The UK's Foreign Investment Position Post Brexit And COVID: Briefing 3

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Highlights

This briefing focuses on the changes in the makeup of Foreign Direct Investment (FDI) that has entered the UK since the Brexit referendum and explores what those changes means for productivity. The main findings include:

1. An increase in the proportion of FDI coming into the UK focused on the local market, rather than using the UK as an export platform.
2. Re-investment by existing investors, which declined dramatically after Brexit, is starting to recover.
3. FDI being attracted into the UK is now more likely to become embedded in local ecosystems, which results in increased spillovers of knowledge and productivity.
4. There is a risk that this FDI will fuel demand for more skilled labour and exacerbate skills shortages.

Figure 1. Top 11 project motives of greenfield FDI investments

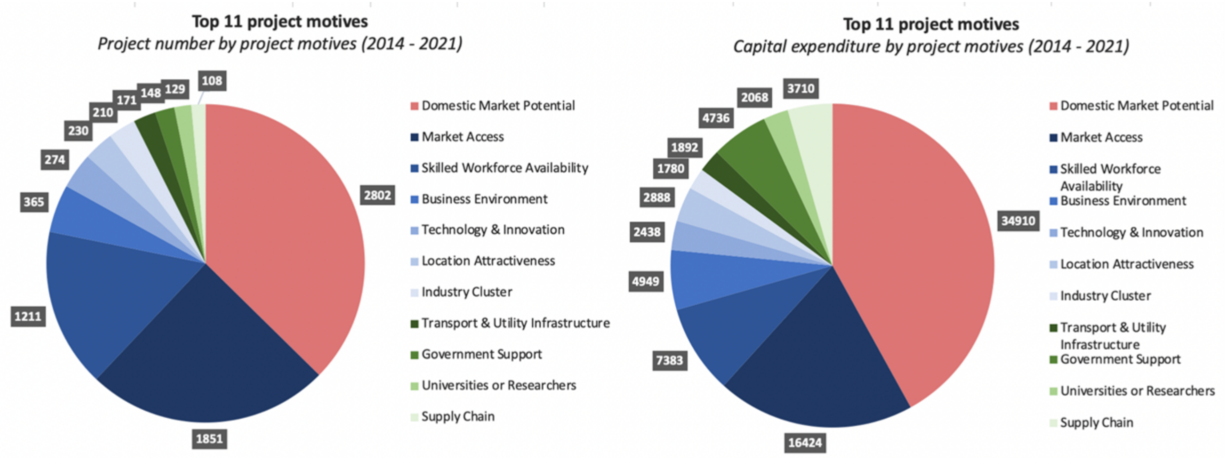
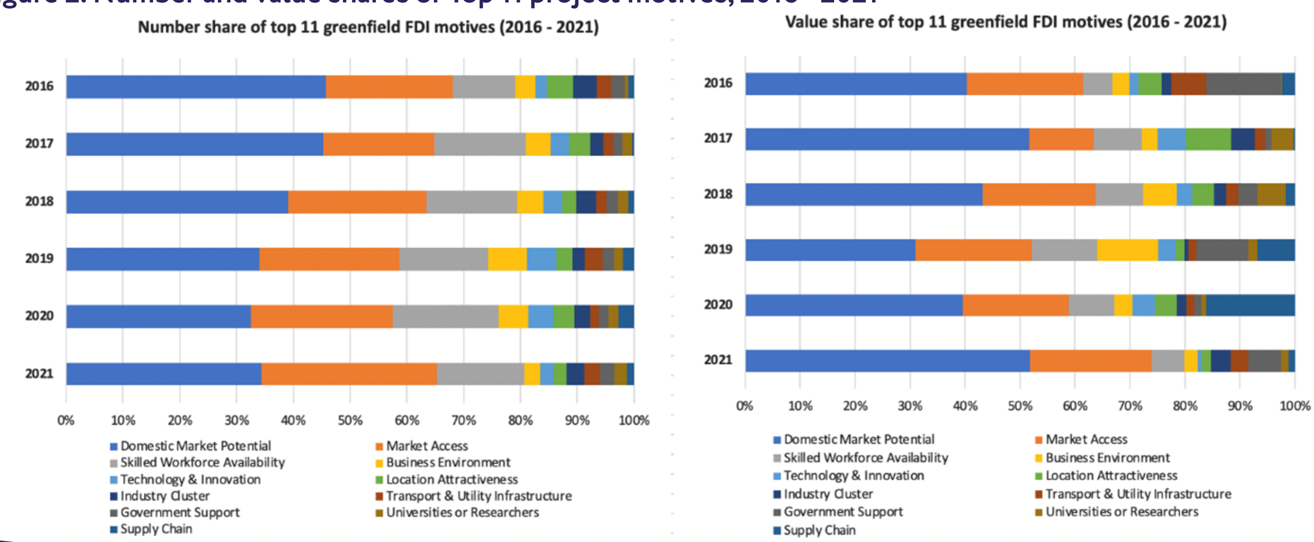


