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Overview

This policy brief investigates the role of investment promotion agencies (IPAs) in attracting foreign direct investment (FDI). Countries today are not only competing for larger amounts but also specific types of FDI, in particular for projects related to higher value-added and more knowledge-intensive activities, such as research and development. Increasingly, IPAs play a critical role in such strategic promotion of FDI.

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Foreign Direct Investment: Key Issues for Promotion Agencies

The growing importance attached to attracting foreign direct investment (FDI) is evidenced by the steady rise of investment promotion agencies (IPAs) worldwide, especially from the early 1990s. Since its launch in 1995, the World Association of Investment Promotion Agencies (WAIPA) has registered a growing number of members representing cities, regions, countries and free zones from all over the world: from 112 in 2002, 161 in 2004, rising to 191 members from 149 countries in 2006. According to the United Nations Conference on Trade and Development (UNCTAD) there were around 500 IPAs in more than 160 countries in 2004.

But do IPAs really make a difference in the race to attract FDI? And if so how? Numerous attempts have been made to benchmark information, and develop guidelines for IPAs—particularly in developing countries—by an array of international organizations including WAIPA, the United Nations Conference on Trade and Development, United Nations Industrial Development Organization, the Organization for Economic Cooperation and Development and the World Bank's Foreign Investment Advisory Service and Multilateral Investment Guarantee Agency.

This Brief contributes to these efforts by analysing a number of issues relating to the role of IPAs that have not been sufficiently addressed so far. At the core of this discussion are three interrelated points of departure:

- First, despite continuing controversy on their true contribution, multinational corporations (MNCs) are central in today's knowledge-driven economy, and therefore attracting FDI continues to be a key issue within policymaking processes. While numerous studies have analysed the potential implications for host countries of having foreign corporations' affiliates as players in their productive structures, experts and scholars are far from reaching a consensus on the overall costs and benefits of inward FDI. Notwithstanding this lack of agreement, it is difficult for host governments to avoid dealing with foreign corporations for at least two reasons: MNCs' worldwide presence has been constantly reinforced as the volume of FDI flows grow vigorously, and they are responsible for the bulk of private expenditure in research and development (R&D) worldwide.
- Second, countries need to adopt a more nuanced approach in dealing with foreign multinationals. In their race to attract FDI host countries have adopted a wide range of policies varying from more quantitative-based approaches focus-

ing on FDI volume, to more qualitative-based approaches targeting investment projects that can boost local development goals. Yet, a general feature of FDI promotion is its focus on the volume of FDI rather than the quality of investment projects attracted. However, in a global context where economic production is increasingly knowledge-driven, the extent to which FDI contributes to improving innovation and knowledge accumulation is critical. Thus host countries should continually strive to promote knowledge-intensive FDI, as well as capture as many potential benefits as possible from the local activities of foreign multinationals.

- Third, IPAs are instrumental in strategic FDI promotion. As the competition amongst countries for FDI projects—especially for those of higher quality—escalates, more sophisticated approaches are required to attract, and keep foreign investors. More than ever before, host countries need to develop a deep understanding of MNC strategies, and to provide the right conditions for foreign investors, without compromising domestic development priorities. This requires considerable capacity in analysing investment opportunities and articulating policies to attract and make the best use of inward FDI. In this sense IPAs have a significant role to play.

Institutional positioning of IPAs

As its name suggests, the primary role of an investment promotion agency is to promote a country (or specific locations) to foreign investors. Among many activities, IPAs disseminate information about investment opportunities in the country, provide services for the investors, contribute to improving overall investment climate, and create a positive image of the country abroad. Apart from attracting and maintaining relations with foreign investors, an IPA's tasks may extend to export promotion, industrial development, fostering entrepreneurship, and small and medium enterprise development.

