Written evidence submission from Professor Nigel Driffield (Professor of International Business / Deputy Pro-Vice Chancellor at University of Warwick) (IFD0005)

Introduction

1. I have been researching inward investment in the context of the UK, its productivity and employment since I started my Phd in 1988. I am now the lead for the ESRC productivity institute for both the midlands, and the areas of research aligned to inward investment. I was asked to contribute to the evidence submission made in response to this call by the Regional Studies Association, which I have (briefly) largely focussing on the responses around sovereign wealth funds.
2. At the time of submitting this, I am finishing editing a "white paper" for the ESRC Productivity Institute on "inward investment and UK productivity", which speaks to the following three questions that you posed in your call for evidence.

In summary:

3. International competition for FDI, especially in high tech sectors, will become more severe.
4. Firms will be encouraged, through emergency funding, to focus on employment at home rather than abroad.
5. Debt financed FDI is going to be more common as interest rates stay low, especially in OECD countries.
6. In order to establish legitimacy in host countries, and to spread risk, investors will seek host country partners. This discourages knowledge transfer from the home country, due to concerns about property rights protection.
7. FDI is going to be concentrated in less tradable sectors, such as construction. These tend to be lower productivity sectors.

The three central tenets of post COVID-19 recovery / levelling up in the UK are likely to be:

8. Investment and productivity – especially in the context of increased levels of debt;
9. Levelling up between regions;
10. Inclusivity within regions. Inward investment policy in the UK has been synonymous with industrial and regional policy. Policy thinking has attempted to identify, support and attract inward investment as a key element of regional development.

Detailed Responses

How can the Office for Investment most effectively fulfil its remit to "support the landing of high value investment opportunities into the UK", while "ensuring high and rigorous standards of scrutiny and security"?

11. Driffield and Karoglou (2019) examine the long run trends in inward investment in the UK, as well as the short-term adjustments in those trends. Their analysis of Brexit suggests that there will be a short term hit on inward investment of perhaps 4 years, but even as inward investment recovers, this will settle on a new lower long-term trend. While the devaluation of sterling has encouraged acquisition of UK assets by wealth funds and other investment arms, foreign investment in new activity is down 90% on pre-referendum levels in many sectors.

12. Equally, as the world recovers from COVID-19, many firms around the world are going to owe their governments a good deal of money, or will have been in receipt of significant support. One return that governments will want on this investment is jobs being brought back home. There is going to be pressure of firms to create jobs at home, and to engage in reshoring. At the same time, COVID-19 has also shone a light on the vulnerability of very long and fragmented global value chains, so it is reasonable to expect many to shorten or become more concentrated (The Economist, 2020). There will be challenges for investors if they seek to operate supply chains that cross (sometimes several times) between the UK and EU.

13. Nevertheless, it is also fair to say that there are some big projects that will take place in the UK irrespective of Brexit—the HS2 train line or Hinckley Point Power Station, for example. Foreign investors will be attracted by such activity. Still, they are not bringing new business as such activity is proceeding independent of Brexit. Locations therefore need to consider the nature of their value proposition to inward investors, backed up by land availability, which possibly involves some difficult decisions regarding opening greenbelt land in the UK. Part of this proposition needs to involve building more robust supply chains to support inward investors; addressing skill shortages in overheated labor markets. Some of these will require a more activist industrial policy in terms of, say, rebuilding supply chains in the UK and encouraging "reshoring." [1]

How does the Government's Investment Strategy relate to its Industrial Strategy, its regional policy and the "levelling up" agenda?

14. A major focus of government policy, especially during a recession, is employment, and inward investment is seen as vital. However, understanding the importance of inward investment to job creation in the UK requires an understanding of investors' motivation for being in the UK, and also the activities that they undertake here. Most of the investment in the UK from abroad may be classified as either 'market seeking', to serve customers across the single market or in the UK, or alternatively 'efficiency seeking FDI'. The latter refers to firms seeking the most efficient location to carry out specific activities. Typically, both types of inward investment are characterised by different local multiplier effects and supply chain activities, which bring additional benefits to the host economy. Previous literature (Driffield and Love, 2007; Becker et al., 2020) has linked FDI, and particularly FDI motive, to its employment effects, and notably the impact on inequality. It is important that any inward investment strategy is part of the "levelling up" agenda, rather than simply pursuing a "productivity at all costs approach". In addition, policy tools will have to focus not only on the attraction of new FDI, but also in the retention of the existing ones to preserve jobs and supply chains in local communities.

15. Research needs to revisit importance of national and local policy for FDI attraction and retention, building on Crescenzi et al. (2020), exploring Investment Promotion Agencies (IPAs) and their effectiveness. One concern is that competition between regions may become "too intense", with regions desperate to attract investment and boost employment. In addition, we will explore the capacity of IPAs to retain FDI with special reference to the challenges of re-shoring discussed above.

