

Measures to Attract FDI

Investment Promotion, Incentives and Policy Intervention

Foreign direct investment (FDI) is attracted into countries for different reasons. At a general level, in order for a country to be more attractive to investors, there is a need to create an enabling environment by reducing so-called hassle costs. But what are these costs? A new study involving 32 developing economies indicates there exists a statistically and economically significant negative nexus between administrative costs and FDI to GDP ratio after controlling for other factors.

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I Introduction

The working assumption nowadays is that in a relatively non-distorted domestic policy environment, foreign direct investment (FDI) brings in much-needed capital, technical know-how, organisational, managerial and marketing practices and global production networks, thus facilitating the process of economic growth and development in host countries [Lall 2000; OECD 2002: Chapters 1 and 3]. For instance, according to the UNCTAD (1999), FDI can complement local development efforts by: (a) increasing financial resources for development; (b) boosting export competitiveness; (c) generating employment and strengthening the skills base; (d) protecting the environment and social responsibility; and (e) enhancing technological capabilities (transfer, diffusion and generation of technology). Technology transfer from FDI in turn operates via four related channels: (i) vertical (backward and forward) linkages with suppliers or purchasers in the host countries; (ii) horizontal linkages with competing or complementary companies in the same industry; (iii) migration of skilled labour; and (iv) the internationalisation of R and D [OECD 2002: 69].

In view of this largely benign view of FDI, there has been an intense 'global race' for foreign investment. No doubt, FDI is attracted into countries for different reasons – resource seeking (natural or human resources), market seeking,

efficiency seeking or strategic-asset seeking. Nonetheless, at a general level, in order for a country to be more attractive to investors (both local and foreign), there is a need to put in place measures to ensure an enabling environment by reducing so-called hassle costs. But what are these costs? Apart from costs arising from an unstable macroeconomic and regulatory environment, administrative barriers and red tape – such as those outlined in Table 1 – can significantly raise the costs of establishing and doing business. A new study involving 32 developing economies indicates there exists a statistically and economically significant negative nexus between administrative costs and FDI to GDP ratio after controlling for other factors [Morisset and Neso 2002].

II Investment Promotion

Over and above the creation of a business-friendly environment, it may be important for a potential host country to actively undertake investment-promotion policies to fill in information gaps or correct perception gaps that may hinder FDI inflows. A commonly used definition of investment promotion is "activities that disseminate information about, or attempt to create an image of the investment site and provide investment services for the prospective investors" [Wells and Wint 1990].

Any investment promotion strategy must be geared towards the following: (a) image-building activities promoting the country and its regions and states as favourable

locations for investment; (b) investment-generating activities through direct targeting of firms by promotion of specific sectors and industries, and personal selling and establishing direct contacts with prospective investors; (c) investment-service activities tailored to prospective and current investors' needs; and (d) raising the realisation ratio (i.e. percentage of the FDI approvals translated into actual flows). Table 2 summarises the annual budgets on investment promotion by selected countries in Asia and elsewhere. As is apparent, Singapore – a major success story as far as FDI-led development is considered [Rajan 2003] – massively outspent the other countries on a per capita basis.

A case might be made for establishing a one-stop investment promotion agency (IPA) to assist in the entry and operation of FDI. The need and logic for an IPA appears to have been embraced by a number of countries, with there being about 160 national IPAs and over 250 sub-national ones [UNCTAD 2001]. While a one-stop investment promotion agency could facilitate FDI by lowering administrative delays and associated cost overruns, Sanjaya Lall (2000) correctly notes that

Table 1: Summary of Administrative Procedures Faced by an Investor

Category and Item
Entry Approvals:
Company registration
Investment code registration
Initial bank deposit
Residence and work permits
Tax office registration
Foreign investment licensing
Business and trading permits
Statistical office registration
Existence, conformity, opening reporting
Health care and pension plans
Social security registration
Land, Site, Development, Utilities:
Access to Land
Town planning certificate
Site inspections and general approvals
Building permits
Electricity and power connection
Telephone and telex
Water and sewerage
Post, box and private bag
Operation requirements:
Import-export intention and permits
Import-export clearance process
Foreign exchange control
Fiscal situation certificate
Health and safety inspections
Labour inspections
Social welfare plan payments

Source: J Morisset and O L Neso (2002), 'Administrative Barriers to Foreign Investment in Developing Countries', *Transnational Corporations*, 11, pp 99-121.