While many of these functions may be entrusted to a single specialized agency—for instance CzechInvest, IDA, ITDH and PAIiIZ discussed elsewhere in the Brief—in most countries such functions are distributed across a range of institutions. Furthermore, FDI promotion is not the exclusive task of national governments since IPAs can be constituted as government departments, parastatal organizations, autonomous public bodies or even as private sector organizations.

In terms of geographical scope, one can find IPAs actively involved in FDI promotion at national, sub-national and even municipal levels. IPAs' territorial scope is closely associated with the degree of autonomy the central government grants to its regions. In most federations economic development falls under the jurisdiction of federal states. Thus each self-governing state may have its own IPA, either semi- or totally autonomous from the federal government, which may have its own central IPA. This structure can lead to conflicts as various IPAs compete amongst themselves, weakening the bargaining power of the country as a whole. Unitary states, in turn, tend to have a single IPA at the national level.

Multinational corporations are responsible for the majority of worldwide private expenditure on R&D

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Ireland and Hungary, for instance, have only one central IPA: the Industrial Development Authority (IDA) and the Investment and Trade Development Agency (ITDH) respectively.

The size of a country also influences the scope of IPAs. In smaller countries having a single central IPA is likely to work better than many IPAs for different regions and areas. Yet, national IPAs may establish representation offices around the country, to strengthen their local presence and be better informed about local investment opportunities. ITD Hungary, for example, has 14 regional offices, while IDA Ireland has 10. In large- and medium-sized territories on the other hand, a constellation of independent IPAs can be more effective. However, as in the case of federal constituencies, competition among IPAs representing different regions can be detrimental to a country's overall development.

The lobbying power of an IPA is determined by its positioning within the government structure and its level of autonomy, which in turn reflects the importance that inward FDI represents for the national economy. Most IPAs are located within, or report to specific ministries, such as the Ministry of the Economy (Slovakia), Ministry of Economy and Transport (Hungary), Ministry of Industry and Trade (Czech Republic), and the Ministry of Economy and Technology (Germany). In rare cases, IPAs report directly to the cabinet (for instance the Romanian Agency for Foreign Investment).

In reality IPAs often operate in a blurry institutional framework, and their functions encompass a multitude of organizations of different forms, often with overlapping jurisdictions. It is therefore crucial to ensure that FDI promotion is well articulated and integrated within broader national development goals. For IPAs this requires coordination with relevant government bodies, particularly those in charge of science, technology and innovation, industrial, trade, education and labour policy. For instance, having identified a lack of high-skilled labour in engineering as an obstacle for promoting more knowledge-intensive FDI, an IPA should be able to engage with the Ministry of Education to achieve the required reorientation of training policy. Thus having identified investors' needs and ensured that these are in line with local development goals, the IPA will have contributed to improving the country's attractiveness to foreign MNCs.

The spatial dimension of FDI promotion

An important justification for FDI promotion is the prospect of market failure: since MNCs do not have perfect information about all countries and investment opportunities, they can make biased decisions with regard to where they invest. In the same way, MNCs may fail to obtain perfect information about all the regions and localities within countries. This is why one of the key tasks of IPAs is to provide foreign investors not only with the information about the country as a whole, but with information about investment opportunities in specific locations.

Most IPAs focus primarily on this informational role, but they can also contribute to national economic development goals by actively promoting investment in disadvantaged regions. However, since it is more likely that FDI will flow to regions that are already performing well, it can be quite difficult to achieve such strategic goals. The evidence suggests that despite policy intervention the bulk of FDI flows to a few selected locations, mostly capital regions. Negative characteristics of a

Project Description

This Brief results from research collaboration between the UNU-MERIT programme on "Innovation, Global Business Strategies and Host Country Development," and the Department of Science and Technology Policy (Unicamp), in Brazil. The UNU-MERIT study investigates how host countries can maximize and capture the potential positive impacts of incoming FDI, particularly to improve their knowledge-base. The Brazilian project analyses the opportunities and conditions under which Brazil can improve its integration into global research and development networks.

