National Institute of Economic and Social Research

Summary of Evidence Session on The Role of International Investment in UK Productivity

20 July 2023

The Productivity Institute

Productivity Commission

Summary of Evidence Session on The Role of International Investment in UK Productivity

This evidence session took place on Thursday 25 May 2023.

The UK Productivity Commission's Commission ers:

- Professor Alan Barrett
- Professor Gillian Bristow
- Professor Jagjit S. Chadha
- Professor Diane Coyle CBE
- Professor Eileen Harkin-Jones OBE
- Dawn Holland
- Rachel Lomax
- Professor Stephen Millard
- Sir Anton Muscatelli
- Professor Adrian Pabst
- Dirk Pilat
- Professor Chris Pissarides
- Professor Bart Van Ark
- Professor Tony Venables
- Professor Jackline Wahba OBE
- Stian Westlake
- Professor Andy Westwood
- Professor Cecilia Wong

Observer:

- Stephen Aldridge

Secretariats

- Max Harvey
- Dr Issam Samiri

The witnesses for this session were:

- Davide Castellani (Professor of International Business and Strategy, University of Reading)
- Riccardo Crescenzi (Professor of Economic Geography, LSE)
- Reza Moghadam (Chief Economic Advisor, Millennium Capital Partners LLP)

Opening statements

Davide Castellani:

- Multinationals are a key actor in effecting the UK's productivity performance. They tend to be more productive than other firms, for many reasons, including: their size, their innovation, and the sectors they tend to operate in.
- Multinationals have specific advantages. For instance, they manage businesses across borders. Accordingly, they have to develop specific managerial capabilities, making them more productive. The UK ranks low in some of the managerial scores, for instance, it ranks bottom of the G7 in investment in training development. Similarly, foreign owned firms tend to have a better managerial performance than locally owned firms.
- One important question to explore is how can multinationals have a positive effect on the local economy?

Riccardo Crescenzi:

- It is important to consider how we can attract more FDI, but it is equally important to understand what drives the expansion of foreign activity in the domestic economy and what drives divestment.

- Looking at this through the prism of Global Value Chains (GVCs) we can better understand the role of the different layers of suppliers, enabling a more detailed analysis.
- An important topic to discuss is what drives decisions to make particular investments, the impacts of such investments, and the public policy decisions which could affect these decisions and impacts.

Reza Moghadam:

- When making an investment decision, seven important factors come into play:
  1. *Market access.* Not just the size of the domestic market, but also the access that this provides to adjacent markets.
  2. *Talent*. The ability to attract talent, both locally and internationally.
  3. *Political and social stability.*
  4. *Regulatory predictability and credibility.* Avoiding regulatory churn and impractical regulation.
  5. *Stable taxation system*. More focus on social security and labour taxation; corporate taxes are not as important.
  6. *Network effects* that enforce a favourable ecosystem (e.g., suppliers, existence of local competitors…).
  7. *Supportive infrastructure.* Not just physical infrastructure. Important that travel to, and from, the host country is possible and comes with ease, and that IT capacity is good.

SECTION ONE: Sizing International Investment in the UK:

- Spillover effects can often fail to materialise. Firms do not operate in host economies in order to share their knowledge or managerial practices; rather, they are interested in pursuing their own interests and optimising their own objective function. For instance, big firms tend to ringfence their best practices and give out less to the host and local economy. They also tend to interact less with the local economy as they have more capacity within their own corporate boundaries. We need to better understand the specific incentives for sharing, as well as understand the capacity of local firms and the local economy to absorb these benefits.
- Multinationals can have a negative effect on local productivity. For instance, through crowding out effects in the local labour market.
- Financial regulation tends to impact smaller financial players more than their larger counterparts, which may have an impact on productivity.
- There are noticeable improvements in FDI flows into the UK after the pandemic. However, the UK's FDI flows underperform those of other advanced economies.
- The inability of the most disadvantaged areas to attract FDI might hamper the UK's Levelling Up efforts.
- *Market access* has deteriorated since Brexit, impacting the attractiveness of the UK for FDI.
- Some positive news for the UK: it is still a large market, and investments are growing in specific sectors, such as R&D-intensive industries.
- The UK needs to attract *talent*, with the immigration rules being crucial to this. Recent research in the US shows that more stringent visa rules can hamper innovations and push firms to move their R&D operations abroad.
- Increasingly, UK firms are moving to the EU to access the European market. As a result, net FDI from France and Germany turned negative after Brexit. This is not necessarily bad for productivity because firms can learn from operating overseas but it does affect the UK's balance of payments.