Figure 2. Number and value shares of Top 11 project motives, 2016 - 2021



Source: Orbis Crossborder Investment database and authors' own calculation

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Introduction

While there has been a good deal of focus on the volumes of FDI that this country attracts, there has been less attention on the motives for the investments entering into the UK. There are a number of reasons why this should not be overlooked. Firstly, it is well established that **the motive for investment to enter a particular location**, for example, in terms of the desire to make gains in efficiency, to access new technology or new markets, or to acquire resources, **is a key driver of the magnitude of the beneficial effects that accrue to the host location, particularly in terms of productivity growth**. This is an argument that dates back to Driffield and Love (2007)[1].

In this third briefing in the series, we explore the motives of inward greenfield FDI and illustrate the changes in the distribution of motives over time. We then analyse the structure of greenfield FDI from the perspectives of project type and type of markets served, revealing that the majority of the new projects landing in the UK are primarily to serve the UK local market. We finish this piece by highlighting what our findings mean for the productivity. Our reason for focusing on greenfield FDI is twofold: firstly, this means we are able to isolate genuinely new investment that enters the UK, rather than changes of ownership; secondly, we can then explain a feature of the data that provides information on FDI motive.

It is reasonable to assume that the changing nature of the relationship between the UK and the EU will change the nature of FDI that the UK attracts. For the past 40 years, Britain's value proposition to inward investors was that it was a bridge between Europe and the rest of the world, with flexible labour markets, stable institutions, and access to seemingly limitless investment capital through the City of London. However, we would expect that investors now seeking to enter the UK will be focused on the UK market rather than exporting to the EU. The UK's withdrawal from the freedom of assets movement of the single market may impinge on the ability of our flexible labour market to attract FDI. In turn, the changing nature of the motives for FDI entering the UK will alter the relationship between inward investment and UK productivity[2].

We also explore the distinctions between new investment and re-investment, and what this tells us about the prospects for productivity. Re-investment is particularly important in this context because it is perhaps the earliest indicator of the confidence that existing investors have in the UK, with subsequent activities indicating further investments in technology or upgrading to deliver new products (such as the revamping of a production line to deliver new models). As we show, there has been some recovery in these figures, surpassing the value in 2015 in real terms.

1 Driffield, N., & Love, J. H. (2007). Linking FDI motivation and host economy productivity effects: conceptual and empirical analysis. Journal of international business studies, 38, 460-473.

2 This relationship in general is discussed in more detail in N. Driffield, X. Yuan, F. Gutierrez Barragan (2022) The UK's Foreign Investment Position Post Brexit And COVID: Briefing 2, October 2022, The Productivity Institute.

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Project motives of greenfield FDI

Figure 1 presents an overview of the motives for greenfield FDI projects in the UK based on the Orbis Crossborder Investment data. Consistently, the top 3 project motives, both in terms of project number and capital expenditure, are Domestic Market Potential[1], Market Access[2], and Skilled Workforce Availability[3]. Together, they account for over 78% of project number and nearly 71% of capital expenditure among the total of the top 11. As a relatively large and open economy, it is not surprising that the UK market has always appealed to investors, but it is worth mentioning that Skilled Workforce Availability occupies a relatively smaller value share than its project number share, whereas capital expenditures associated with Government Support[4] and Supply Chain[5] motives are proportionally larger compared with the project counts of these two motives.

