Nesta

FOREIGN DIRECT INNOVATION?

THE EFFECT OF FDI ON INNOVATION IN THE UK AND WHAT TO DO ABOUT IT

INTRODUCTION

Foreign direct investment (FDI) occurs when overseas businesses invest in the UK, either by acquiring a British company or a stake in one, or by setting up a brand–new subsidiary.

The UK has a strong track record in attracting FDI and in benefitting from it. FDI helped turn the ailing British car industry into a productive powerhouse, and the City of London from a sleepy gentleman's club into the world's financial nexus.

But in recent years, the role of FDI in the UK's economy has come under challenge. Critics have argued that FDI, in the form of acquisitions, hollows out the UK's productive capacity.[1] It is suggested that foreign owners are more likely to shift high–value functions overseas and to neglect UK supply chains, gradually turning their UK subsidiaries and partners into dumb and disposable operations.[2]

Lord Young, a staunch advocate of FDI as Secretary of State for Trade and Industry in the 1980s, recently argued that foreign investment is no longer the future of economic growth.[3] Government's ability to attract FDI has also declined, at least in England: the abolition of the Regional Development Agencies removed a key part of the support mechanisms for inward investors, specifically those designed to improve supplier development.

This report offers a reassessment. In particular, it uses detailed business records data and new surveys to examine the effect of FDI on job creation (between 1997 and 2010), business innovation and on innovation in the supply chain.

Firstly, it presents new evidence on the scale of FDI in the UK, and how the importance of foreign investors as employers here has increased dramatically in the past decade. Secondly, it compares the amount of innovation undertaken by companies that received

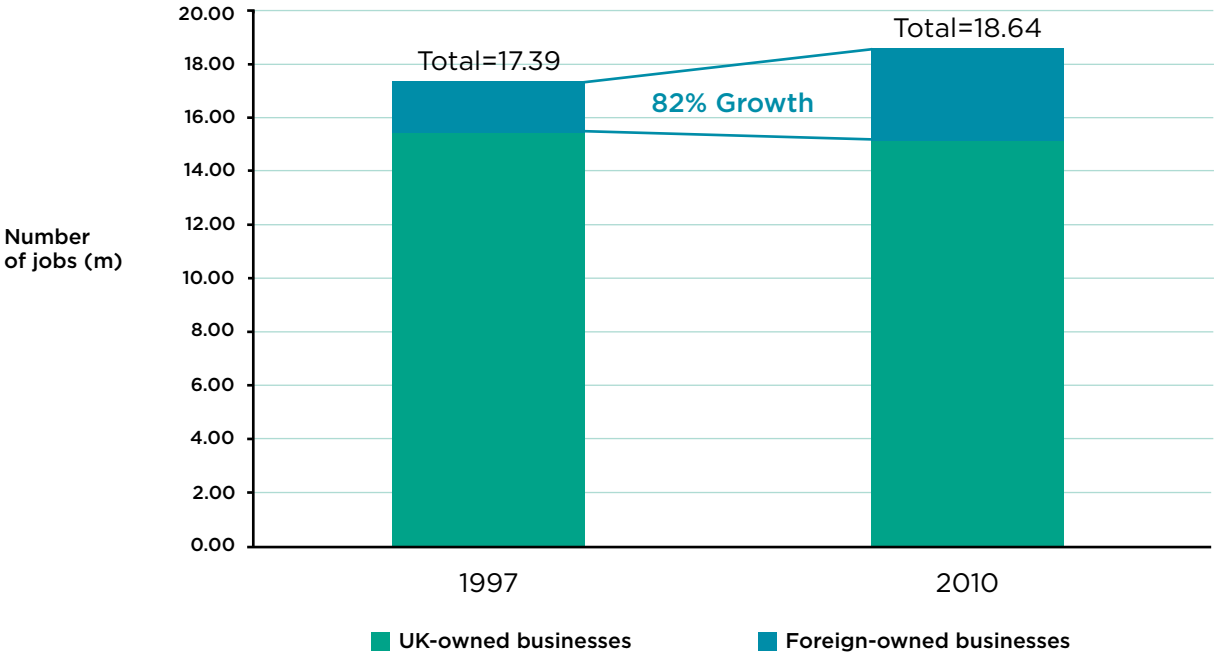
FDI to a sample of similar UK–owned businesses. Thirdly, it looks at UK suppliers to foreign– and UK–owned businesses, looking at how much they innovate and to what extent this is influenced by their business customers. Finally, it looks at the implications for government policy, in particular how government attracts and assists potential and current foreign investors.