“unless the agencies have the authority needed to negotiate the regulatory system, and unless the rules themselves are simplified, this may not help. On the contrary, there is a very real risk that a ‘one stop shop’ becomes ‘one more stop’” (p 10).

The foregoing conclusion finds justification from a recent empirical analysis of IPAs in 58 countries between February and May 2002 [Morisset 2003]. In particular, while there is some evidence that IPAs have a positive impact on FDI, this is more likely to be the case in circumstances where IPAs (a) have a high degree of political visibility (for instance, by being linked to the highest government official such as the prime minister’s office); (b) have active private sector involvement, via, for instance, participation on the IPA’s board; and (c) operate in a country with an overall good investment environment. The study further finds that the types of functions that IPAs undertake have bearing on their effectiveness (see Table 3 for definitions). ‘Policy advocacy’, which is defined as steps to improve overall investment climate and identify views of private sector, appears to be the most effective function. This is followed by investment facilitation or servicing (the roles conventionally attributed to a one stop shop), and image building. IPAs seem least effective in actually generating sector-specific investments.

This suggests that growth-enhancing policy intervention probably ought not to be sectorally biased. Instead, industrial policy ought to be focused on enhancing a country’s general capability to benefit from FDI by (a) improving the general quality of the country’s labour force and infrastructure; (b) developing local skills and technology and local learning; and (c) ensuring a stable and conducive overall macroeconomic and regulatory environment.

This said, the UNCTAD (2002) continues to advocate a policy of targeted promotion, suggesting it has potentially high payoffs, though also acknowledging that it can be a risky proposition. The UNCTAD position finds support from the successes of countries like Singapore whose investment promotion authority, the Economic Development Board (EDB), has quite successfully targeted specific global corporations or broad sectors to invest in the city state. [For instance see Oman 2000:Chapter 2.]¹

More generally, the choice of the exact type and extent of such investment promotion activities and agencies must be based on a careful and systematic evaluation of potential costs and benefits. One size cannot fit all countries at all times. Particularly in cases where administrative capacity is weak, government failure is pervasive, and resources are scarce, it may

be advisable for countries to eschew selective policy intervention. As Sanjaya Lall notes:

FDI strategy is an art not a science...If administrative capabilities are not appropriate to the skill, information, negotiation and implementation abilities needed, it may be best to minimise interventions with the market: to simply reduce obstacles in the way of FDI, minimise business costs and leave resource allocation to the market... (T)here is no ideal universal strategy on FDI. Strategy has to suit the particular conditions of the country at the particular times, and evolve as its needs change and its competitive position in the world alters [Lall 2000:20-21].

III Fiscal and Financial Incentives

Countries have and will increasingly compete with each other to attract FDI by offering a number of incentives and other concessionary measures. Apart from fiscal or tax incentives, defined as “policies that are designed to reduce the tax burden of a firm” (including loss write-offs and accelerated depreciation), countries could offer financial incentives, defined as “direct contributions to the firm from the government” (including direct capital subsidies, subsidised loans or dedicated infrastructure) [World Bank 2003:Chapter 3].

Many east Asian economies have been particularly aggressive in using preferential tax treatments and other implicit and explicit subsidies to attract FDI, i.e. ‘bidding wars’ or ‘fiscal wars’. To be sure, while systematic evidence of such phenomenon is limited to specific industries (like automobiles and regional headquarter services), as Oman (2000) notes, “the prisoner’s dilemma nature of the competition creates a permanent danger of such wars” (p ii). As is apparent in the case of India and the US, the danger of fiscal wars is particularly prevalent among regions within large countries. From the viewpoint of the country as a whole, broad national

codes of conduct may be useful for effective and economically rational use of such incentives.