16. We will then link this to the problems being addressed in the workstream of part of the ESRC Productivity Institute. This will in part build on the analysis of Castellani & Zanfei (2006), Driffield and Love (2007), Castellani and Pieri (2013), Crescenzi et al (2015); Driffield et al. (2016); in terms of, not merely the spillover effects (Du and Vanino, 2020), but how foreign affiliates in the UK generate productivity growth

[1] For a more detailed discussion, please see Regional Studies Association, "Response to the industrial strategy green paper consultation," 2017, http://www.regionalstudies.org/uploads/documents/Regional_Studies_Association_FINAL-5.pdf

themselves. In turn, we will explore differential gains, across regions and sectors, benchmarking with other countries. An example is work done for Germany exploring the importance of inward investment for the post-crash recovery (Driffield and Temouri, 2014).

17. In this context, there is a trade-off between employment and productivity – inward investors that generate large numbers of jobs may be in lower value-added activity, compared with investments in for example biotech than create fewer jobs. Local policy then needs to emphasise linkages and connectivity, encouraging local sourcing, and focussing for example on local labour or capital markets that may hinder this. Finally, working with universities and other R&D facilities locally to encourage collaboration between higher education, inward investors and local companies on innovation. Reiterating our point from above, this requires an understanding of the benefits of inward investment, for example of the benefits to supply chains or through knowledge transfer from inward investors into local firms. In terms of fostering productivity growth from inward investment can generate productivity growth in the host location are by no means straightforward.

Devolution and inward investment promotion

18. In terms of the direct effects of attracting inward investment, as Harris and Robinson (2001) outline in some detail, the impact of productivity is not straightforward. Continuing the theme developed above when discussing the indirect effects, then the various evaluations of government interventions highlight a key distinction. Firstly, most interventions are focussed on areas of above average unemployment, and emphasise job creation. In contrast, the literature on the location of R&D activity or other high-tech activity emphasise that these tend to be concentrated in richer areas. The most appealing approach to this problem is offered by Devereux et al. (2007), who link tax incentives to firms' location decisions, showing that a key driver, irrespective of activity, is the user cost of capital, for which of course tax policy can be important. They also show that agglomeration economies, and proximity to other firms with high R&D spend drives location.

19. This, therefore, highlights a dichotomy in terms of inward investment's contribution to regional productivity. Areas with higher average productivity attract high productivity FDI, while areas with lower average productivity attract more mundane activities, which may well generate higher levels of employment, but contribute less to productivity growth. The risk therefore is that inward investment can act to increase productivity differences between regions.

20. Recent work by Crescenzi et al (2020) highlight this, in their analysis of regions drive to attract FDI. In the case of the UK, they find that the targeting of certain sectors by Local Economic Partnerships (LEPs) is effective in attracting inward investment in those sectors. Again, it should be notes that LEPs again have jobs targets as part of their remit, and ongoing work as part of the ESRC funded work on local institutions and prosperity[2] highlights a similar result, that is LEPs with lower levels of prosperity focus on attracting large scale (but low productivity) jobs, while richer ones do the opposite. This runs the risk of locking the less prosperous areas of the UK into a low skill- low productivity equilibrium, where successive rounds of inward investment simply re-enforce this.

21. The overlap between FDI promotion and governance is discussed in detail by Pasquinelli and Vuignier (2020), who explore the multiple layers of export promotion, and overlapping policy objectives. The UK for example has sought to address this by placing business at the centre of local development strategy through the introduction of LEPs. Thus, partnerships between local economic development functions, inward investors and local firms, have changed the process of local economic development and the corresponding patterns of internationalisation, (Almond, Ferner, & Tregaskis, 2015), but present some hitherto unanswered questions regarding the value propositions these partnerships are able to offer to international business. For productivity, the most notable consideration is that LEPs have employment targets, so many have to seek employment of any kind, to improve the overall economic performance of the region, and to close the fiscal gap. This however risks pushing less prosperous locations into low productivity employment, and location decisions of internationally mobile capital may reinforce this.

[2] For additional details, please see https://lipsit.ac.uk/project-outputs/

What advice, support and assistance should the Government be providing to inward investors – and how can it most effectively communicate with investors?

22. One cannot divorce the analysis of the impacts of inward investment from a firm's rationale or motive for undertaking this investment. There are numerous reasons for this, but they centre around the motivations for multinational enterprises (MNEs) to transfer knowledge between the parent and affiliates, or between affiliates. The motive for engaging in FDI in a given location determines not only the nature of direct international knowledge transfer by the firm, but also its engagement with local businesses, through buyer-supplier relationships, clusters, and also factors such as demands for different types of labour, which in turn influences the extent of knowledge transfer from the inward investor to local firms.

23. Building on this, one crucially cannot ignore the ownership structure of foreign subsidiaries. Minority versus majority foreign ownership and other more complex ownerships structure analysis will have varying effects on productivity. We find that the international business and strategy literature has been more effective in showing conceptually why and how foreign ownership structures matter for productivity, while the applied economics literature has been better at analysing it empirically.

24. One also needs to consider the nature of the host locations and sectors. Typically, this has been expressed in terms of their ability to assimilate knowledge, but we argue that the issue is more fundamental than this. A crucial element of the analysis of UK productivity is the question of whether certain locations have low productivity sectors, or whether comparing like for like, productivity in a given location is lower than elsewhere. The impact of inward investment needs to be seen in a similar light, not just in terms of the types of firms that enter, but the links between them and the local sector. Low productivity firms are less appealing and suppliers to inward investors, but equally if low levels of prosperity are being driven by low productivity, then attracting inward investment is unlikely to change this.

February 2021