These charts highlight the attractiveness of the UK over a prolonged period and reflect our historic performance in attracting inward investment. The most notable change in the pattern of motive between 2016 and 2021 is the reduction in the importance of the potential market that investing in the UK can reach (though still important) and the steady increase in the role of Market Access to the market. This is not surprising and suggests that the UK is attracting investment from firms wishing to serve the UK market, who may previously have done so to serve the EU market. More variations can be detected when the aggregate inflows of different motives are mapped across our observation period.

Figure 2 depicts the patterns of both number and value shares of different motives between 2016 and 2021. Interestingly, while Government Support only takes up a relatively small share of project quantity, those projects tend to be of high value. For example, in 2016, Siemens and Associated British Ports announced the opening of a turbine blade manufacturing plant worth 310 million GBP in Hull, and in 2019, Esso Petroleum announced the expansion of its petroleum refinery plant, hydrogen manufacturing plant and hydrotreater unit worth over 770 million GBP in Fawley. The flow of Supply Chain motive has experienced an evident growth starting from 2018, with its value share reaching over 16% of the total of top 11 in 2020.

The COVID-19 pandemic brought about disruptions to the existing supply chains globally, leading to regional breakdowns and triggering the reconfigurations of global value chains and global production networks. Part of the reason behind this change might be the fact that, after the pandemic, companies started to rebuild their trading relationships and are more inclined to find alternative local suppliers and customers in order to mitigate the potential disruptions.

1 Domestic Market Potential is selected when the company has identified that demand in this market/country/city is growing or is on the cusp of growth.

2 Market Access is selected when the company has identified a location as beneficial due to its location being close to existing customers and potential clients.

3 Skilled Workforce Availability is selected when the company has stated that a qualified, skilled or appropriately educated workforce in the area was one of the reasons it chose to establish itself there.

4 Government Support is selected when the company has cited non-financial support from the local IPA or government body as a reason for locating there.

5 Supply Chain is selected when the company cites a location as being desirable because its suppliers are close by.

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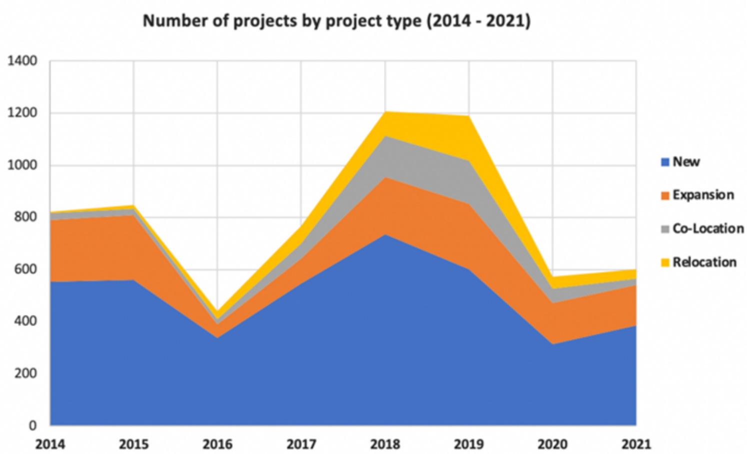
Structure of greenfield FDI - Project type

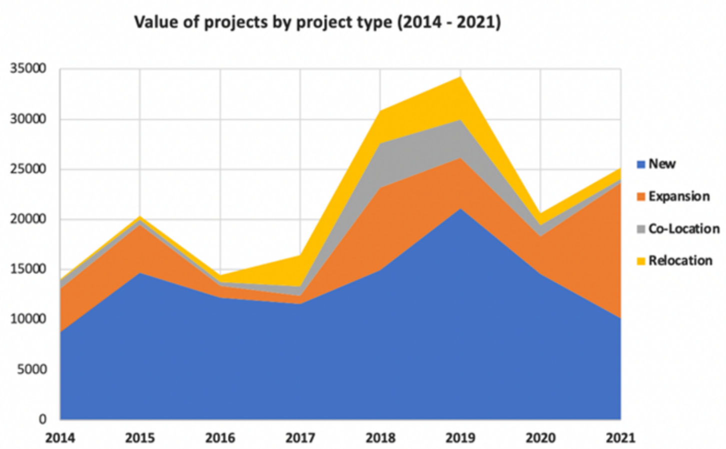
Figure 3 presents the outline of different project types in terms of quantity and capital expenditure over time. In general, all four types of project investment showed a decline in quantity and capital expenditure around the time of the 2016 referendum. In 2020, FDI was hit by the COVID-19 pandemic, explaining the overall changing patterns of the UK FDI performance.

