FOREIGN DIRECT INVESTMENT IN THE UK - MYTHS AND REALITIES

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"Britain is already Europe's top location for inward investment. We get over 25% of all investment into the EU, including over 40% of all US and Japanese investment.

This investment accounts for 19% of British employment and over a third of manufacturing investment. There are 18,000 foreign firms now operating in Britain, accounting for 20% of Britain's top 100 exporters.

The total stock of investment at the end of last year stood at £240bn, 50% up since the general election. Since 1997, foreign investment has created over 90,000 new jobs and safeguarded 158,000 more.

Figures being published on 5 July will further show that last financial year set new records in terms of new investment, particularly in terms of new start-ups and new jobs. These figures will demonstrate that investors not only regard Britain as the business centre of Europe but they increasingly see us as Europe's digital centre - the natural home of Europe's vibrant and growing software and e-commerce industries. "

Speech to Global Borrowers and Investors Forum by Tony Blair - 3 February 2000.

SUMMARY

We argue that:

1) The Foreign Direct Investment statistics do not mean what people think they mean.
2) There is no correlation between FDI and jobs.
3) There is no proof that, overall, there is any correlation between FDI and economic competitiveness.
4) The figures quoted for jobs created or safeguarded by inward investment are grossly misleading.
5) The misguided obsession with inward investment skews resources towards capital-intensive manufacturing and is damaging to Britain's economic competitiveness.

By 2000, 74% of FDI was mergers and acquisitions, not direct investment in plant and jobs. Changes in FDI largely reflect movements in share prices not real investment.

Takeovers often result in job losses.

The stereotypical foreign investor of the past was a Japanese car manufacturing establishing a new factory with "kaizan" and just-in-time techniques. However, the stereotype in 2000 was more likely to be a recklessly optimistic French corporation with a state-protected monopoly in its home market and opaque accounting techniques that hid poor profitability. This kind of investor is unlikely to improve British competitiveness.

Figures quoted for jobs created or safeguarded are gross figures, so very often they are part of a restructuring in which the total number of jobs went down, not up. Up to 50% of jobs claimed never actually materialise.

Britain spends too much time and money chasing inward investment jobs when they are few and far between. It would be more sensible to put effort into other programmes.

1 Introduction

1.1 When Tony Blair uttered those words in 2000, he was not making a party political point. He was simply reiterating the long established belief of the Department of Trade and Industry (DTI) that the level of foreign direct investment (FDI) in the UK is a crucial mark of economic competitiveness. Any favourable movement in the figures has always been trumpeted as a success by the government of the day.

1.2 Since 2000, of course, hubris has been followed by nemesis. FDI figures have plummeted. The government does not issue triumphalist press releases any more. Nor does it talk about the exciting future for "Europe's vibrant and growing software and e-commerce industries." However, we are not concerned in this paper about cyclical changes in FDI or, indeed, about the relative distribution of FDI between European countries (another thing that obsesses government). What we think is that government does not understand what the FDI figures really mean and this misunderstanding is distorting government policy.

1.3 Thirty or forty years ago, there was little doubt that Foreign Direct Investment (FDI) in Britain was A Good Thing. The foreign investors were generally Japanese or American manufacturers setting up a European regional plant. If they came to Britain they provided valuable jobs - and exports from the British plant to Europe provided foreign currency earnings to help our balance of trade. If they went to Germany instead, it showed that that Britain could not compete effectively.

1.4 Even if the new plant only served the UK and did not export, it was still good news. It provided better technology and increased productivity, both of which rubbed off on British industry – think Japanese TVs or motor cars. When ministers talk about the benefits of FDI, this is the cosy picture they evoke – with the added hint that, if the jobs are in manufacturing, they are probably going to the depressed parts of the Midlands and North.

1.5 That picture might have been true 30-40 years ago, but we think that it is now so unrealistic that it is completely misleading. Worse, by giving people such an old-fashioned view of the world, the DTI is contradicting the advice of its own experts. It also encourages English regions, Wales and Scotland to chase inward investment opportunities which, even if they existed, would only provide a short term boost to the economy. We argue that:

1) The FDI figures do not mean what people think they mean.
2) There is no correlation between FDI and jobs.
3) There is no proof that, overall, there is any correlation between FDI and economic competitiveness.
4) The figures quoted for jobs created or safeguarded by inward investment are misleading.
5) The misguided obsession with inward investment skews resources towards capital-intensive manufacturing and is damaging to Britain's economic competitiveness.

