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## Foreign Firms and Host-Country Investment Promotion

Investment promotion has come to occupy a prominent place in the development strategies of developing countries and economies in transition. Since 1991, 58 more nations have begun to undertake proactive approaches to attracting FDI, making a total of 116 countries that now do so.

To what extent are proactive efforts necessary? Leaving aside (for now) the question of providing grants and subsidies directly to foreign investors, why should hosts have to expend resources on promotional activities per se? Cannot host countries rely on international market forces to drive foreign investors to them?

The predominant justification for investment promotion comes from the demonstration of positive results. There is a long-held belief that would-be host countries that adopt an energetic approach to investment promotion are much more successful in attracting foreign firms than are those that do not.

To investigate this assertion with some rigor, Wells and Wint (1990) attempted to control for the most common variables that might influence FDI (GNP per capita, growth rate of GNP, inflation rate, survey rankings of political stability) to isolate the impact of a variable associated with investment-promotion effort on attracting FDI.

They discovered that the investment-promotion variable had a strongly significant statistical impact. Promotional efforts were highly cost effective, generating benefits with a net present value of almost four dollars for every dollar spent. Strongest in producing results were sector-specific investment missions that were guided by firm-specific research and featured customized “sales” presentations that matched the presumed needs

of the target investors with the alleged ability of the particular host country to meet those needs. Much weaker in producing results were general advertising campaigns on behalf of the host country and general show-and-tell visits to major cities in the developed world. A concentrated proactive approach was particularly valuable for countries that had not been major hosts of FDI in the past or that were trying to change their image as they reformed their domestic policies. Still, investment-promotion activities generated high returns for all hosts that engaged in them.

What accounts for such a strong response? The Wells and Wint (1990) study likened investment promotion to a marketing challenge. It adduced no further evidence of market imperfections.

Relaxing only the most unrealistic of assumptions about perfect competition—instantaneous and cost-free acquisition of information by all parties—it becomes rational for a potential host, like any advertiser, to spend resources to expand demand for its product so long as the returns outweigh the costs. Moving deeper into possible imperfections in information markets, the host might want to differentiate its product, so to speak, as well.

How much effort should the host make, and what might be the prospects for success? To try to judge the effectiveness of expending scarce host-country resources on product differentiation, one might compare investment promotion to economic theories of search and signaling that embody poor indices of quality differentials among products (McKenna 1986). Models of search and signaling are frequently used to assess how job markets function: when workers do not have clearly defined degrees or certified skills, potential employers may regard all workers as being of the same poor quality and bid for their services at the same low level. Workers who believe they are superior in nonobvious ways have an interest, therefore, in expending resources to demonstrate that they have favorable attributes in comparison to their less appealing counterparts; seeking help in preparing a simple resume or soliciting recommendations from past employers are common examples.

By analogy, host countries may find it beneficial to show that they have superior characteristics to those of rival countries, to stimulate more interest among potential investors than those investors would have for the least attractive alternatives.

But firms also have an interest in ferreting out information that may provide them with an advantage over rivals. And, as part of search theory, investors, like employers, have an interest in developing screening devices to sort among potential prospects.

If the investment-promotion task could be limited to efforts at advertising and product differentiation and there were no larger issues of market failure or investment-diverting interventions by others to deal with, then potential hosts could accomplish these goals with only modest expenditure of resources and minimal potential for distortion.

In terms of providing information, the Multilateral Investment Guarantee Agency of the World Bank Group, for example, has established an internet system, the Investment Promotion Network (IPAnet), that offers host countries the opportunity to post economic statistics, legislation governing FDI, other laws and regulations, maps, accommodations, names of current investors and suppliers, and names of relevant officials (with hyperlinks). Innovations like this lower the foreigners' cost of search in comparing alternative investment sites and provide nearly real-time interactive follow-up via internet, email, fax, and telephone.

In terms of projecting a favorable image, Wells and Wint (1990) found that personal contact between host-country officials and individual companies had a substantially larger impact than did impersonal advertising (even advertising in highly visible and expensive outlets). Mixed investment missions, including satisfied private-sector representatives and ministry representatives from the host country, were particularly effective.

In terms of certification, the International Monetary Fund and World Bank Group already serve in this capacity. They are backed by private sector rating agencies such as Moody's and Standard & Poor's and by an array of consultants and evaluation services.

Even such modest efforts pose some threat of distortion to the would-be host country. But the penalty levied on the rest of the economy can be minimized by keeping the resources devoted to investment promotion small. And the dangers of industrial-policy "targeting" errors can be minimized by ensuring that nonpromoted sectors also enjoy investor-friendly treatment.

Many successful FDI projects do emerge independent of the planning of investment promotion agencies: Chilean investment teams concentrated on minerals, timber, fish, wine, and agricultural products; they did not suspect that Santiago would become a center for the development of financial services. Early investment teams from India focused on attracting foreigners to unskilled-labor-intensive assembly operations; they did not immediately assume that highly-skilled-labor-intensive sectors such as software development would be a magnet for foreign investors.

Absent larger justifications for investment promotion, therefore, host-country efforts at advertising and product differentiation could easily be kept within moderate limits. Developing countries and economies in transition would be well-advised to draw a clear line between spending small amounts of public funds for marketing purposes, even for intensive and proactive marketing purposes, and giving marketing teams sizable tax breaks, grants, subsidies, and preferences to bestow upon prospective investors.

In fact, the reverse has been the case: developed countries and developing countries alike have expanded the deployment of expensive incentives and preferences in the effort to attract FDI.

And, as evidence from the globalization of the automotive, petrochemical, and electronics/computer industries examined in later chapters shows,

the rewards for a country that is successful in this endeavor can be much larger, and the opportunity cost for a host that lets the opportunity pass by also much larger, than Wells and Wint (1990) indicated.

How should host governments in the developing world and economies in transition respond to this competition for investment? Is the escalation in incentives and preferences that has become a central feature of investment promotion merely driven by the need to match the moves of others? Or are there larger signs of market failure that justify intervention on the part of hosts and would-be hosts in the developing world and the economies in transition? What are the “prisoners’ dilemma” dimensions to this process? Finally, should host governments insist upon special performance from the foreign investors, such as high levels of domestic content or high levels of exports, in return for such investment incentives?

Addressing these questions is the task of the next three chapters.