Overall, between 2014 and 2021, nearly 63% of total FDI projects landing in the UK were to set up a new operation, noted as New projects, which could be a manufacturing plant, regional headquarters, or sales office. The share of New projects by quantity was on a descending slope from 2016 to 2019, followed by a recovery in the share starting from 2020.

While the reduction in the value of New projects is a concern, the partial recovery of Expansion projects is perhaps the most reassuring aspect of these data. Expansion is typically described as additional capital being invested or jobs being created in an existing project, such as new staff hires or adding a new line to an existing manufacturing plant. It is the second most important project type, on average holding 22% of project number and 24% of capital expenditure of the total. Figure 3 demonstrates that, while there was an initial decline in expansion investment post-Brexit, it has recovered in recent years and has surpassed the value in 2015 in real terms.

Figure 3. Number and capital expenditure of projects by project type, 2014 - 2021





Source: Orbis Crossborder Investment database and authors' own calculation

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Structure of greenfield FDI - Markets served

Three types of markets that investments are designed to serve are included in this analysis: Domestic[1], Region (Europe)[2], and Global[3 4]. Figure 4 delineates the trends in the three types of markets served, with the distribution of number of projects and value share over the period presented in Figure 5.

Looking across the period, Domestic market attracted the largest share of FDI projects, amounting to over 62% of project number and 70% of capital expenditure. This is followed by Regional (Europe) market, which accounted for a relatively stable share of project number (on average 28%) over 2016-2020. What is noteworthy is that its value share reached up to 38% in 2017, one year after the Brexit referendum, and rebounded to 25% in 2021 after the pandemic.

One interesting feature of the data is the relationship between the scale of new project investment and the intended market of greenfield projects; that is to say, the relationship between new projects and those with a UK local market focus. When comparing the graphs of project number and capital expenditure in Figure 3 with those in Figure 4, one can see that the two blue segments ("New" in Figure 3, and "Domestic" in Figure 4) display a strikingly similar trend between 2016-2021.

Figure 6 illustrates the two-way scatter; using the monthly data for the relationship between New projects and projects serving the domestic market between 2016 and 2021 across the UK, we find that both the quantity and value of New projects are highly correlated with those of the projects focused on domestic markets in a given month. As one can see from the trends in Figure 6, as the number and value of New projects increase, the number and value of projects serving the domestic market go up. This implies that new investments are strongly focused on the UK market, which in turn means that such investment activities (possibly because of the frictions in trade due to Brexit) are likely to become more embedded in the UK and generate greater spillover effects. This is, of course, dependent on the nature of the technology employed.

1 This means the project is primarily designed to serve the local market of the area where the investment will be.
2 A project will be classified as serving "Regional" markets when the article description stipulates that the project will serve multiple countries.
3 A project serving "Global" markets will typically serve a number of regions or several regions across different continents. These projects also tend to be highly mobile, having considered multiple global locations.
4 The fourth category "Not specified" is omitted due to missing information.