2 The FDI figures do not mean what people think they mean.

2.1 Government statistics on FDI do not actually measure what most people think they measure. Most people think FDI means direct investment in factories and jobs in the UK – and speeches like Tony Blair's do not discourage this idea. However, since the abolition of foreign exchange controls in 1979, an increasing proportion of FDI is made up of mergers and acquisitions.

2.2 The headline figures for FDI in the UK are complied by the Office of National Statistics on an annual basis. We've taken the figures for 2000 – the year of Tony Blair's pronouncement and the year that FDI peaked in this cycle.

2.3 In 2000, the net inflow of FDI increased by £22bn to £78bn, a new record. However, the ONS statistics record investment by overseas companies in subsidiaries, including cross border flows due to mergers and acquisitions (M&A). The capital investment in mergers and acquisitions reflects prevailing share prices and 2000 was the peak of the share price boom – so the record level of investment is more a reflection of inflated share prices than of genuine new investment. Net changes in investment in share capital made were £58.3bn - 74% of the total net FDI.

2.4 Indeed, most of the volatility in the FDI figures is down to changes in M&A activity. It rose from £28.3bn in 1998 to £58.3bn in 2000, then collapsed to £20.3bn in 2001. In contrast, other FDI activity went from £16.6bn to £20bn to £21.6bn – a much smaller change in absolute and percentage terms.

2.5 It is clear that the surge in net inflow figures was due mainly to France increasing its net investment from £19bn. to £31bn. The ONS does not give a breakdown of its figures, so we went to the Institute of Directors library, pulled out 12 months back-copies of "Acquisitions Monthly" and totted up the completed deals. This suggests that the surge in French investment is probably due to one deal – the acquisition of Orange by France Telecom for a price of £46bn. This deal accounted for about half of the total foreign acquisitions over £1bn in that year. Because the FDI figures do not include any locally raised finance, not all of the purchase price is necessarily included in the FDI figures

2.6 Orange was originally set up by Hutchison Whampoa, which sold its investment to Mannesmann, a German company, in 1999. Mannesmann was subsequently taken over by Vodafone, a British company, which agreed to divest Orange (to France Telecom) in order to satisfy the competition authorities. However you dress this game of regulatory pass–the-parcel, there is no way the Orange/France Telecom deal provided any tangible benefit in terms of jobs or competitiveness to the British economy at all.

2.7 The second largest deal that year was the £12bn purchase of Allied Zurich shares (British) by Zurich Allied (Swiss) – a restructuring between connected parties which has little to do with job creation or competitiveness. Indeed, considering what has happened to the insurance industry since, it looks more like an expensive exercise in rearranging the deckchairs. None the less, to the government, it counts as evidence of Britain's competitiveness.

3 There is no correlation between FDI and jobs.

3.1 In fact, there is an inherent contradiction between the argument that inward investment improves productivity and the argument that it provides more employment. As we all know, the quickest way to improve productivity is to reduce the number of people employed. So, where the investor is taking over and operating an existing business, the merger is often followed by cost-cutting and rationalisation.

3.2 Moreover, where the inward investment is in domestic activity, it may merely displace existing jobs provided by domestic firms. As an example, Gap, a US firm, invested in Britain and succeeded in taking market share from British firms, including Marks and Spencer. Marks and Spencer responded by sourcing its clothing from foreign suppliers, so its British suppliers closed plants and laid off workers.

3.3 Even if the change of control does not involve any changes to productivity, the first step is usually the closure of the UK head office and the repatriation of its central functions.

3.4 For instance, NTL (at the time an American-owned company) announced the loss of 4,000 jobs in December 2001. A spokesman said: "We've been focused on controlling our costs. We have also been highly acquisitive, buying 13 companies in two years, and all this is part and parcel of that integration."[ii]

3.5 The reality is that inward investment can be a cause of job destruction, not job creation.

4 There is no proof that, overall, there is any correlation between FDI and economic competitiveness.

4.1 The evidence in favour of a correlation between competitiveness and FDI is surprisingly partial. Most of the evidence seems to come from government-sponsored studies that concentrate on manufacturing, particularly engineering and electronics – the industries which fit the traditional view of FDI [iii].

4.2 The argument is that the foreign investor must have competitive advantage to be able to invest overseas. This competitive advantage probably consists of better technology and management techniques. Introduction of foreign investment will transfer these advantages to the UK operation, thus improving UK competitiveness. While this may be true for some investment in manufacturing capacity, it is not clear that the same arguments can be applied to other FDI activity.

4.3 First, the ONS figures for FDI include both mergers and acquisitions, which result in changes of control, and minority investments, which do not. So, they do not differentiate between passive investors and active business managers. As a result there is no correlation between FDI and the introduction of foreign management techniques.

