How Does Investment Promotion Affect FDI Inflows? Empirical Evidence from Asian Countries

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Abstract: Despite the fact that investment promotion plays an important role for recipient countries to attract FDI, there has not been much research in the case of Asian countries – which are gradually becoming attractive destinations for FDI investors. To bridge this gap, by utilizing Dunning’s location advantage and UNCTAD’s host country determinant framework, using the data of 20 Asian countries from 2006-2021, and looking into investment promotion from the perspective of budget, our paper found that investment promotion budgets have a significantly positive impact on FDI in these Asian countries. In addition, while the FDI effect is significant in high investment promotion budget countries, it is insignificant in low budget countries. This implies the considerable role of the spent budget of countries for FDI attraction.

Keywords: Investment promotion, IPAs, investment promotion budget, FDI inflows.

1. Introduction

Foreign direct investment (FDI) plays an important role in promoting economic growth and development of a country (UNCTAD, 1995). FDI determinants include not only policy frameworks and economic determinants (e.g. market size, low-cost unskilled labor, raw materials, strategic assets, and technology) but also business facilitation (e.g. investment promotion, investment incentives and administrative services) (UNCTAD (1998, p. 91)). An important part of business facilitation (UNCTAD, 1995, 1998) is the promotional activities by investment promotion agencies (IPAs).

Investment promotion is a cost-effective way of increasing FDI inflows, particularly in developing countries where information about business conditions is less readily available and bureaucratic procedures tend to be more burdensome (Harding & Javorcik, 2011). The purpose of investment promotion is to reduce transaction costs facing foreign investors by providing information (on business opportunities, prevailing laws and regulations as well as factor cost in a host country) and helping foreign investors deal with bureaucratic procedures. Therefore, besides creating a business-friendly environment, it is important for host countries to actively implement
investment promotion policies to fill information gaps or adjust the perception gap that can impede FDI inflows.

In addition, in the case of market imperfections, Wells and Wint (1990) found that investment promotion can combat these issues in location decision-making. Specifically, investment promotion can (1) help investors overcome information asymmetry; (2) compensate for the imperfect functioning of international markets that discourage parent companies from considering new production sites; (3) lead to product differentiation of host countries to serve as a venue for targeted activities. When decision-making about where to base the information of transnational corporations (TNCs) is imperfect, the decision-making process can be subjective and biased (UNCTAD, 1999).

Despite the important role of investment promotion in attracting FDI, current research has little evidence on the practical ability of active investment promotion to attract foreign capital (Crescenzi et al., 2021). Almost all studies on the impact of investment promotion on FDI have looked at the role of IPA offices of the host country. Wint and Williams (2002) tested whether the existence of IPAs, as measured by a dummy variable, has an effect on FDI inflows of the host country or not. Lim (2008) showed that the cumulative years of establishment of IPAs and the number of IPA employees are positively related to FDI attraction. Crescenzi et al. (2021) explored the ability of national investment promotion efforts to cope with heterogeneity in economic characteristics in both between host countries and investment countries by the difference-in-difference technique. This approach has difficulty in accurately assessing the effectiveness of IPAs due to endogenous problems (Hayakawa et al., 2014). For example, the Vietnamese government may decide to set up an IPA office in Japan just because there are many Japanese companies investing in Vietnam. To fix that problem, this study uses investment promotion budget as a proxy to examine the impact of investment promotion on FDI inflows. This is supported by Morisset’s (2004) argument that a positive association between investment promotion and FDI can be found only when promotion effort is measured by the IPA budget.

The relationship between FDI and promotion requires less labor than money (Morriset, 2004). This study focuses on examining the impact of investment promotion on FDI attraction in Asian countries, which previous studies did not really pay attention to. Moreover, we also examine whether the impact of investment promotion is different between two groups of countries with high and low budgets of investment promotion. The findings are expected to be a useful reference for policy makers as well as foreign investors.

The next section of the paper is structured as follows. Section 2 shows the literature review. Section 3 explains empirical strategies. Section 4 presents the results. The final section gives the conclusion and implications.

