Rolling Out the Red Carpet: Investment Promotion and FDI Inflows

Investment promotion is viable option for developing countries that wish to attract FDI

Torfinn Harding and Beata Smarzynska Javorcik

Countries around the world compete fiercely to attract foreign direct investment (FDI). Policymakers, especially those in developing countries, hope that FDI inflows will bring much-needed capital, new technologies, marketing techniques and management skills. Foreign investment is expected to create jobs and increase the overall competitiveness of the host economy.

Technological progress which allows firms to split various stages of production, declines in transport and communication costs, increasing openness of countries to foreign capital, and international trade have increased the attractiveness of spreading the production chain across various geographic locations. This phenomenon has led to a spectacular increase in global FDI flows thus giving more countries an opportunity to become part of the global production chains. But it has also intensified competition for FDI.

In response, many countries have set up investment promotion agencies (IPAs) as a key part of their strategy to attract foreign investors — there are more than 160 IPAs at the national level and over 250 at the sub-national level. In 2004, the total spending of the 82 IPAs that reported their budget figures in the recent IPA Census reached almost a billion dollars; a quarter of this amount was spent on investment promotion (see Table). In addition, some IPAs are empowered to provide support in the form of tax holidays or other quasi-fiscal measures.

The main purpose of investment promotion is to reduce the costs of FDI by providing information on business conditions and opportunities in the host economy and by helping foreign investors cut through bureaucratic procedures. Investment promotion activities encompass: advertising, investment seminars and missions, participation in trade shows, one-to-one direct marketing efforts, matching prospective investors with local partners, helping obtain permits and approvals, preparing project proposals, conducting feasibility studies and servicing investors whose projects have already become operational. As obtaining information on investment opportunities in developing countries tends to be more difficult than gathering data on industrialized economies, investment promotion should be particularly effective in a developing country context.

How Inward Investment Promotion Works

Investment promotion can affect the choice of foreign investment site at all stages of the decision-making process. The process of site selection usually starts with drawing a long list of potential host countries. Such list typically includes 8 to 20 countries which can be thought of as belonging to three groups:

- most popular FDI destinations in the world,
- countries close to the existing operations of the investor, and
- emerging FDI destinations (i.e., countries that the investor may not be initially very serious about but which represent "out of the box" thinking).

Size of Investment Promotion Budget in 2004 by Income Group

Income group	FDI promotion budget in 2004	
	Median	Mean
High income	US$1,214,708	US$9,447,493
Upper middle income	US$487,480	US$1,376,448
Lower middle income	US$342,319	US$983,926
Low income	US$304,349	US$534,864

Notes: Based on 19 responses for HI, 15 for UMI, 18 for LMI and 14 for LI .
Source: IPA Census 2005.

The inclusion of the third category presents an opportunity for IPAs to increase the chances of their country being listed via advertising, trade shows or pro-active contacting of potential investors. The long list is then narrowed down to about five potential sites based on the trade-off between costs and the quality of business environment. As this is usually done without visiting sites under consideration, the accessibility of the information about potential host countries plays a crucial role. IPAs that provide up-to-date, detailed and accurate data on their websites and IPAs that are willing to spend time preparing detailed answers to investors' inquiries and customize these answers to the needs of an individual investor can increase the chances of their countries being included in the short list. A visit by the investor to the host country, which is the next step in the process, gives IPAs the opportunity to emphasize the advantages of locating in their country, answer questions, show off potential investment sites and facilitate contacts with the local business community. IPAs can also play a role in the final stage of the process by providing information on investment incentives and offering help with the registration process.

Does it Work?

Is there any indication that investment promotion leads to higher FDI inflows? To examine this question, it is helpful to rely on the fact that the majority of IPAs target particular sectors in their efforts to attract FDI, as it is believed that more intense efforts concentrated on a few priority sectors are likely to lead to greater FDI inflows than less intense across-the-board attempts to attract FDI. If investment promotion is effective then we expect to see that priority sectors experience an increase in FDI inflows after targeting starts relative to non-priority sectors during the same time period.