4.4 Secondly, there is a wealth of literature to show that most acquisitions never deliver the promised benefits and destroy shareholder value for the acquirer. So, foreign investors are less likely to bring superior productivity and more likely to bring unwarranted optimism to the acquisition process.

4.5 Thirdly, this econometric approach to measuring competitiveness cheerfully ignores all the extensive literature on business competitiveness (including that of the government's own favourite guru, Michael Porter). There are many sources of competitive advantage other than productivity. They include access to cheap capital, monopoly power, protected home markets and government support.

4.6 So, the stereotypical foreign investor of the past was a Japanese car manufacturing establishing a new factory with "kaizan" and just-in-time techniques. However, the stereotype in 2000 is more likely to be a recklessly optimistic French corporation with a state-protected monopoly in its home market and opaque accounting techniques that hide poor profitability. This kind of investor is unlikely to improve British competitiveness.

4.7 Take an extreme example – Connex, a French-owned railway company which:

- never exported anything except profits,
- destroyed jobs;
- was so inefficient it was stripped of its franchise; and
- which, by failing to run part of London's transport infrastructure adequately, undermined UK competitiveness for its entire life in the UK.

4.8 It would be perverse to argue that the UK benefited from inward investment in this case. Moreover, as with a number of other French companies, Connex were able to invest in Britain even though they were protected from takeover at home by their own government. Nor is it just the French who benefit from anti-competitive practices – the Germans, Swiss Japanese and Americans all have their own obstacles to foreign control in strategic industries. If investors from these non-competitive, protected industries are investing in Britain, it seems unlikely that they are bringing efficient competitive practices with them.

4.9 In fact, the reverse seems to be true. Many of the major foreign investors in Britain in recent years seem to have been spectacular destroyers of shareholder value, even by normal standards. Apart from France Telecom and Zurich, almost every company which invested in the British energy market – Enron, TXU, Drax, RWE – has lost money. The water industry is a similar story on a smaller scale. The banks who put up the money – especially the Germans and Japanese - are also suffering. Indeed, the most obvious benefit of FDI in recent years is that it has allowed Britain (especially the government) to sell off assets to foreigners at vastly inflated prices.

4.10 So, there is no clear evidence that FDI actually produces improves productivity or competitiveness. It is not surprising. Common sense should tell you that a foreign takeover, by itself, is no automatic guarantee of prosperity. It depends if it is Attilla the Hun or the Roman Empire taking over.

4.11 We also think the enthusiasm for FDI is based (at least partly) on a syllogistic fallacy. It is true that transferring economic activity from other countries into the UK is beneficial. It means that either the UK is importing less and/or it is being used as an exporting base. It is also true that the people who transfer this activity are usually foreign investors. However, it does not follow that all activity financed by foreign investors increases economic activity in the UK – a lot of foreign investment is merely displacing UK investment.

5 The figures quoted for jobs created or safeguarded by inward investment are misleading.

5.1 The other source of inward investment statistics is UK Invest (formerly Invest in Britain Bureau), an agency jointly funded by the Department of Trade and Industry and the Foreign Office to attract inward investment to the UK. In their annual report for 2001, they announce a total of 71,488 new jobs created by inward investment, an increase of 35% on the 2000 figure of 52,783.

5.2 Unfortunately, while one would not want to criticise them (or their sponsoring ministers) for blowing their own trumpet, the figures they quote are misleading. UK Invest only counts the gross new jobs created, not the net job creation – even where the same company is involved. So, among the 71,488 new jobs created in 2000 were:

- 600 jobs at Ford's engine plant in Bridgend, which were actually part of a re-structuring with 3,250 jobs lost at Dagenham.
- 700 jobs "protected" at Vauxhall Ellesmere Port following the loss of 2,000 jobs at Vauxhall Luton.
- 550 jobs (expected by 2005) in a research centre for Motorola at Livingston, following the closure of their Bathgate plant with the loss of 3,000 jobs.

5.3 Worse, it appears that the confident announcements of new jobs may not always translate into reality. Figures produced by Locate in Scotland show that 27% of new jobs announced in Scotland never materialised[iv.] A more a recent inquiry by the National Audit Office (NAO) into Regional Selective Assistance (RSA), a grant programme run by DTI, concluded that up to 50% of the forecast jobs never materialised[v]. In other words, the net gain in jobs from inward investment has been consistently overstated.

6 The misguided obsession with inward investment skews resources towards capital-intensive manufacturing and is damaging to Britain's economic competitiveness.