2. Theoretical background and literature review

A commonly used definition of investment promotion is “the activities of disseminating information or attempting to create an image of an investment location and providing investment services to potential investors” (Wells & Wint, 1990). Building on the work of IFC (1997), Christodoulou (1996), Young et al. (1994), and Dicken (1990), investment promotion can be divided into four main areas.

The effect of investment promotion on FDI can be clearly explained via Dunning’s location advantage and UNCTAD’s business facilitation framework.

Regarding Dunning’s location advantage, which stresses the importance of advantages from recipient countries for attracting FDI investors, investment promotion, according to the World Association of Investment Promotion Agencies (2020), could include four service categories such as: (i) Marketing services; (ii) Information delivery; (iii) Assistance to investors; (iv) Advocacy to improve investment climate and ecosystems. These activities directly improve or indirectly facilitate the location advantages of host countries. The basis for establishing investment promotion stems from the existence of asymmetric information and transaction costs in capital markets (Williamson, 1985; Wells & Wint, 2000; Loewendahl, 2001). International investors, who intend to invest in
foreign markets, often lack specific information about the host country’s potential business partners, government regulations, and the broad investment environment (OECD, 2015). Investment promotion will influence the investment decisions of multinational corporations (MNCs) by addressing information or perception gaps about the host economy (OECD, 2008).

In addition, regarding the FDI determinants proposed in the World Investment Report by UNCTAD (1998) and investment promotion as a part of business facilitation, also play a certain role in FDI attraction in host countries. As a result, the more investment promotion countries implement, the higher value of FDI they can obtain.

Table 1: Investment promotion framework

<table>
<thead>
<tr>
<th>Task Message</th>
<th>Task</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategy and organization (setting the national policy context; setting objectives; structure of investment promotion; competitive positioning; sector targeting strategy)</td>
<td>An investment promotion strategy should be based on consistent objectives that are set and agreed upon by all key stakeholders and underpinned by rigorous analysis of a venue’s competitive position.</td>
</tr>
<tr>
<td>Lead generation (marketing; company targeting)</td>
<td>Lead generation is most effective when building long-term relationships with targeted investors in priority areas is combined with focused marketing.</td>
</tr>
<tr>
<td>Facilitation (project handling)</td>
<td>Effective support is crucial if leads are converted into real projects. A coordinated and professional approach to project handling at the national and regional levels is essential if a venue is to successfully compete for international mobility projects.</td>
</tr>
<tr>
<td>Investment services (after-care and product improvement; monitoring and evaluation)</td>
<td>In order to maximize the long-term benefits from the inward investment and maintain and develop the location’s competitive advantage, after-sales care and product improvement activities should be key components of the investment promotion activities.</td>
</tr>
</tbody>
</table>


Figure 1: Host country determinants of FDI

In empirical studies, there has been different research regarding the impact of investment promotion on FDI. However, most of that research uses IPAs’ existence (which could lead to the endogenous problem) as a proxy for investment promotion. Other than that, there are very few papers using other types of proxies.

IPAs are used as a proxy in most of the preceding studies. IPAs are often governmental organizations, funded by regional or national government agencies to promote inward investment. The seminal work of Wells and Wint (1990) was among the first to question the effectiveness of IPAs in generating inward FDI. They determined that IPAs offer benefits to countries in much the same way marketing campaigns benefit for-profit organizations. In an updated version of this work, Wells and Wint (2001) defined IPAs rather broadly, as “activities that disseminate information about or attempt to create an image of the investment site and provide investment services for the prospective investors” (p. 4). They went on to identify four main functions of the IPA, that is: image building, investor facilitation, investment generation, and policy advocacy. Morisset and Andrews-Johnson (2003) empirically used data from a survey of 58 IPAs on investment promotion levels to help explain differences between countries in the flow of investment. The results showed that IPA spending, together with the influence of other key factors such as the country’s investment environment market size, has a positive relationship with FDI attraction.