1. FDI: A LOT OF IT ABOUT NOWADAYS

Stories of British firms being bought by foreign companies are a staple of the business news. The biggest often provide an element of drama, even national crisis, as anyone who read the coverage of Kraft's takeover of Cadbury or HP's purchase of Autonomy can confirm. As well as making the headlines, FDI touches most facets of our daily lives. Many of us bank with foreign–owned banks, go on holiday from foreign–owned airports, drive cars made in Britain by overseas companies, and use electricity and water delivered by foreign firms.

The magnitude of foreign ownership in the UK economy is illustrated by new research funded by Nesta and carried out by Michael Anyadike–Danes and Mark Hart of Aston University, using the Office of National Statistics' Intergovernmental Business Research Database, which holds detailed records of all companies in the UK. Between 1997 and 2010, foreign–owned firms went from employing 11 per cent of the UK's private sector workforce to employing 19 per cent. Employment by foreign–owned businesses increased for ten of the 13 years in the period; in total, 1.6 million more people were employed by foreign–owned firms in 2010 than in 1997. This is a very significant increase, especially if we consider that only 1.25 million net new private sector jobs were created in total in the UK in the period. Indeed, if we discounted the increase in employment from foreign–owned firms (including the initial shift in employment when a foreign firm acquires a UK one), the UK would have created no new jobs at all between 1997 and 2010 (in fact, it would have lost 350,000).

Stock of private sector jobs by employer ownership



The employment growth in foreign-owned businesses is particularly important for being geographically dispersed. Statistics from UK Trade and Investment (UKTI) show that in the period 2001/2 to 2010/11, FDI generated jobs not just in the South East but throughout the UK.

	Investments	New Jobs	Existing jobs safeguarded	Total Gross Jobs
UK-wide	22	5,972	32,670	**38,642**
East Midlands	643	19,335	23,015	**42,350**
East of England	822	25,637	21,097	**46,734**
London	3,465	56,087	34,235	**90,322**
North East	620	28,714	27,654	**56,368**
North West	1,178	46,680	51,142	**97,822**
Northern Ireland	355	24,663	13,424	**38,087**
Scotland	747	33,487	21,352	**54,839**
South East	1,748	36,631	35,394	**72,025**
South West	577	17,952	27,761	**45,713**
Wales	593	32,926	24,775	**57,701**
West Midlands	855	31,817	73,140	**104,957**
Yorkshire And The Humber	746	19,696	20,449	**40,145**
Grand Total	**12,371**	**379,597**	**406,108**	**785,705**

(Note: the UK-wide figure at the top of the table refers to projects with no specified location)
Source: UKTI

2. FDI AND INNOVATION

Given the importance of foreign-owned businesses to UK industry and employment, it is worth looking at the value they add. If FDI is all about performing low-value functions in the UK or using Britain as a distribution centre for goods made elsewhere, there is cause to worry. The second research project we are reporting here addressed this question, looking specifically at the link between FDI and innovation, based on a survey of 1,135 foreign- and UK-owned businesses in Britain, undertaken by PACEC (Private and Corporate Economic Consultants).

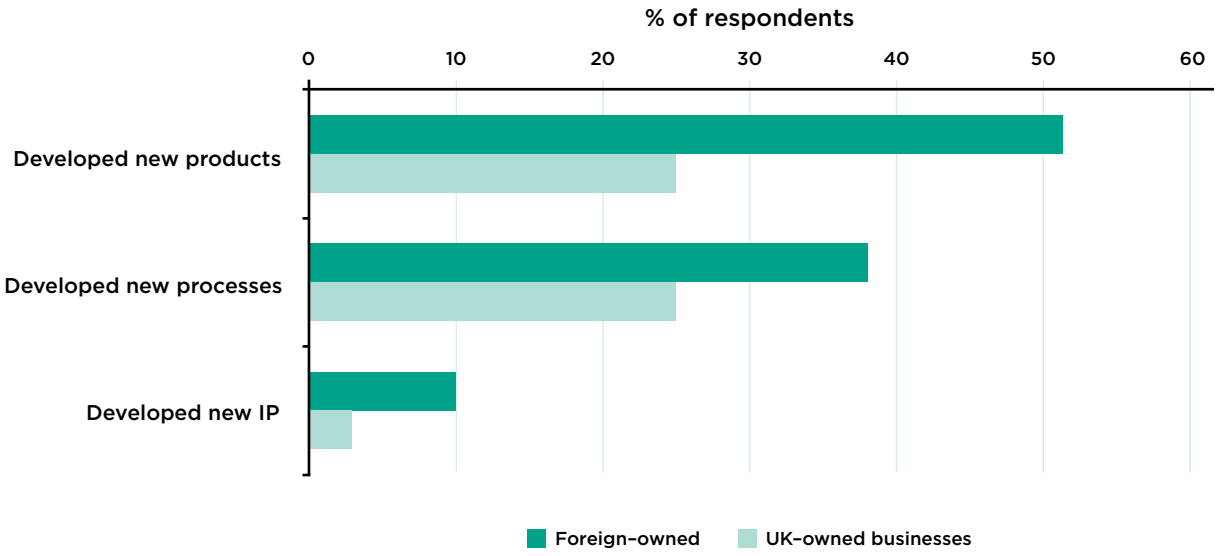
Most foreign investors did not cite the UK's innovative skills as a particularly important reason for investing here. Instead 64 per cent of the respondents to the survey cited access to markets, 53 per cent growth and expansion, and acquisition at 28 per cent. Other responses include technology and skills, but interestingly these trail significantly behind at 13 per cent.

