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Roll out the red carpet and they will come: Investment promotion and FDI inflows

by
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Foreign direct investment (FDI) flows to developing countries are hindered by many factors. Two of these factors -- the mere lack of information and red tape -- could be easily remedied through investment promotion efforts.

Prior to undertaking FDI in a foreign country, investors need to familiarize themselves with the rules and regulations prevailing in the host country. They need to analyze its growth prospects and obtain detailed information on labor costs. They may want to know about the availability of potential joint venture partners or suppliers of inputs. While information on developed countries is readily available and consulting firms can assist in this process, obtaining information on business conditions in developing countries is often tricky.

Once an investment decision is made, investors need to comply with a series of bureaucratic procedures. As illustrated by the *Doing Business Indicators* produced by the World Bank, such procedures may be quite burdensome. For instance, the number of procedures required to start a business varies from 2 in Georgia to 21 in Equatorial Guinea. The number of days required to complete a registration process ranges from 2 in Georgia to 649 in Suriname.

Investment promotion efforts can reduce the negative effect of the lack of information and the burden of bureaucratic procedures and in this way stimulate inflows of FDI.[1] Sectors targeted by

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investment promotion agencies receive twice as much FDI in the post-targeting period relative to the pre-targeting period and non-targeted sectors. Importantly, the effect is not driven by promising industries being targeted.[2] The magnitude of the effect is plausible, since the median sector-level investment (in country-sector combinations with positive FDI flows) reached US$ 11 million in 2004. The estimated effect of investment promotion, therefore, translates into an additional annual inflow of US$ 17 million.

How exactly does investment promotion increase FDI inflows? The process of selecting an FDI site typically involves four stages. First, a long list of 8-20 potential host countries encompassing popular FDI destinations, countries close to existing operations and emerging FDI destinations is created. The third group represents an opportunity for an IPA that, by advertising in the business press and participating in industry fairs, can draw attention to its country. In the second stage, about five sites are selected from the long list, based on the trade-off between costs and the quality of the business environment. The accessibility of the information about potential host countries plays a crucial role, as sites under consideration are rarely visited during this stage. IPAs that have up-to-date, detailed and accurate data on their websites and are willing to prepare detailed answers to investors' inquiries can increase the chances of their countries being included in the short list. In the third step, the investor typically visits the host country, giving the IPA an opportunity to emphasize the advantages of locating there, present potential investment sites and facilitate contacts with the local business community. IPAs can also play a role in the fourth and final stage by providing information on investment incentives and offering help with the registration process.

IPAs stimulate FDI inflows by facilitating access to information and reducing the burden of red tape. More specifically, investment promotion is more effective in countries where English is not an official language and in countries that are more culturally distant from the United States. These two findings are consistent with investment promotion reducing information and communication barriers between US investors and host countries. Also, investment promotion works better in countries with less effective governments, higher corruption and a longer time period required to start a business or obtain a construction permit, which is consistent with investment promotion alleviating problems of red tape.

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[1] For details, see our "Roll out the red carpet and they will come: Investment promotion and FDI inflows," *Economic Journal*, vol. 121 (December 2011), pp. 1445-1476. Our study took advantage of differences in investment promotion efforts across countries, sectors and time and the fact that most investment promotion agencies (IPAs) target particular sectors to attract FDI. It used information on sector-specific investment promotion efforts and detailed figures on flows of US FDI into 95 developing countries during 1990-2004 to conduct a difference-in-differences analysis.

[2] The results hold when the sample excludes countries whose targeting decision was based on the past success or failure in attracting FDI to the sector. There is no evidence suggesting that targeting took place in sectors with relatively high or low inflows in the years preceding targeting. Finally, a strict exogeneity test does not reject the validity of the empirical strategy used. The analysis controls for changes in host country business environment by including country-year fixed effects, heterogeneity of sectors in different locations by including country-sector fixed effects and shocks to supply of FDI in particular sectors by adding sector-time fixed effects.

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