Empirical tests of Wells and Wint (1990) 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. Wint and Williams (2002) developed the measure of IPA in a similar way. The effectiveness of investment promotion activities is measured through a variable calculated based on a questionnaire sent to 10 investment promotion experts around the world in a research process similar to the Delphi method. Empirical results have shown that investment promotion activities have no statistically significant effect on FDI inflows. Head et al. (1999) used the existence of a foreign office in Japan between 1980 and 1992 to explore the effectiveness of investment promotion by US states in attracting Japanese FDI. The authors found no evidence of any effect of the IPA and the explanation for this was that Japanese investors may have been well informed about the US states, hence the role of IPA no longer determining attraction. In contrast, Bobonis and Shatz (2007) analyzed eight different countries and found that state offices did influence their FDI into US states between 1976 and 1996. Similarly, Anderson and Sutherland (2015) found that the presence of Canadian provincial IPAs located in China increases the likelihood that Chinese companies are based in that Canadian province. Hayakawa et al., (2014) focused on IPA-established countries in Japan and Korea and found that the presence of IPAs has a positive effect on FDI inflows, but only for countries that “have political risk”. Lim (2008) examined the age and number of employees (domestic and foreign) of investment agencies and found that additional staff is positively correlated with foreign investment attraction. Harding and Javorcik (2011) discovered that IPAs that handle investor requests more professionally and have high-quality websites attract larger amounts of FDI.

Regarding studies evaluating IPAs through indices, there has been a general report by Martincus and Sztajerowska (2019) presenting various novel indices - ranging from institutional independence to evaluation depth - summarizing the different organizational and operational characteristics of the IPAs. The purpose of this report is not only to meaningfully capture and describe the wide range of investment promotion approaches but also to provide a comparative exercise that can serve as a basis for reflection and give operational guidance for IPAs.

Only a few studies have examined the role of IPAs with heterogeneity conditions in host countries. Crescenzi et al. (2021) explored the ability of national investment promotion efforts to cope with heterogeneity in economic characteristics. The results showed IPAs attract foreign direct investment even in advanced economies. Provincial regional IPAs attract FDI especially towards less developed regions by up to 71%. Chuop (2022) also examined the impact of investment promotion through the special economic zone (SEZ) mechanism on FDI flows into Cambodia. The results showed that the number of SEZs positively affects FDI inflows.
and it was especially interesting that a province in the SEZ could attract more FDI than a province in the non-SEZ.

As mentioned, most of the studies take the presence of an IPA office as a proxy for investment promotion. However, this approach may have some errors due to endogenous problems (Hayakawa et al., 2014). As suggested by Morisset (2004), IPA effectiveness is influenced by the wide range of the size of their annual budgets. In this paper, we use the investment promotion budget to measure instead of IPA existence as suggested by Morisset (2004) to overcome the endogeneity problem.

3. Empirical strategies and data

3.1. Model and methods

**Model**

As the main purpose of discovering the effect of investment promotion on FDI across Asian countries across years (panel data), based on the previous empirical studies (Morisset, 2003; Morisset & Kelly, 2004), we construct our model with the following specifications:

\[
\text{ln}(\text{FDI})_{it} = \alpha_i + \beta_1 \text{ln}(\text{BudgetIP})_{it} + \sum \beta_j \text{Control}_{it} + u_{it} (1)
\]

Where:

\( \text{ln}(\text{FDI})_{it} \) denotes the natural logarithm of foreign direct investment (USD) of country i in year t;

\( \text{ln}(\text{BudgetIP})_{it} \) is the natural logarithm of total money spent on investment promotion (million USD) of country i in year t;

\( \text{Control}_{it} \) is a matrix of variables of country i in year t including:

- \( \text{lnMarketsize} \) is the natural logarithm of GDP per capita (USD).
- According to UNCTAD (1998), country market size is an important traditional determinant of market-seeking investment. Large markets can accommodate more companies and allow each to reap the benefits of economies of scale and scope. Gricic and Babic (2003) have used the GDP of the host country as an indicator of absolute market size.

\( \text{lnLaborcost} \) is the natural logarithm of Real wage (USD)

- According to UNCTAD (1998), labor cost is also a key determinant for efficiency-seeking investors. Many studies have explored the role of wages in attracting FDI including Tsai (1994) who was the first one that tested a cheap labor hypothesis using cross-country data and found that an increase in labor cost does discourage FDI. A much earlier study by Schneider and Frey (1985) also suggested that the lower the wage costs, the more profitable it is to invest in the host country.

- NR is the value of Natural resources exports (USD).

