

# How investment promotion affects attracting foreign direct investment: Analytical argument and empirical analyses

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## Abstract

This paper examines that how a host government's promotional effort, through the establishment of investment promotion agency (IPA), can influence foreign direct investment (FDI) inflows. This paper conducts structural equation analyses with maximum-likelihood estimations focusing upon the effectiveness of investment promotion as a mediator between the host country's FDI environment and FDI inflows. The empirical results show that the effectiveness of investment promotion, measured by IPA age, IPA's overseas staff intensity, and number of IPA staff, positively affects the attraction of FDI. From the results, we infer that enhancing investment promotion can be a tool for attracting FDI through the mediation effect that coordinates other determinants of FDI such as market size, market growth, and low labor costs.

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## 1. Introduction

There is some view that national strategic marketing management is needed to create or increase economic development (Kotler, Jatusripitak, & Maesincee, 1997). That means, in other words, a government can market a country in the same way as a company's products and services in order to attract foreign direct investment (FDI). Most governments have increasingly adopted measures such as liberalizing the legal and regulatory framework for FDI and establishing mechanisms for the settlement of investment disputes to attract FDI, as a means to achieve their economic development goals.

According to UNCTAD (1998, p. 91), the determinants of FDI include not only economic determinants (e.g., market size, low-cost unskilled labor, raw materials, and strategic assets and technology) but also business facilitation (e.g., investment promotion activities, investment incentives, and administrative services). As for determinants of FDI, even if the literature argued that business facilitation plays a less crucial role than economic determinants (Guisinger, 1992; Shah, 1995; UNCTAD, 1996, 1998; Wells & Wint, 1990), most

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governments regard business facilitation as a significant policy instrument (Bergsman, 1999; Lim, 2005; Morisset & Pirnia 2000; Wells & Wint, 1990). Promotion activities by investment promotion agencies (IPAs) have been considered to be a major part of business facilitation (UNCTAD, 1995, 1998). However, the role of IPA in attracting FDI has been the subject of only a few studies (Morisset & Andrews-Johnson, 2003; Wells & Wint, 1990) and the literature has never been clearly argued as to how IPA activity affects FDI inflows. There are some exceptions: Wells and Wint (1990) and Wint and Williams (2002) tested whether the existence of IPA, measured by a dummy variable and four-category scale, has affected a host country's FDI inflows or not; Morisset and Andrews-Johnson (2003) showed recently that spending by IPAs was positively associated with attracting FDI.

Regarding empirical tests in previous studies, they have developed in two directions: first, how to select proxies for the effectiveness of investment promotion affecting FDI inflows in large-sample analysis; second, which role of an IPA is the most important among various promotion activities, i.e., image-building activity, investment-generating activity, and investment service (after care service) with case analysis.

The main line of inquiry of this paper is how and to what extent a host government's promotional effort, through an IPA, can influence FDI inflows. I regard an IPA as acting in the role of a mediator between the host country's FDI environment and FDI inflows, while the previous paper regards it as one of the determinants of FDI. That is, an IPA can function as a catalyst between the FDI environment and FDI-attraction performance of the host country. This view puts the IPA's role apart from other determinants affecting FDI inducement in this paper. Accordingly, this paper has three main contributions in developing the previous approach: first, various proxy of effectiveness of investment promotion is adopted even though it is an analysis of a relatively large set of countries in these kinds of studies; second, the functions of IPA, as a FDI promotion factor, is regarded not as a normal independent factor but a mediator between the host country's FDI environment and FDI inflows; third, related theories, such as the transaction cost economy approach and information searching cost are adopted to make a link between the hypothesis and empirical tests.

## 2. Literature reviews and hypotheses

### 2.1. Investment promotion and FDI determinants

Dunning (1996, p. 56) identified four types of motive behind the FDI activities of multinational corporations (MNCs): resource seeking, market seeking, efficiency seeking, and strategic asset or capability seeking. UNCTAD (1998, p. 91) defines these motives as economic determinants with two other FDI determinants, i.e., host country's policy framework and business facilitation. Policy framework refers to social and political stability, regulations regarding entry and operations, fair competition between foreign and domestic firms, and international agreements on FDI. Business facilitation refers to providing facilitation services for foreign investors such as investment incentives, government promotional activities, and administrative support for foreign investors. Among those determinants, the importance of IPA promotion activities such as image-building activities, investment-generating activities, and investment-service activities have become more important (UNCTAD, 1995). Because investment promotion activities can be taken to shorten the delayed reactions of investors to emerging investment opportunities' or to help investors, especially those small and medium-sized firms, to discover new opportunities that they would not find on their own (UNCTAD, 1998, pp. 99–100).

### 2.2. Information dissemination activities and market imperfection

If there is to be an optimal allocation of resources through market mechanisms, participants should have free access to information. However, instead of circulating freely, information is concentrated and transaction costs occur, resulting in some investment decision makers possessing it and some who do not. This type of 'information impactedness' usually occurs from uncertainty and opportunism (Williamson, 1975, 1985). The asymmetry of information tends to change the bargaining power between the supplier and the demander and the side which possesses less information will be at a disadvantage. Therefore, in order to overcome this

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