- Data shows that the distribution of FDI into the UK is very skewed. London accounts for approximately 40 percent of investments and this share has been declining due to fewer investments in London.
- Diverting investment away from London is not necessarily that beneficial. Medium size cities in the UK are in competition with other similar size cities in Western Europe, they generally do not compete with London.

SECTION TWO: The Makeup of International Investment:

- The investments that add the most value are often facilitated by a supportive ecosystem and public investment in R&D. These investments take more time to plan and implement. Any strength the UK has in these areas needs to be maintained.
- As a result of *market access* deteriorating since Brexit, there has been less investments made for the purpose of market access and more for investing in the UK market itself.
- Brexit has also meant that the UK's attractiveness to be part of GVCs has reduced because trade has become more difficult and more costly.
- Granular FDI data is either missing or produced by private agencies. Improvements in data availability and quality are required to better understand the links between FDI and productivity.
- Many foreign owned firms are not divesting but many are not looking to make new investments. It is hard to know whether these investments would have continued if different policy choices had been made.
- Larger domestic firms are better at benefitting from spillovers, due to their increased capacity for absorption; FDI can mean more divergence between the firms at the productivity frontier and those struggling with lower levels of productivity.
- Evidence shows that a very productive firm in a lagging area is more likely to benefit from the presence of a multinational than an unproductive firm in a frontier area.

SECTION THREE: International Investment and the New Global Trade Landscape:

- Firms have become more aware of resilience and the importance of being mindful of risks when deciding upon investment decisions.
- The UK does not seem to have prioritised policy focused on FDI since Brexit.
- UK firms are facing greater competition from the EU as a result of Brexit making trade more costly. This could improve productivity of some UK firms that would have to make productivity gains to keep up with the competition; however, it could also displace UK firms and reduce economic activity in the UK.
- The EU has managed to attract *talent* more easily since the Brexit referendum, with the UK falling behind on this front.
- China's appeal to the financial sector has completely changed as a result of recent international events. Previously, China was a big focus and was perceived as an important market to invest in for the future. However, now, reliance upon China as a destination for investment has waned.
- Democracies may have been considered inefficient in the past but are now being perceived as more desirable destinations for investment due to their relative *political and social stability.*
- GVCs and supply chains have shifted to become more localised.

SECTION FOUR: Improving International Investment:

- Investment zones are nothing new, they can vary in nature and their impact is therefore hard to assess. However, they tend to divert investment and employment from one locality within the nation to another locality for the purposes of tax benefits. Accordingly, they do not necessarily produce the benefits of additional investment and they may not change the underlying conditions which would attract more investment and help increase productivity.
- Connectedness and the ability to foster and attract talent are key to bring foreign investments to the periphery.
- The UK has lost its selling point of ease of access to the EU market since Brexit. Accordingly, the UK needs to focus on what can make the country attractive to foreign investments going forward.
- Attracting new greenfield investment can be hard. Attracting investment from existing foreign investors, who know the market, can be easier. Accordingly, focusing on the latter may be a good place to start.
- Policies to attract more FDI investment need to be considered in the round, to include other important aspects of economic policymaking.
- Policies to attract more FDI investment should be integrated with other complementary policies such as those directed at improving trade relations, local infrastructure and human capital.
- Current challenges related to the shifting geopolitical landscape and fast-paced technological change might present an opportunity to the UK to quickly capitalise on well-designed FDI policies.