According to UNCTAD (1998), natural resources have their own importance for resource-seeking investors. Many scholars (Poelhekke and Ploeg, 2010; Davies, 2009) have studied the role of natural resource abundance in FDI inflows into the host country. The richer in natural resources a country is, the more advantages that country has in terms of assets and available resources, so according to Dunning’s theory of location advantage, multinational companies will prefer to invest in a country rich in natural resources.

**Method**

With the panel data, we would take advantage of a two-part regression GMM model to overcome the defects with data (Baum, Schaffer & Stillman, 2003) to capture the endogeneity problem (if appearing) between the dependent and independent variables. For robustness check of the result consistency, we will also use Generalized least squares (GLS), Fixed-effect model (FEM) and Random effect model (REM).

**Data**

- The value of FDI and other control variables are taken from the available data of the World Bank.
- The value of the investment promotion budget for each Asian country in each year has been manually collected from the media reports from government sites.

\(^1\) The list of nation-level investment promotion agencies will be provided as requested.
Our sample covers 20 Asian countries for the period from 2006-2021\(^2\). Table 2 provides the information of summary statistics\(^3\).

Table 2 shows that the total number of observations of the sample is 173. The variable lnFDI has an average value of 21.51322 (with the corresponding max and min values 26.77641 and 13.81062). The variable lnBudgetIPA has an average value of 7.802744. The standard deviation of lnBudgetIPA is quite significant compared to the average value. We can see an evident variation in BudgetIPA of countries over the years.

Table 2: Summary statistics

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnFDI</td>
<td>173</td>
<td>21.51322</td>
<td>2.382368</td>
<td>13.81062</td>
<td>26.77641</td>
</tr>
<tr>
<td>lnBudgetIP</td>
<td>173</td>
<td>7.802744</td>
<td>3.427503</td>
<td>-1.51413</td>
<td>13.14608</td>
</tr>
<tr>
<td>lnMarketsize</td>
<td>173</td>
<td>25.17371</td>
<td>2.195484</td>
<td>19.93318</td>
<td>30.66237</td>
</tr>
<tr>
<td>lnLaborcost</td>
<td>173</td>
<td>25.92158</td>
<td>3.311379</td>
<td>18.50543</td>
<td>33.5839</td>
</tr>
<tr>
<td>NR</td>
<td>173</td>
<td>8.527978</td>
<td>12.92157</td>
<td>0.000169</td>
<td>79.43095</td>
</tr>
</tbody>
</table>

Source: Authors’ calculation.

Table 3: The results of the effect of investment promotion on FDI for all Asian countries

<table>
<thead>
<tr>
<th></th>
<th>GMM (1)</th>
<th>GLS (2)</th>
<th>FE (3)</th>
<th>RE (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>lnBudgetIP</td>
<td>0.0726*</td>
<td>0.0714*</td>
<td>0.0726*</td>
<td>0.0977**</td>
</tr>
<tr>
<td></td>
<td>(0.0406)</td>
<td>(0.0411)</td>
<td>(0.0406)</td>
<td>(0.0438)</td>
</tr>
<tr>
<td>lnMarketsize</td>
<td>0.575***</td>
<td>0.582***</td>
<td>0.575***</td>
<td>0.538***</td>
</tr>
<tr>
<td></td>
<td>(0.0884)</td>
<td>(0.0951)</td>
<td>(0.0884)</td>
<td>(0.129)</td>
</tr>
<tr>
<td>lnLaborcost</td>
<td>-0.146***</td>
<td>-0.148***</td>
<td>-0.146***</td>
<td>1.453**</td>
</tr>
<tr>
<td></td>
<td>(0.0361)</td>
<td>(0.0366)</td>
<td>(0.0361)</td>
<td>(0.0653)</td>
</tr>
<tr>
<td>NR</td>
<td>0.00298</td>
<td>0.00298</td>
<td>0.0353*</td>
<td>0.0652**</td>
</tr>
<tr>
<td></td>
<td>(0.0157)</td>
<td>(0.0157)</td>
<td>(0.0157)</td>
<td>(0.0201)</td>
</tr>
<tr>
<td>Constant</td>
<td>11.00***</td>
<td>10.86***</td>
<td>10.86***</td>
<td>10.71***</td>
</tr>
<tr>
<td></td>
<td>(1.915)</td>
<td>(2.068)</td>
<td>(1.915)</td>
<td>(2.068)</td>
</tr>
<tr>
<td>Observations</td>
<td>110</td>
<td>110</td>
<td>110</td>
<td>110</td>
</tr>
</tbody>
</table>