Table 4 highlights some common tax incentives – (a) reduced corporate income taxes; (b) tax holidays; (c) investment allowances and tax credits; (d) accelerated depreciation; (e) exemptions from selected indirect taxes; and (f) export processing zones (EPZs) – and their relative merits. Tax holidays and accelerated depreciation appear to be the least desirable, while accelerated depreciation seems to be the most efficient [For an elaboration of the various tax incentives see Fletcher 2002].

As noted, tax incentives form only a part of the overall picture. Even though formal tax incentives may not be available, businesses may still benefit significantly from

Table 3: Functions of an Investment Promotion Agency (IPA)

<i>Image Building:</i> Refers to the function of creating the perception of a country as an attractive site for international investment. Activities commonly associated with image building include focused advertising, public relations events and the generation of favourable news stories by cultivating journalists.
<i>Investor Facilitation and Investors Servicing:</i> Refers to the range of services provided in a host country that can assist an investor in analysing investment decisions, establishing a business, and maintaining it in good standing. Activities include information provision, ‘one-stop shop’ service aimed at expediting approval process, and various assistance in obtaining sites, utilities.
<i>Investment Generation:</i> This entails targeting specific sectors and companies with the aim of creating investment leads. Activities include identification of potential sectors and investors, direct mailing, telephone campaigns, investor forums and seminars and individual presentations to targeted investors.
<i>Policy Advocacy:</i> This consists of the activities via which the agency supports initiatives to improve the investment climate and identifies the views of the private sector on that matter. Activities include surveys of the private sector, participation in task forces, policy and legal proposals, and lobbying.

Source: Reproduced with minor changes from J Morisset (2003). ‘Does a Country Need a Promotion Agency to Attract Foreign Direct Investment? A Small Analytical Model Applied to 58 Countries’, Policy Research Working Paper No 3028, The World Bank.

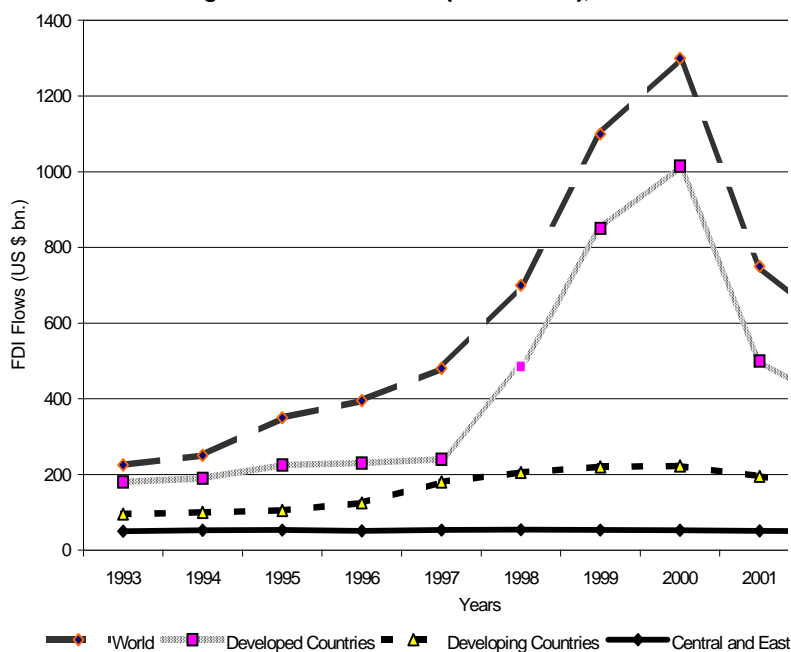
Table 2: Annual FDI Promotion Budget of Selected Countries, 1999