The inward investors survey sample, which was designed to mirror the population of inward investors in the UK, comes from five main sectors, with financial and business services, and

retail and hospitality representing around a quarter, conventional manufacturing and high-technology each representing about a fifth of businesses, and infrastructure one in ten.

First of all, the research looked at how businesses' innovative activity varied by ownership by comparing foreign-owned businesses with UK-owned businesses, (the UK-owned business cohort was selected to match the FDI cohort in size and sector in the interests of accurate comparison).

Percentage of respondents that have innovated in the last three years



The survey strongly suggests that foreign-owned businesses are more likely to innovate, as judged by a range of metrics, than UK-owned ones. This is not to say that there are not highly innovative UK-owned firms; however, it runs counter to the claim that the effect of FDI on the UK's innovation system is a negative one.

3. THE EFFECT OF FDI ON INNOVATION IN THE SUPPLY CHAIN

Just as important as the performance of foreign-owned firms is the effect they have on other businesses in the UK, in particular those in their supply chain.

Our survey compared businesses that supplied UK-owned firms with those that supplied foreign-owned firms and found that here again, there was a link between FDI and innovation.

One potential explanation for the differences in the innovation level of suppliers presented above is that foreign-owned firms chose more innovative suppliers. The survey asked firms their main reasons for selecting suppliers, but found that in the vast majority of cases, innovative capability was not one of them. Most firms, whether British- or foreign-owned cited 'efficiency/costs' and 'reliability/quality' as the main reasons for selecting suppliers.