Notes: Estimations obtained by using Panel data techniques of two part GMM, Generalized least squares, Fixed and Random effect. *** / ** / * denote the significance level of 1% / 5% / 10% of the t-statistic. Columns (a) considers the inclusion of three control variables which are lnFDI, lnMarketsize and lnLaborcost; Columns (b) adds another variable of NR.

Source: Authors’ calculation.

From Table 3, it is clear that the effects of an investment promotion budget as well as other control variables on FDI are quite consistent across different methods. All the coefficients are consistent in signs, indicating the similarity in the direction of the effect of interested variables on FDI. Except for the only case of NR (Natural Resource), the coefficients for all other three

\(^2\) The list of countries in the whole sample will be provided as requested.

\(^3\) The correlation of variables has been checked and will be provided as requested.
variables of lnBudgetIP, lnMarketsize and lnLaborcost are statistically significant across the main method of GMM and others. We will analyze the results based on what was obtained from the two-part GMM estimations.

Regarding Investment promotion (lnBudgetIP), the statistically significant and positive coefficients prove for the fact that the increase in investment promotion leads to the rise in FDI attraction into Asian countries. In particular, from Column (1-b), the coefficient of $\beta=0.0714$ could be interpreted in the way that as the government of the host country increases the budget spent on investment promotion by 1%, it will attract an additional 0.0714% of foreign direct investment (FDI inflows). This supports the main hypothesis regarding the role of investment promotion.

About the Market size (lnMarketsize), the results also support the idea of market-seeking FDI. The statistically significant coefficient of 0.582 (from Column (1-b)) indicates that when the market size of host countries increases by 1%, FDI inflow goes up by 0.582%.

About the Labor cost (lnLaborcost), the hypothesis that the rise in labor costs will negatively affect the attraction of foreign direct investment is supported as the coefficient of lnLaborcost was -0.148 (Column (1-b)). This means that when labor costs go up by 1%, FDI inflows into the host country will decrease by 0.148%. This explains the cases of efficiency-seeking FDI as foreign investors intend to implement their investment to take advantage of low labor costs.

Regarding Natural Resource (NR); although the coefficients are not significant, they still somehow reflect the role of the availability of natural resources to FDI attraction. However, in the trend of more scarcity of natural resources, the effects are insignificant.

4.2. Effect of investment promotion on FDI for the sub-samples of Asian countries with high and low investment promotion budget

How the effect of investment promotion on FDI could be different in the two groups of Asian countries with high and low investment promotion budgets needs further clarification. The authors calculate the average budget IP. The mean is defined as 10 billion USD, so the authors classify low budget when the average budget is < 10 billion USD and high budget when it is ≥ 10 billion USD. The authors look into the estimation results applying the main method of two-part GMM and the other of GLS for a robustness check for the two groups with a high budget (≥ 10 billion USD) and with a low one (< 10 billion USD) in Table 4.

Table 4: The results of the effect of investment promotion on FDI for sub-samples of Asian countries with high and low investment promotion budget

<table>
<thead>
<tr>
<th></th>
<th>High Budget</th>
<th>Low Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GMM (1)</td>
<td>GLS (2)</td>
</tr>
<tr>
<td>lnBudgetIP</td>
<td>0.137*</td>
<td>0.126*</td>
</tr>
<tr>
<td></td>
<td>(0.0787)</td>
<td>(0.0765)</td>
</tr>
<tr>
<td>lnMarketsize</td>
<td>0.477***</td>
<td>0.506***</td>
</tr>
<tr>
<td></td>
<td>(0.0711)</td>
<td>(0.0705)</td>
</tr>
<tr>
<td>lnLaborcost</td>
<td>-0.106***</td>
<td>-0.0878***</td>
</tr>
<tr>
<td></td>
<td>(0.0307)</td>
<td>(0.0311)</td>
</tr>
<tr>
<td>NR</td>
<td>0.0363**</td>
<td>0.0363**</td>
</tr>
<tr>
<td></td>
<td>(0.0179)</td>
<td>(0.0179)</td>
</tr>
<tr>
<td>Constant</td>
<td>11.83***</td>
<td>10.51***</td>
</tr>
<tr>
<td></td>
<td>(2.001)</td>
<td>(2.046)</td>
</tr>
<tr>
<td>Observations</td>
<td>65</td>
<td>65</td>
</tr>
</tbody>
</table>