The detailed information on priority sectors and the timing of FDI targeting activities in developing countries combined with the figures on flows of US FDI, disaggregated by host country and sector, suggests that investment promotion efforts are associated with higher FDI inflows to developing countries.

Priority sectors receive more than twice as much FDI as sectors not targeted by IPAs. While the magnitude of the effect may seem large, it is not implausible. If we consider only positive flows of US FDI to developing countries, the median sector-level flow to a host country was equal to US$11 million during the 1990-2004 period. Thus, the estimated effect of investment promotion translates into an additional annual inflow of US$17 million for the median sector-country combination. A quick look at the amounts multinational corporations actually invest in developing countries reveals that FDI inflows of that magnitude are not uncommon. For example, in 2005 Wal-Mart planned to open 70 new units in Mexico with an expected investment of US$736 million and in 1995 Pepsi announced a US$55 million investment in a snack-food company in South Africa, while Boeing McDonnell Douglas invested US$31 million in the Czech Republic in 1998.

One may be concerned that IPAs choose sectors that already receive a lot of FDI as their priority industries in order to show good results. This is, however, unlikely. In 67 of 97 IPAs surveyed in the Census, the agency board was not at all involved in choosing priority sectors. Moreover, our conclusions hold even if we exclude countries that reported in the Census that the targeting decision was based on the past success or failure in attracting FDI to the sector. In addition, we find no evidence suggesting that targeting took place in sectors with relatively high or low inflows in the years preceding targeting.

If investment promotion works, we should also see that agencies following the best practice model are more effective. For instance, it is generally believed that a quasi-government status is the most appropriate IPA setup. Quasi-governmental bodies benefit from their links to the government when assisting investors in getting regulatory approvals and lobbying authorities on behalf of foreign companies. At the same time, they have more flexibility in planning their activities and are not bound by government pay scales and hiring and firing practices, which makes them better positioned to engage the private sector and respond quickly to changing market conditions. As expected, our analysis confirms that quasi-governmental bodies are more effective at attracting FDI than subunits of ministries.

Our final observation pertains to the concern of government officials that policies in competing countries might divert FDI inflows. Anecdotal evidence suggests that many large foreign investors narrow their attention to a few potential sites in neighboring countries and then let the host country authorities bid on tax, financial or other incentives they want to offer. Our data presents evidence in support of this view. We find that investment incentives offered by other countries in the same region are associated with lower FDI inflows. This competition is limited to a geographic region as there is no evidence of such competition taking place among countries with the same level of income, but located in different regions.

What the Research Means for Policy

Our observations have two policy implications.

- Investment promotion is a viable policy option for developing countries that have a sound business climate and wish to attract FDI inflows. In the presence of knowledge externalities associated with FDI subsidizing provision of information is an appropriate policy action.
- Regional competition in tax incentives point to potential benefits of regional coordination in this area.

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Impact of Ukraine's WTO Accession

Ukraine's WTO membership may bring 5.7% increase in real GDP in the long term

Veronika Movchan

On February 5, 2008 the General Council of the WTO approved the accession package of Ukraine, thereby successfully completing almost 14 years of negotiations. Ukraine applied for the membership in 1993, when most of the country's commodity trade was conducted with non-GATT/WTO members. The situation has changed dramatically since then. According to the State Committee of Statistics of Ukraine, in 2007 the country's commodity trade with WTO members accounted for over 62% of exports and 58% of imports. Ukraine's major non-WTO trade partners remain the CIS countries, primarily Russia, Belarus, and Kazakhstan, currently also negotiating the WTO membership.

The long negotiations ensured that a lot of changes embedded in Ukraine's accession agreements have already been introduced. This includes passing strict intellectual property rights protection legislation, harmonizing the Ukrainian system of standardization and conformity assessment, adopting the new Customs Code, and bringing import tariffs for almost all manufacturing products in line with Ukraine's tariff proposal.

Post-Accession Changes

What will change after Ukraine becomes a WTO member? Most importantly, import tariffs will be bound at quite a low level. For agricultural products, this means a reduction of the average tariff rate by a quarter to 10.66%. The maximum binding tariffs are envisaged for sugar (50%) and sunflower seed