Country	Annual FDI Promotion Budget (US\$ Millions)	Population (Millions)	Per Capita Budget (US\$)
<i>Asian Countries</i>			
Indonesia (BKPM)	2.8	207	0.01
Malaysia (MIDA)	15	22.7	0.66
Philippines (BOI)	3	76.8	0.04
Singapore (EDB)	45	3.2	14.06
<i>Memo: Non-Asian Countries</i>			
Dominican Republic (IPC)	8.8	8.4	1.05
Mauritius Export Development and Investment Authority (1996)	3.1	1.2	2.58
Ireland (IDA, 1999, including grants) ^a	213 (41)	3.7	57.57 (11.16)
Costa Rica (CINDE)	11	3.5	3.14

Notes: a) Figures in parenthesis exclude grants

Source: D W Te Velde (2001), ‘Policies towards Foreign Direct Investment in Developing Countries: Emerging Issues and Outstanding Issues’, Overseas Development Institute, London.

Figure: Global FDI Flows (US\$ Billions), 1993-2002



Source: UNCTAD FDI Database.

fiscal costs of such incentives along with those of investment promotion activities noted above can be fairly burdensome and must always be kept in mind when deciding if and the extent to which such measures are to be utilised.

IV FDI Prospects and Role of Government

The current global environment is characterised by a general slow down in FDI inflows to developing economies, on the one hand, and the existence of a large number of investment alternatives, on the other. Specifically, there have been growing fears that FDI is being diverted from south-east Asia and other developing countries in the Asia-Pacific to China.⁶ In addition, the increased uncertainty and heightened international political and security riskiness worldwide, and cyclical concerns with regard to oversupply of certain goods and services, may preclude global FDI from growing nearly as rapidly as it did in the 1990s. A recent UNCTAD research note refers to “the most dramatic downturn of FDI inflows in history” to describe the current global investment climate [UNCTAD2003].⁷ The downturn has been particularly sharp in developed countries which continue to receive over two-thirds of global FDI flows (see the Figure).

Counterbalancing this pessimism is the possibility that heightened uncertainty could lead investors to consider diversifying investments geographically. The recent SARS outbreak centred in Greater China appears to have fortified this conclusion [Rajan 2003b]. However, if the hitherto peripheral countries are to benefit from this desire by foreign investors for risk diversification, they need to ensure that they have in place sound macroeconomic policies (including a ‘fairly valued’ exchange rate) and a favourable investment climate so as to be seen as viable investment alternatives. In this regard, steps developing countries need to take to ensure an enabling business environment centre around enhancing inter-sectoral factor mobility (and especially reducing labour market rigidities), dismantling barriers to the free entry and exit of firms, relieving some infrastructural bottlenecks (roads, ports and storage), reducing other transactions costs of doing business (investment approvals, custom clearance, etc), including regulatory and legal impediments and strengthening overall governance, including strengthening intellectual property rights (IPRs) [World Bank 2003:Chapter 3].

The role of IPR regime and dispute resolution mechanism warrants mention.

financial incentives.² For instance, Singapore provides subsidies to investors that go well beyond traditional tax measures involving training, expenditure, pricing of land and utilities, and even taking rather large equity stakes in selected ventures.³ As with the formal tax incentives, financial incentives are likely to benefit large companies, both domestic and foreign, disproportionately. In turn, states like Singapore with strong fiscal positions can use a combination of low tax rates and aggressive fiscal incentives as competitive strategies to attract FDI vis-à-vis fiscally weak states in neighbouring south-east Asia (given that such competition tends to be largely intraregional), but elsewhere as well.

While the theoretical literature on FDI incentives is burgeoning [see the review by Devereux 1990], the empirical literature in this area is rather lagging. However, the available empirical evidence to date suggests that such fiscal incentives may be important at the margin in influencing investment decisions. Incentives are particularly useful when used essentially as signalling devices about the government’s/country’s general (welcoming) attitude towards foreign investment and the overall business environment.⁴ Indeed, a recent OECD study suggests the existence of a two-stage investment decision process. Investors initially shortlist a set of potential host countries on the basis of economic and political fundamentals. Investment incentives play no role at this stage. It is only after the shortlist is made that investors consider and in fact seek out investment incentives before deciding where to

invest (by playing off one potential host country against another) [Oman 2000]. Conversely, from the potential host country’s perspective, apart from being costly (given the tax revenues foregone as well as costs of implementation and oversight), such incentives will be least effective when used as substitutes for necessary investment-conducive policies such as disciplined macroeconomic policies, adequate infrastructural and supporting facilities, and a stable and transparent regulatory environment.