As part of this collaboration, researchers at the two Institutes carried out interviews in June 2006 with the four IPAs featured in this Brief. They are: Ireland Development Agency—IDA (www.idaireland.com); The Hungarian Investment and Trade Development Agency—ITDH (www.itdh.hu); Polish Information and Foreign Investment Agency—PAIiIZ (www.paiz.pl) and CzechInvest (www.czechinvest.org).

The Brief also benefited from comments from the coordinators of the two projects: Sérgio Queiroz (Unicamp) and Geert Duysters (UNU-MERIT).

region such as remoteness and lack of infrastructure often outweigh the beneficial effect of government incentives. The exceptions are likely to be cases where an MNC might specifically seek access to abundant and cheap labour, potentially contributing to employment opportunities and reduction of poverty in particular locations.

In the case of FDI in higher value-added and knowledge-intensive activities the characteristics of a region, such as its knowledge base and quality of life, are of utmost importance. As a rule, population density is closely related to knowledge activities due to agglomeration effects, so highly-skilled human capital concentrates mostly in the largest cities, further contributing to the growth of informal knowledge networks and an accumulation of tacit knowledge within these networks. In most cases, even generous concessions from the government cannot convince an MNC to locate its R&D centre in poorly developed regions lacking such human capital. These regions are trapped in a vicious circle: they need investments to upgrade technologically, but they cannot attract such investments unless they reach a certain level of technological development.

There is need therefore for coherence between FDI promotion and regional policy, as well as with national innovation policy. IPAs have a role to play in such the coordination of all three policy areas.

Fighting for FDI in Brazil: The case of Ford

The case of Ford famously illustrated the fiscal war between federal states in Brazil. In 1999, Ford had already identified a location for its new assembly plant in the Brazilian South state of Rio Grande do Sul. When the new state government decided to review the terms of the contract considering it too costly for the state Ford decided to look for a different location. Subsequently several other Brazilian states started to compete against each other, each making alluring offers to Ford.

The Northwest state of Bahia won the war, by offering Ford a broad incentive package encompassing land and special incentives from the National Automotive Regime, despite the fact that the programme had been discontinued in 1998. The federal government backed Bahia's offer to Ford, reopening the Automotive Regime for one more year and throwing in credits from the National Bank for Economic and Social Development (BNDES). Thus Ford decided to move to Bahia instead of Rio Grande do Sul. This case points to the political and economic complexity of a fiscal war, which can involve several levels of government, with potential benefits or losses of investment projects.

Do incentives boost FDI?

As competition for FDI has intensified, governments are increasingly offering incentives to attract investors. In this sense one may argue that incentives do influence FDI flows. However, the debate on the effectiveness of various incentive schemes is still ongoing.

Do incentives offered by host countries to MNCs make sense? Would MNCs not invest anyway? The specialized literature on FDI promotion suggests that public incentives are not the most important factor in determining a country's attractiveness for investors, however they can influence MNCs' final decision when all other factors are comparable for competing locations.

Another set of issues relates to the cost and benefits for countries in granting incentives to foreign MNCs. Can incentives lead to win-win results? In general, the effectiveness of incentives is tied to the host government's ability to negotiate favourable terms. To make the most of their incentive schemes some countries, notably Ireland and China require investors to recruit highly skilled workers locally, to cooperate with local research institutes and universities, or to invest in particular regions.

The importance of follow up—particularly to avoid premature withdrawal of foreign investors before incentives conceded to them have paid off—is well illustrated in the role played by

CzechInvest in the withdrawal of LG Philips Displays and Flextronics from the Czech Republic.

Effective targeting

Strategic FDI promotion involves the definition of targets—at industry, business function and investor levels. This requires a comprehensive understanding of the country's development needs, and an awareness of the determinants, impacts and characteristics of FDI. It is only with a clear picture of the dynamics of MNCs' strategies and business principles that an IPA can effectively promote investment opportunities that match the interests both of investors and the recipient country.

