country attract such substantial FDI? According to a study by R. et al. (2025), several determinants beyond the rule of law impacted FDI in India between 2000 and 2023. These included GDP, infrastructure, technological capability and trade agreements. Beyond these, India also has competitive labour costs, a large and growing domestic market and certain tax and investment incentives. Because multinational organisations do not make location decisions based solely on legal institutions, the other aforementioned factors may make investors more willing to tolerate greater institutional or regulatory risk in exchange for higher potential returns, lower production costs and access to a wider range of skills.

India provides qualified support for a positive relationship between rule of law and FDI. India's recent reforms show how regulatory predictability, effective enforcement and efficient dispute resolution can strengthen investor confidence. However, the country's substantial FDI despite continuing institutional weaknesses shows that rule of law is not independently determinative. Factors such as India's market size, growth prospects and other economic advantages can partially compensate for institutional risk. Overall, while the rule of law is one important determinant of India's FDI attractiveness, it operates alongside wider economic and location advantages.

CASE STUDY II: RULE OF LAW AND FOREIGN DIRECT INVESTMENT IN VIETNAM

Similar to India, Vietnam has also proven to be a highly successful FDI destination. The country's inward FDI stock has increased at an average annual rate of 13.1% since 2007, the year it joined the World Trade Organisation (WTO). It is important to note that Vietnam is a much smaller economy, so these inflows have been particularly impressive relative to its size. For instance, between 2015 and 2023, FDI inflows averaged 4.8% of GDP, exceeding ASEAN peers as well as India and China, as seen in Figure 4 (OECD,

2025b). Vietnam's sustained FDI performance makes it another valuable case for examining whether its rule-of-law environment helps explain investment attractiveness or whether other location advantages matter more.

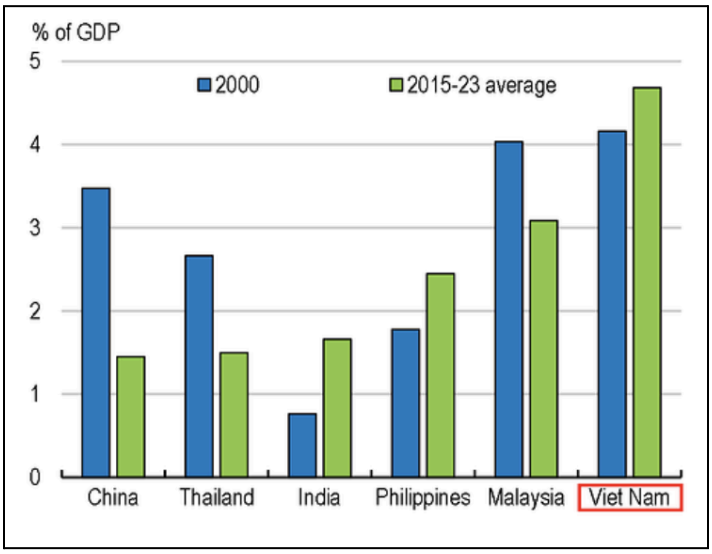

Figure 4: FDI Inflows as a Percentage of GDP, 2015-23 (OECD, 2025b)

Vietnam's success in attracting FDI exists alongside meaningful rule-of-law weaknesses. WJP's 2025 score for the country was approximately 0.5, and the global ranking was 83/143. Scores for the relevant investor factors include corruption (0.43), regulatory enforcement (0.45) and civil justice (0.47). Foreign investors have commonly reported inconsistent regulatory interpretation, unclear legal frameworks, irregular enforcement, as well as concerns about slow government decision-making (U.S. Department of State, 2025). These trends directly undermine the predictability that foreign investors commonly value. Even when the written law may be favourable to investors, inconsistent application makes it harder for firms to anticipate future costs, treatment by authorities, dispute outcomes and regulatory obligations. Consequently, these institutional weaknesses could theoretically make Vietnam less attractive than it otherwise would be.

In light of the above, Vietnam's recent attempts to simplify and clarify its investment regime are particularly relevant to analyse. The Law on Investment 2025, effective 1 March 2026, was introduced with the explicit aim of simplifying market-entry procedures for foreign investors and shifting aspects of government management from pre-inspection to post-inspection supervision (Dentons LuatViet, 2026). For example, foreign investors previously needed an Investment Registration Certificate before incorporating a company. However, under the new framework, foreign investors can establish the project-implementing FDI enterprise prior to completing certain investment procedures. Such reforms directly target the mechanisms through which institutional weakness can increase FDI costs and can foster a more predictable investment process, making long-term commitments less risky. However, given the

recency of these reforms, they do not explain Vietnam's historically strong FDI performance; instead, they indicate attempts to improve its future investment environment.

Once again, though, Vietnam's high FDI cannot be explained by the rule of law alone. Vietnam has many other powerful location advantages which make it attractive to multinational investors. As per the OECD (2025b), these include: extensive integration into the global trading system - Vietnam has 17 bilateral/plurilateral free trade agreements (FTAs); strategic location near major suppliers and consumer markets including China; a growing domestic economy; and a young and affordable workforce. These factors are particularly attractive for firms using Vietnam as an export/manufacturing base, those looking to integrate into existing Asian supply chains and those seeking lower logistics and manufacturing costs. As a result, such investors may be more accepting of greater regulatory and institutional risk because the economic benefits of locating production in Vietnam can offset some of that risk.

Like India, Vietnam also provides qualified support for the rule of law-FDI relationship. It shows how regulatory inconsistency and unpredictability can increase investor risk, while recent reforms have attempted to address such institutional barriers. However, once again, the country's sustained FDI success despite these weaknesses shows that the rule of law does not independently determine FDI. Instead, trade integration, strategic location, supply-chain access and labour advantages partially compensate for any arising institutional risk. The final judgment is that the rule of law influences Vietnam's investment environment, but its effects operate closely with powerful location-specific advantages

CONCLUSION

This paper examined the extent to which the rule of law influences foreign direct investment attractiveness, with reference to India and Vietnam. The evidence provides qualified support for a positive relationship. Across much of the empirical literature, stronger rule of law is associated with higher FDI, as effective contract enforcement, property-rights protection, regulatory consistency and judicial effectiveness can reduce uncertainty and institutional risk for foreign investors. However, the literature also demonstrates that this relationship is not universal. In particular, evidence concerning Chinese outward investment suggests that investor characteristics and motivations may alter the importance attached to institutional quality.

The cases of India and Vietnam reinforce this complexity. Both countries have attracted substantial FDI despite relatively modest rule of law scores and continuing weaknesses in areas such as regulatory enforcement and civil justice. In India, its large domestic market, economic growth, technological capabilities and other investment advantages may partially compensate for institutional risk. Similarly, Vietnam benefits from extensive trade integration, competitive labour costs, strategic proximity to major Asian markets and its position within regional manufacturing supply chains. Recent legal and regulatory reforms in both countries nevertheless indicate recognition that greater predictability and institutional efficiency can further strengthen their investment environments.

Therefore, rule of law should be understood as an important enabling condition for FDI rather than an independently determinative factor. Consistent with the OLI framework, location attractiveness emerges from a combination of institutional, economic and strategic advantages. The influence of rule of law consequently depends partly on the strength of these competing advantages and the characteristics of the investor. While the two-country comparison cannot establish a universal causal relationship, the findings suggest that improving legal certainty and regulatory effectiveness can reduce investment risk and strengthen long-term FDI attractiveness.

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