In the final analysis, countries will no doubt continue to employ FDI incentives, not least because unilateral withdrawal of incentives as policy instruments by any single country might be potentially costly to it. However, the use of such incentives ought to be guided by certain commonsensical principles. Ad hoc, discretionary regimes which could give rise to rent-seeking activities should be eschewed. Focus should instead be on deploying a simple and predictable tax system with low rates for all investors, with there being no preference between domestic and foreign investors (i.e., uniformity). Corporate tax rates ought to be comparable to those prevailing in capital exporting countries [Moran 1998].⁵

However, three points bear emphasising. One, complexity and uncertainty (i.e., frequent changes) in FDI-related policies (be they incentives, taxes or laws) can have a significant deterring effect on inflows. Two, beyond a signalling role, FDI incentives do not make up for deficiencies in the overall investment climate. Three, the

While the empirical evidence regarding the impact of the quality of the IPR regime on the magnitude of FDI inflows remains uncertain, there is evidence to suggest that inadequate safeguards for protection of IPRs cause a diversion of investment from technology intensive industries ('second-generation investments') and more generally, from projects involving production – especially longer-term investments – to activities involving distribution [Smarzynska 2002].

With regard to specific investment promotion, too many developing countries make public new policy pronouncements regarding ambitious investment and overall growth-enhancing policies but fail at the implementation stage. Done often enough this erodes the credibility of the authorities, thus making it that much harder to attract FDI. It is of little surprise then that FDI is concentrated in developed countries (largely due to cross-border merger and acquisitions activities) and a handful of developing ones, while others lag far behind.

An insufficiently recognised point is that for FDI to have a significantly positive impact on the host country it must have attained a minimum threshold of development itself [OECD 2002:Chapter 2]. Indeed, a careful examination of the empirical studies linking FDI and technological development suggests that FDI is more likely to be a significant catalyst to overall industrial development the higher the income of the host country. This in turn is often interpreted as signifying that the host country must be capable of absorbing the new technology manifested in FDI [for instance Blomstrom et al 1994:521-33]. In similar vein, another common finding is that greatest technological spillovers from FDI occur when the technological gap between local and foreign enterprises is 'not very large', and crowding in of FDI and technology transfer is more likely the higher the level of human capital [OECD 2002: Chapters 5 and 6; Borensztein et al 1995].

In view of the above, and at the risk of generalising, the most effective type of policy intervention appears to involve broad measures to enhance overall human capital and technical capabilities of the domestic economy on a non-discriminatory basis rather than selective intervention to maximise linkages between local firms and local subsidiaries of multinationals or technology transfer domestically from FDI. In any event, policies such as domestic content or performance requirements, joint venture requirements, caps on foreign ownership, technology licensing, location or local employment requirements and the like have generally had mixed results at

best. [For instance, see OECD 2002:Chapter 10.] There may in fact be a tradeoff in the sense that 'artificial' attempts to indigenise FDI activities may make the affiliate operations of multinationals less integrated with the production network of the parent to the detriment of the host country (i.e., 'screw-driver operations').⁸ To maximise spillover benefits from FDI on a sustained basis, host country characteristics (in terms of human capital, technological capacity, etc) must be improved. Any other policy is likely to be ineffective or short-lived at best, distortionary and detrimental at worst. [47]

Notes

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Table 4: Relative Pros and Cons of Selected Types of Fiscal and Financial Incentives