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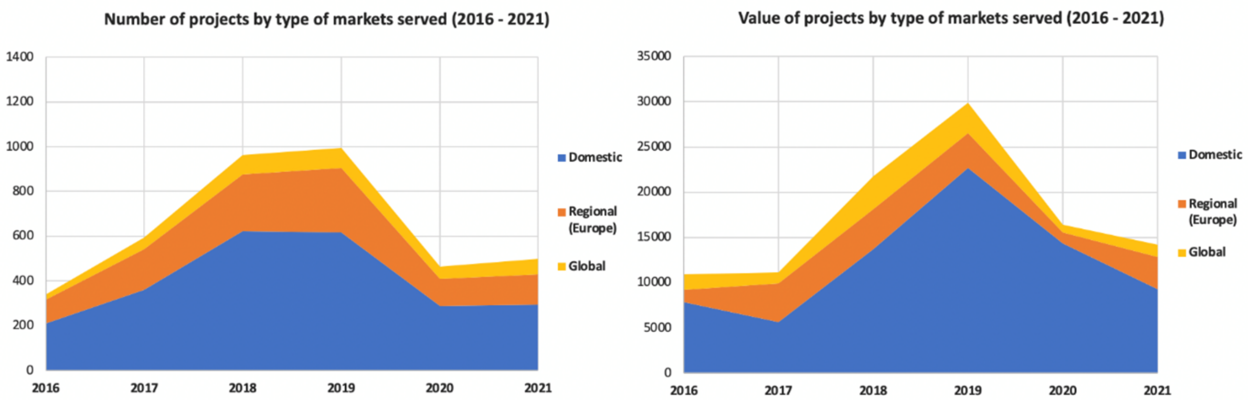
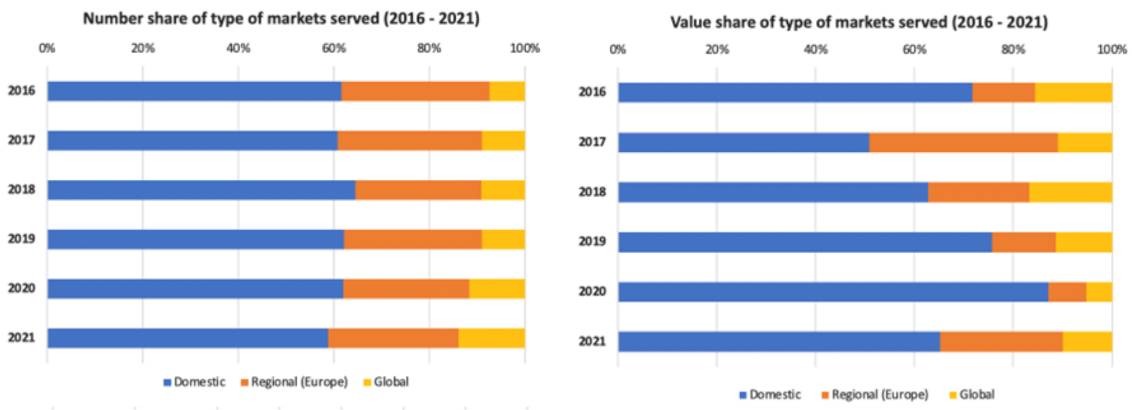
Figure 4. Number and capital expenditure of projects by type of markets served, 2016 - 2021