Notes: Estimations obtained by using Panel data techniques of two part GMM, Generalized least squares. 
*** / ** / * denote the significance level of 1% / 5% / 10% of the t-statistic.
Source: Authors’ calculation.
Table 4 presents consistent results of coefficients for each of the groups with the usage of the main method of two-part GMM and the other of GLS.

Regarding Investment promotion, it is interesting that the increase in the investment promotion just significantly affects the FDI inflows for the group of high investment promotion budget. In particular, for those countries, as the investment promotion budget goes up by 1%, FDI inflows will be boosted up by 0.126% (Column (1-b)). For the group with a low investment promotion budget, the coefficients are insignificant. Although the coefficients could capture positive signs, their magnitudes are still much lower than those for the other group of high budget. These prove the importance of investment promotion to FDI attraction, but just as the budget for this activity reaches a substantial level.

About Market size and labor cost, the impacts of rises in market size and labor cost are statistically significant and consistent in signs for both groups of high and low investment promotion budget countries. That means the higher the market size or the lower the labor cost, the more FDI host countries could attract. This could be understood in the way that Asian countries either with high or low budgets of investment promotion attract both market-seeking and efficiency-seeking FDI investors. However, interestingly, the effects of both market size and labor costs for countries with low investment promotion budgets are higher than those for the high ones. We could think about the complementarity of investment promotion to other internal factors of host countries to attract FDI. Regarding Natural resources, the coefficients are statistically significant and positive for high budget countries.

4. Conclusion and limitations

Via looking into 20 Asian countries for the period of 2006-2021, applying the main method of two-part GMM (with robustness check), the authors find differently interesting results:

Firstly, investment promotion significantly affects FDI inflows into Asian countries. The positive impact of investment promotion is verified by Wells and Wint (1990); Wells and Wint (2001) and Morisset and Andrews-Johnson (2003). In particular, as the budget for investment promotion increases, FDI into those countries goes up.

Secondly, the effect of investment promotion is significant for the group of high investment promotion budget countries but insignificant for low budget countries. This is consistent with the findings from Morisset (2004) that the effectiveness of investment promotion agencies in attracting FDI varies widely across countries and regions: low, lower-middle, upper-middle, and high-income countries. This is a basis for policy-makers to come up with appropriate investment promotion strategies to attract foreign investment. It is necessary for governments to establish and maintain the operation of the national IPAs. The budget for investment promotion should also account for a relatively high proportion of the government's capital allocation strategy because investment promotion activities such as promoting and after-sales attractive incentives need an expenditure to attract FDI effectively.

Finally, within the Asian region, other factors such as market size and labor cost also have a significant impact on net FDI inflows. Therefore, increasing the market size by promoting economic growth and reducing labor costs are also ways to attract FDI. These are all traditional economic factors that are believed to have a significant impact on FDI attraction from previous studies of Farzanegan and Fereidouni (2014), He et al. (2011), Rodriguez and Bustillo (2010), Lasalle (2006), and Fereidouni et al. (2013).

Despite what has been taken into consideration, this study has not yet explored why countries spend more or less on investment promotion. Future research may investigate the factors affecting the amount of investment promotion budget spending to know more about this. It is possible to examine how the FDI effects differ with the heterogeneity in the economic characteristics of countries, for example comparing the effects of FDI on developed and developing countries. Furthermore, it may also be interesting to investigate in more detail how the location of the investment promotion abroad affects the host country’s ability to generate FDI. Again, this could potentially be investigated
using an expanded sample of countries. Qualitative firm-level or mixed-method studies including interviews with MNE managers investing in developed markets can also help in understanding which investment promotion works the most effectively and ultimately stimulating enterprises to carry out FDI in a certain location.

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