Pros	Cons
<i>Lower Corporate Income Tax Rate on a Selective Basis</i>	
<ul style="list-style-type: none"> ▪ Simple to administer. ▪ Revenue costs more transparent. 	<ul style="list-style-type: none"> ▪ Largest benefits go to high-return firms that are likely to have invested even without incentive. ▪ Could lead to tax avoidance via transfer pricing (intracountry and international). ▪ Acts as windfall to existing investments. ▪ May not be tax spared by home country tax authorities.
<i>Tax Holidays</i>	
<ul style="list-style-type: none"> ▪ Simple to administer. ▪ Allows taxpayers to avoid contact with tax administration (minimising corruption). 	<ul style="list-style-type: none"> ▪ Similar to lower Corporate Income Tax rates, except that it might be tax spared. ▪ Attracts projects of short-term maturity. ▪ Could lead to tax avoidance through the indefinite extension of holidays via 'redesignation' of existing investments as new investments. ▪ Creates competitive distortions between existing and new firms. ▪ Costs are not transparent unless tax filing is required, in which case administrative benefits are foregone.
<i>Investment Allowances and Tax Credits</i>	
<ul style="list-style-type: none"> ▪ Costs are relative transparent. ▪ Can be targeted to certain types of investment. 	<ul style="list-style-type: none"> ▪ Distorts the choice of capital assets towards projects of short-term maturity since an additional allowance is available each time an asset is replaced. ▪ Qualified enterprises might attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. ▪ Greater administrative burden. ▪ Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
<i>Accelerated Depreciation</i>	
<ul style="list-style-type: none"> ▪ Similar benefits to investment allowances and credits. ▪ Generally does not discriminate against long-lived assets. ▪ Moves the corporate tax closer to a consumption-based tax, reducing the distortion against investment typically produced by the former. 	<ul style="list-style-type: none"> ▪ Some administrative burden. ▪ Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
<i>Exemptions from Indirect Taxes (VAT, Import Tariffs, etc)</i>	
<ul style="list-style-type: none"> ▪ Allows taxpayers to avoid contact with tax administration (minimising corruption) 	<ul style="list-style-type: none"> ▪ VAT exemptions may be of little benefit (under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage). ▪ Prone to abuse (easy to divert exempt purchases to unintended recipients).
<i>Export Processing Zones</i>	
<ul style="list-style-type: none"> ▪ Allows taxpayers to avoid contact with tax administration (minimising corruption) 	<ul style="list-style-type: none"> ▪ Distorts locational decisions. ▪ Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base.

Source: K Fletcher (2002). 'Tax Incentives in Cambodia, Lao PDR, and Vietnam', paper prepared for the IMF Conference on Foreign Direct Investment for Cambodia, Lao PDR and Vietnam, (Hanoi, Vietnam, August 16-17) with slight modifications.

- 4 This conclusion with regard to fiscal incentives in east Asia is drawn by V Tanzi and P Shome (1992), 'The Role of Taxation in the Development of East Asian Countries' in T Ito and A Krueger (eds), *The Political Economy of Tax Reform*, University of Chicago Press, Chicago.
 - 5 Indeed, the close nexus between host and source country tax policies is a rather under-appreciated but significant factor in determining the effectiveness of tax incentives (for instance, see Asher and Rajan 2001 and 2003, op cit).
 - 6 For instance, see R Rajan (2003a). 'Emergence of China as an Economic Power: What Does It Imply for Southeast Asia?', *Economic and Political Weekly*, 38 (26), June 28, 2003, pp 2639-44 and R Rajan (2003b), 'Implications of the Emergence of the PRC as an Economic Power for ASEAN: Threat, Opportunity, or Both?', report prepared for the Asian Development Bank (April). For a discussion of why India versus China, see R Maitra (2003). 'Why India's Economy Lags Behind China's', *Asia Times*, September 9 and Y Huang T Khanna (2003). 'Can India Overtake China?', *Foreign Policy*, July-August, pp 74-81.
 - 7 General reasons behind this decline include continued weakness and uncertainty in global economic prospects, decline in equity markets worldwide and drop in the value of cross-border mergers and acquisition (M and A) activities.
 - 8 In addition, there are acute risks in restricting FDI inflows or activities so as to promote the development of local enterprises (conventional 'infant industry' argument). For instance, it is often quite difficult in reality to distinguish between crowding out and legitimate competition.
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