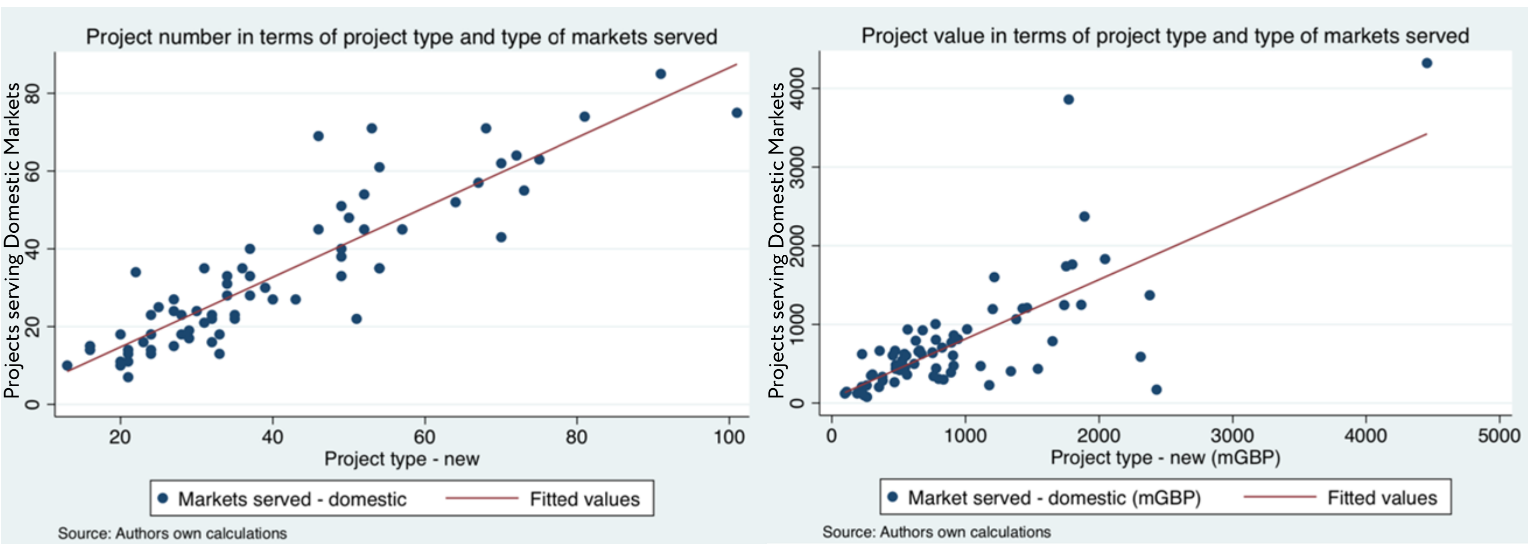
Source: Orbis Crossborder Investment database and authors' own calculation

Figure 5. Number and value shares of type of markets served, 2016 - 2021



Source: Orbis Crossborder Investment database and authors' own calculation

Figure 6. The relationship between New projects and projects serving Domestic Markets, by month between 2016-2021



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What do changes in investment motive mean for productivity?

A recent National Audit Office report into inward investment promotion in the UK highlights the challenges that the UK has faced in terms of maintaining inward investment levels post-Brexit. It also underlines the challenges in maintaining the historic levels of additionality, in terms of additional jobs created, or the wider benefits to the UK, such as improved productivity.

The data presented here underscores some reasons for the above argument, as FDI focused on the UK local market potentially has less headroom for growth than export-oriented FDI. However, in terms of its contribution to productivity, there are some reasons for optimism. FDI focused on a particular market tends to become more integrated into the local economy, and as a result, generate higher rates of productivity spillovers. It can also increase the competition in those markets, encouraging competition-led efficiency gains and further productivity growth. In addition, FDI attracted by a skilled workforce is also inclined to be more high-tech, and thus larger efficiency gains can be expected in the wider economy via investors' levering their existing technology into the UK market.[1]

It is notable that the percentage of FDI attracted to pre-existing clusters or existing supply chains remains low, suggesting that **further action is needed to encourage investors to support clusters and supply chains**, as such interactions have been shown to generate the greatest benefits for productivity from attracting FDI. These investments, likely to be concentrated in particular locations, reflect the large differences in the additionality generated by inward investment across both locations and sectors.

Finally, the recovery of the Expansion figures (additional capital being invested or jobs being created in an existing project) is also suggestive of the potential for fostering future productivity growth. Such firms are already integrated into the local economy, so any spillovers or knowledge transfer effects are more immediate, fostering productivity growth at the local level. Policy needs to focus on such businesses, encouraging re-investment of the type recently announced by BMW at the mini plant in Oxford.

1 These relationships are discussed in detail in N.Driffield, K. Lavoratori, Y. Temouri (2021) Inward investment and UK productivity. Working Paper No. 014, The Productivity Institute.

Upcoming Research

Building on this briefing, further work funded by The Productivity Institute is exploring the links between FDI motive and the availability of skills. Of particular interest is the importance of labour market flexibility in explaining FDI location decision, particularly as the UK diverges further from the EU in terms of labour market institutions. As international competition for investment becomes ever hotter, establishing and communicating the value proposition of the UK for investors will become ever more vital.

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