Industry targeting is a poplar feature in FDI promotion policies. However, the simple selection of priority industries is not sufficient. Successful targeting entails focusing on industries in which countries have some competitive advantages, as well as on those with potential for future development. In other words, target industries should reflect countries' economic characteristics.

In defining targets for FDI promotion it is crucial to bear in mind that not all projects will yield the same benefits. This is due not only to variations in the size of investment or the type of sector, but importantly, the business functions that may be comprised in the project, such as sales, marketing, retail, accounting, manufacturing and research and development (R&D). With the increasing attention being paid to the promotion of investments in R&D it is particularly important to understand the potential contribution of each business function.

Studies of recent trends towards increased internationalization of R&D have identified a broad range of motives for the setting up of R&D units overseas by MNCs. Unlike R&D units in home countries, MNC affiliates primarily provide support to manufacturing units by means of product and process adaptation, and facilitate market access. In other words, FDI projects on R&D are closely associated with manufacturing-oriented projects. Therefore, the promotion of FDI in R&D should not be disconnected from the promotion of FDI in manufacturing.

> In reality, IPAs often operate in a blurry institutional framework, and their functions encompass a multitude of organizations, often with overlapping jurisdictions

Stay or Go? LG Philips and Flextronics in the Czech Republic

LG Philips Displays—a producer of cathode ray tubes (CRTs) for use in TV and computer monitors—received several grants from the Czech Republic to open its Hranice plant in 2001. As the global market became increasingly unfavourable due to a shift in consumers' preferences towards flat screen units, reduced demand for CRT TVs made production unprofitable. In January 2006 LG Philips Displays Holding filed for insolvency protection, and many production facilities across Europe were closed down. However the Czech affiliate remains operational until the end of 2007 otherwise it will have to return a part of the initial grant to the state.

Flextronics International, a Singaporean MNC and electronics manufacturing services provider, established a production unit near the Czech city of Brno in 2000. In 2003 the company decided to leave the country. Flextronics had not obtained any funding from the state and withdrew only the production facilities, leaving its design centre. CzechInvest managed to attract a new investor (Honeywell) to take over former Flextronics' facilities.

Unlike other countries where impacts of withdrawal have been quite negative, the Czech Republic has experienced only these two cases of withdrawal, both relatively painless.

In addition R&D targeting may be easier and more effective among MNC affiliates already established in the country. MNCs with no previous presence in a country are more likely to start their local activities by setting up manufacturing or retail units. The incorporation of more complex business functions by newly established affiliates may (or may not) come with time. This is particularly true of developing countries.

Bearing these trends in mind, IPAs should:

- Strive not only to attract new MNCs, but focus on function-upgrading (incorporating new business functions, especially R&D) by MNC affiliates already located in the country;
- Evaluate the potential for function-upgrading of incoming MNC affiliates.

These considerations are particularly pertinent for IPAs in countries with well established MNC affiliates. Through their local production activities, such affiliates accumulate valuable technological capabilities and competencies that may give them an edge, particularly when competing for R&D investments against less established subsidiaries of the same MNC located in other countries.

The case of the IDA and Apple's affiliate in Ireland illustrates the role an IPA can play in function-upgrading, hence contributing to more knowledge-intensive FDI. A critical factor in the IDA's success was its long term approach. The IDA has played a central role in directioning Apple's activities in Ireland since the setting up process of its initial operations in the city of Cork in 1980. Originally set up to manufacture Apple Mac personal computers, Apple Ireland has incorporated other functions and today employs 1,500 people in R&D activities.

> Ireland and China require investors to recruit highly skilled workers locally, to cooperate with local research institutes, or to invest in particular regions

Conclusion

The role played by IPAs in promoting their countries to MNCs varies considerably across countries. IPAs can be limited to the role of "information kiosks," in which case MNCs may prefer to get information from specialized consultancy companies. At the other extreme, an IPA can assume full responsibility for relations with foreign investors, mediating between investors and various government ministries, or even directly negotiating incentives with the foreign MNCs.

