Evidence for Inward Foreign Direct Investment

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Dear International Trade Committee,

1. I am very pleased to offer my thoughts in this piece of written evidence for Inward Foreign Direct Investment, based on my own research and the wider international business literature, with a hope to assist the Committee and the Office for Investment (hereafter the Office) to make informed decisions on the particular question of "<u>What advice, support and assistance should the Government be providing to inward investors – and how can it most effectively communicate with investors?</u>" Please feel free to contact if there is any query or anything I can help further.

Advice, support and assistance for inward investors

Difficulties faced by foreign investors

2. Foreign direct investment (FDI) can be very risky for foreign investors due to the liability of foreignness (Zaheer, 1995) and the institutional distance (Eden & Miller, 2004) lying between the host country and the home country, which have been well documented in the literature. To attract FDI and support investors, it is important to have a **market orientation** (Narver and Slater, 1990) and consider FDI from the foreign investors' perspective. Being market orientated means the Office understands its customers – investors, the competitors – other investment destinations, and works as one sharing and using the information about investors and competitors across different departments, which ensures the service and support from multiple points deliver the same voice and coherent standards and quality in promoting the investment opportunities in the UK.

Liability of foreignness (LOF)

3. Liability of foreignness (LOF) refers to fundamental hurdles that foreign investors face in choosing and operating in host countries in comparison to

local ones, including the lack of knowledge among local stakeholders of the foreign firm's products and brand, and differences in management practices that ultimately lead to foreign firms' competitive disadvantage and underperformance in host markets (Zaheer, 1995). LOF also increase the exit probability of foreign firms from the market (Mata & Freitas, 2012).

4. The literature reveals at least four sources of disadvantage for foreign firms due to LOF (Zaheer, 1995). First, they incur spatial costs that come from extra costs in long-distance transportation, coordination and management. Despite development in communication and logistic technologies, these costs can stubbornly persist.

5. Second, they have costs due to unfamiliarity with the local environment.

6. Third, they have costs due to the lack of legitimacy of the foreign identity, as well as the prevalence of economic nationalism in host countries (Bell, Filatotchev, & Rasheed, 2012; Zhang & He, 2014). Moreover, the costs arise because local customers are less familiar with their brand and products, and they would tend to purchase local brands, which they feel more familiar with. Firms from emerging markets are particularly victims because of their poor institutional image (He & Zhang, 2018).

7. Fourth, there are costs rising out of the home-country environment, e.g. trade and investment restriction (e.g. high-technology exports).

8. On the contrary, local businesses own better information regarding local competitive environment, including the societal environment (politics, law, economy, society and technology), the industry and forces affecting it (suppliers, competition, buyers, stakeholders).

Institutional distance

9. Institutional distance exacerbates the social costs of access and acceptance from liability of foreignness (Eden & Miller, 2004). Here institutions do not refer to organisations, but "cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior" (Scott, 1995, p. 33).

10. Institutional distance is the extent to which institutions vary between countries. Institutional differences give rise to difficulties for foreign firms to gain **legitimacy** in a host country.

11. The regulatory dimension, consisting of the rules, laws and regulations that define mechanisms (e.g. regulating competition and transactions) for market participants for access to resources, is very salient. Regulative distance captures the differences in the general legal environments between home and host countries, and higher regulative distance can discourage foreign investors from coming (Bell, Filatotchev, & Rasheed, 2012).

12. Another key dimension is cultural distance. A country's culture constitutes "created and learned standards for perception, cognition, judgment, or behavior shared by members of a certain group" (Fu et al. 2004, p. 288). Differences between the cultures of the home and the host not only add difficulty for foreign investors to understand the customers and partners in the host country, but also for them to be properly understood and accepted by local stakeholders.

13. Institutional distance is the key driver behind each of these costs arising from unfamiliarity, relational, and discriminatory hazards that are caused by LOF, as mentioned above.

How to effectively advise, support, assist and communicate with inward investors?