6.1 There can be little doubt that the people involved in promoting regional economic competitiveness are more proportionally more excited by foreign direct investment than endogenous growth. You have only to look at the effort that goes into attending international trade fairs and chasing the few inward investors that do appear.

6.2 It is also true that in the southeast there are good examples of FDI in sustainable high-value clusters – Microsoft in Cambridge for instance.

6.3 However, away from the southeast the emphasis on inward investment is distorting and damaging regional economies. Proof of this emerged from the NAO report into RSA – the main weapon for promoting investment in the UK regions. This showed that 90% of all grant aid in the last five years went to manufacturing companies and 30% went on repeat applications – of which 2/3 (by value) went to the car manufacturing sector (dominated by foreign companies). Yet only 10% of grant went to internationally-mobile projects – reinforcing our view in Para 4.11 that people are failing to distinguish between projects that transfer economic activity and those that merely displace UK financed activity.

6.4 It is true that the distortion produced by RSA is partly a function of European rules restricting state aid to businesses in depressed areas (Assisted Areas). This aid is also largely restricted to capital grants since the EC regards any operational assistance as potentially unfair. The result is that only capital-intensive manufacturing companies are able to benefit significantly.

6.5 There is a school of thought that says the answer is to relax EC state aid rules to enable assistance to be given more widely. We would argue that the answer is to stop giving aid to attract FDI. It is not just a waste of money, it is actually counter-productive.

6.6 First, by failing to distinguish clearly between cross border activity and internal activity, the government is mis-directing support and wasting money that could be better used elsewhere.

6.7 Secondly, many of the jobs it seeks to attract are not sustainable – they are low-cost, low-value jobs which will always move to the lowest cost region available as soon as the market changes - think call centres and India or Samsung on Teesside. You don't even have to take our word on it. Read the views of Michael Porter, the American guru and consultant to DTI and Treasury [vi]. He is clear that subsidising low cost low value activity is a mug's game.

6.8 Next, however you look at it, it is economic lunacy to continue to subsidise a car manufacturing industry that has structural over-capacity throughout the whole of Europe. It is perpetuating a problem, not solving it.

6.9 By supporting existing industries in trouble ("safeguarding jobs"), the government is actually creating barriers to economic progress and condemning regions to old-fashioned and uncompetitive economies.

6.10 There can be no better example of this than the way the government pumped money into the lost causes of Vauxhall at Luton and Ford at Dagenham, delaying the inevitable. These areas will be far better off with a more dynamic mixed economy and it would be better if the government had saved all the time and money it put into the car plants and spent it, instead, on accelerating the transition to a post car manufacturing economy.

6.11 Moreover, in the process of propping up failing car manufacturers, the government managed to get its main urban regeneration tool – the Partnership Investment Programme – neutered by the EC, thus slowing down the rate of improvement in regional economies further.

6.12 Next, the amount of genuine job-creating inward investment has shrunk dramatically in recent years but politicians are failing to adapt to this.[vii] Regional policy and especially regional planning policy still places emphasis on strategic inward investment sites and inward investment is still the cornerstone of too many economic development strategies.

6.13 Like the cargo cults of the South Pacific, many local and regional agencies in the UK are still praying for the magic that benefited their forefathers to fall on them once more.

Conclusion

6.14 We do not have a quarrel with the accuracy of the figures produced by ONS on FDI (although the complexity of definitions is sometimes greater than it might be). We do not argue that FDI is bad or ought to be discouraged. On the contrary, we are economic liberals at heart.

6.15 What we are saying, however, is that the FDI figures bandied about as evidence of Britain's economic competitiveness are not capable of bearing the simplistic meaning they are given by the government.

6.16 Moreover, that simplistic approach is actually undermining and contradicting more sensible approaches to improving Britain's competitiveness.

6.17 So, it would help if more people understood what the FDI figures really mean, and what the implications are for regional policy.

References

[ii] "Guardian Unlimited". 10 December 2001

[iii] "Assessment of the Wider Effects of Foreign Direct Investment in Manufacturing in the UK" – PA Cambridge Economic Consultants – October 1995.

[iv] Locate in Scotland Annual Report 1998-9, cited in "Invest in Britain Evaluation" carried out by Economics Advisory Group for DTI – August 2000.

[v] "Regional Grants in England"- – National Audit Office June - 2003.

[vi] "On Competition" – Michael Porter - pub. Harvard Business Review 1996

[vii] See e.g. The Economist "Where have all the foreigners gone?" 11 Oct 2001 and "Wrong Target" 12 June 2003.