The effectiveness of an IPA in strategic FDI promotion is subject not only to its technical capacity and positioning within the government structure, but is also linked to country's overall bargaining power. This in turn rests on the assets that the country is able to leverage to attract investors, including market size; geographical location, human capital and science and technology (S&T) infrastructure. The role played by an IPA is therefore inextricably linked to its country's economic context and level of development. In countries with high unemployment rates, for instance, an IPA might focus primarily on promoting labour intensive activities, such as retail and manufacturing activities. The same holds true for different regions within the same country.

The cases of Hungary, Czech Republic and Poland are illustrative in this regard. While their IPAs—ITD

Hungary, CzechInvest and PAIilZ respectively—have been highlighting their focus on promoting FDI in R&D and in hi-tech sectors such as ICT and biotech, the urgent need to tackle high unemployment rates, particularly in some regions, means that specific industry and business function targeting is not always feasible. Ireland Development Agency on the other hand has enjoyed more freedom to focus on the promotion of specific types of FDI projects due to consistently low levels of unemployment in the country.

Finally, it is important to highlight that despite their growing importance, IPAs are not the only actors in FDI promotion. IPAs help in bringing together the various stakeholders, including the private sector, and ensuring coherence between a country's development goals, FDI strategy and innovation policy. The effectiveness of an IPA depends on the scope of its activities, its political visibility, and its ability to mobilize public and private resources to harness foreign investment.

Selected Resources

There are numerous online resources on the subject of FDI promotion, Investment Promotion Agencies, and capacity building in this area more generally. A few of these are listed below.

WAIPA (www.waipa.org) organizes a range of activities for members, including annual conferences, regional workshops and training programmes. The World Bank Group, in particular its Multilateral Investment Guarantee Agency (www.miga.org) provides a wide range of support services such as: the Investment Promotion Toolkit (www.fdipromotion.com/toolkit), IPAworks (www.ipaworks.com) and the Investment Promotion Network (www.ipanet.net).

Surveys are a valuable source of information not only for policymakers and technical staff, but for scholars as well. The UN Conference on Trade and Development (www.unctad.org) publishes regular reports including: *A Survey of Support by Investment Promotion Agencies to Linkage*; *The World of Investment Promotion at a Glance: A Survey of Investment Promotion Practices*; and *Survey of Best Practices in Investment Promotion*. Other interesting surveys include: *Industry Targeting within Foreign Investment Promotion*, a survey of the targeting practices of 122 IPAs prepared by the Oxford Investment Research (www.oxfordinvestment.org.uk), and the *Survey of International Foreign Investment Promotion Practices* conducted by The Bleyzer Foundation (www.sigmableyzer.com).

Other useful resources:

Guidelines for Investment Promotion Agencies: Foreign Direct Investment Flows to Developing Countries (www.unido.org); *A Policy Framework for Investment: Investment Promotion and Facilitation* (www.oecd.org); *Institutional Framework for Attracting Foreign Direct Investment and the Importance of an Investment Promotion Strategy* (www.fias.org); and *Competition for Investment: Best Practice in Investor Targeting* (www.ococonsulting.com).

www.merit.unu.edu

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UNU-MERIT is the United Nations University Maastricht Economic and social Research and training centre on Innovation and Technology. It integrates the former UNU Institute for New Technologies (UNU-INTECH) and the Maastricht Economic Research Institute on Innovation and Technology (MERIT). UNU-MERIT provides insights into the social, political and economic contexts within which innovation and technological change is created, adapted, selected, diffused, and improved upon. The Institute's research and training programmes address a broad range of relevant policy questions dealing with the national and international governance of innovation, intellectual property protection, and knowledge creation and diffusion. UNU-MERIT is located at, and works in close collaboration with Maastricht University in The Netherlands.

INSIDE:

Policy Brief

FDI: Key Issues for Promotion Agencies

How Investment Promotion Agencies can attract foreign direct investment in a competitive global environment

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