14. Based on the discussions above, it is key to help potential and existing foreign investors to overcome LOF and institutional distance, and reduce the costs that rise from them, and to communicate with them on these fronts.

15. Foreign investors can actively develop and implement strategies to tackle some of these issues (Bell, Filatotchev, & Rasheed, 2012). For example, many internationalising firms carry out market research to gather and analyse information to understand the host country, hire experienced employees and/or consultants, accumulate and learn from their internationalisation experience, and imitate domestic firms' practices (Wu & Salomon, 2016).

16. Nevertheless, for them, even large and experienced businesses, gaining **legitimacy** stands a critical challenge. No matter the investment is mergers and acquisitions or greenfield investment, legitimacy is important for the investors to be considered as consistent with other businesses and to be able to acquire key resources for its operations. Moreover, the LOF and institutional distance can vary among investors from different countries, mitigated to various degrees due to their capabilities and international experience.

17. The Office needs to help inward investors on this aspect, and close the institutional distance they face.

18. First, for the spatial costs, the Office along with other agencies and local governments need to provide first class infrastructures, facilities and services including roads, easy and stable access to utilities, supply of services, fast speed internet, fast track of business visa processing, etc.

19. Second, it can provide advice and support to close the gap in unfamiliarity of foreign investors. These can include websites and materials by the Office and its overseas branches offering systematic information package on the investment environment and its advantage in the UK, covering the macro- and micro- environments. Task forces in different languages are helpful to respond to investor's queries in forms of calls, posts and emails.

20. Third, it can help to address the issue of lack of legitimacy of foreign investors by promoting the overall image of foreign investment and creating a welcoming environment, including the issues of the prevalence of economic nationalism which can put off investment. Research suggests endorsements by reputable third parties may reduce LOF and enhance FDI's legitimacy in the host countries (Bell, Filatotchev & Rasheed, 2012). The UK Government and the Office need to work on this area by helping foreign investors use certification by high-status information intermediaries including rating agencies, audit firms, market analysts, and alliance partners to improve their legitimacy.

21. Fourth, to lower the investors' costs rising out of the home-country environment, the Government and the Office can look to develop better trading relationship with potential and existing investing countries to foster stable and healthy relationships.

22. The communication with foreign investors is ideally customised to target and deliver tailored information to specific firms or firms from a particular region/industry. This can be done following a SWOT analysis (strengths, weaknesses, opportunities and threats) of the UK's and its regions' (SWOT) in relation to sectors and key competitors. Based on SWOT, a marketing plan for each sectors and target markets is very useful to guide the communication to clearly identify potential investors, competitively position the UK as their investment destination, and outline FDI opportunities and explain how they meet investors' objectives.

23. Communication and promotion tools include both targeted and general tools, e.g. dedicated FDI promotion and informative websites, email campaigns, PR campaigns, brochures, newsletters, investment exhibitions, business conferences (Loewendahl, 2001). For instance, investment missions to key target country is a useful way to create investment interest and initiate connection with potential customers. This can be even more effective when aiming at identified investors to demonstrate the feasibility to meet their strategic needs. Another useful channel is investment promotion events to showcase investment opportunities, particularly sector-specific information. It will be very helpful to include presentations satisfied investors to enhance credibility.

24. A recent study (Knoerich & Vitting, 2021) shows that running investment promotion agencies (IPA) branches in emerging economies, where multinationals are beginning to internationalise and are in greater need for guidance and support in the process, helps the most in promoting and creating new investments. IPA branches can improve awareness and confidence among potential investors about their advantages, provide investment facilitation and servicing, and policy advocacy. Of course, IPAs and branches need investment in the human capital to have officers that are specialised, business-savvy and internationalised.

25. Another study (Wilson & Baack, 2012) shows advertising attracting FDI can focus on knowledge resources, market attractiveness, economic governance, infrastructure, and natural resources. For the UK, knowledge resources, market attractiveness, economic governance, infrastructure can particularly be attractive to investors.

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