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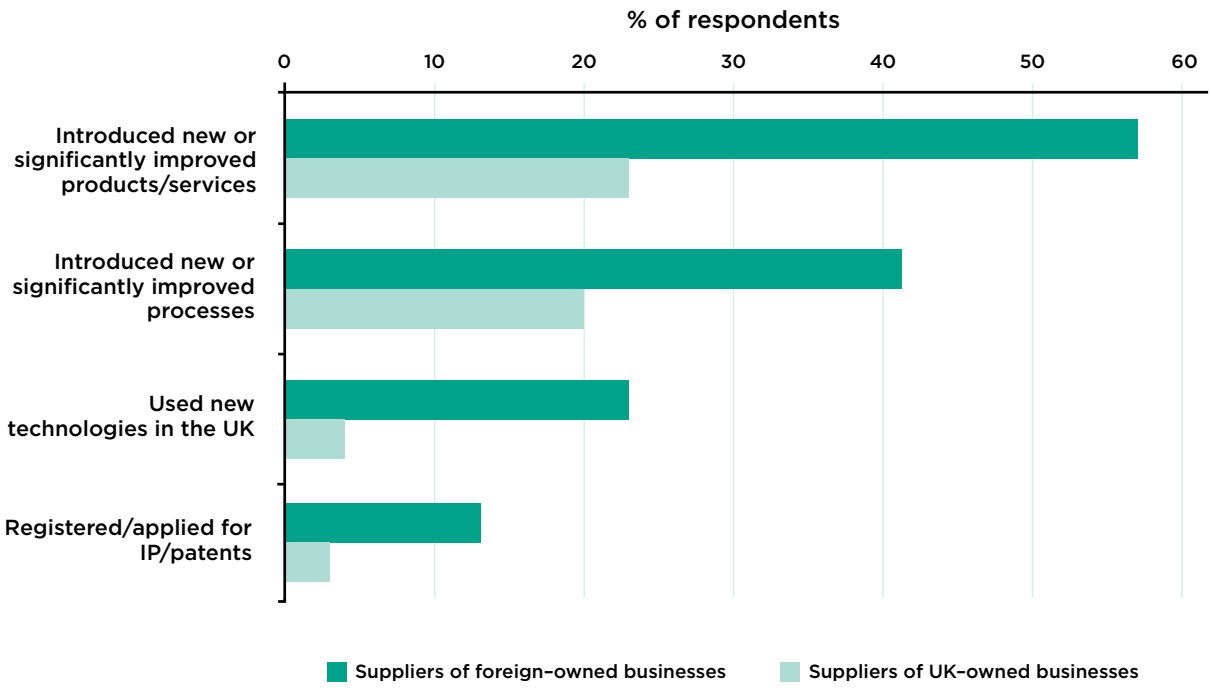
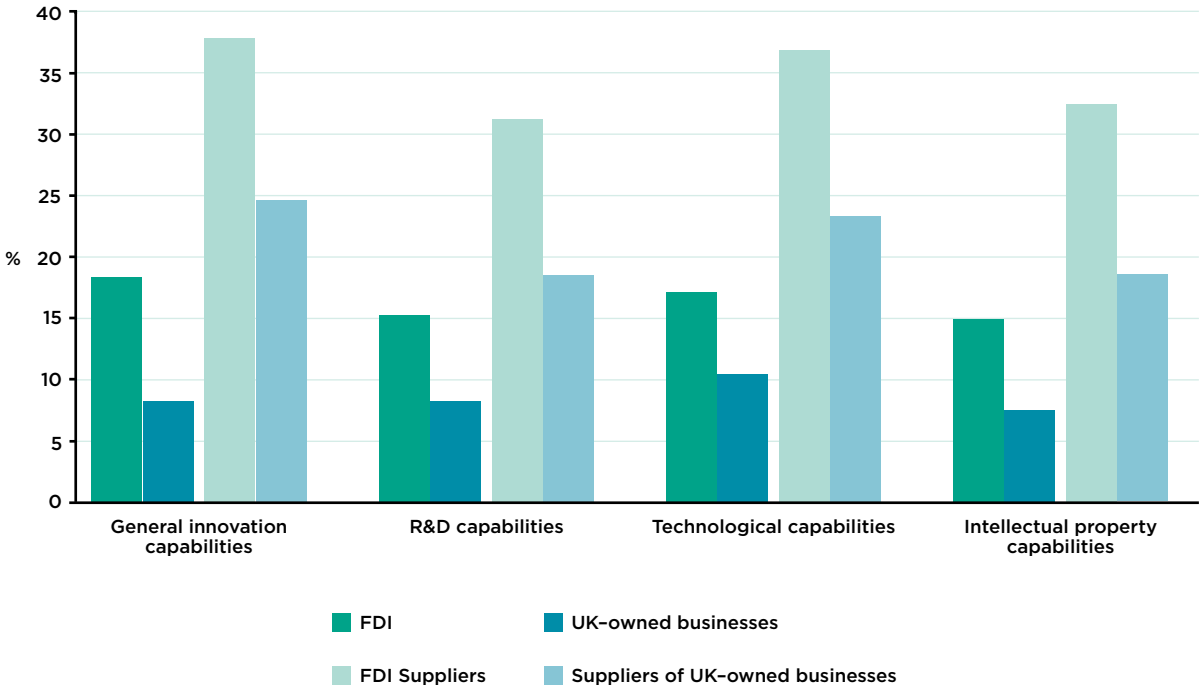


Instead, it seems that the difference in innovative capacity between suppliers to foreign- and UK-owned businesses is at least partly caused by the foreign-owned businesses themselves. The survey looked into this point specifically, asking about the effect that their customers had on various aspects of their innovative capabilities.[4]

Percentage of respondents reporting impacts on suppliers



(Follow–up interviews suggest that the difference in perceptions in impact between customers and suppliers (for both foreign– and UK–owned firms) is likely to be a function of proximity: suppliers themselves are more aware of investments they have made to meet the needs of their customers and so are more likely to report them.)

High–tech foreign–owned companies were particularly likely to have increased the innovative capability of their suppliers. The survey also showed that American companies were more likely to report an impact on the innovation capabilities of their suppliers followed, in order, by those originating from the rest of Europe, and from the rest of the world.

WHAT'S SO SPECIAL ABOUT FOREIGN–OWNED FIRMS?

The research also looked into the question of why suppliers of foreign–owned firms were more likely to impact on suppliers' capabilities. It used regressions analysis to identify which behaviours and characteristics of customer firms were most associated with increased innovation on the part of suppliers. One relevant factor was that foreign–owned businesses were themselves more likely to have innovated in the last three years.

But it also appears that the efforts that foreign–owned firms make to encourage their suppliers to innovation make a difference too. The analysis showed that a number of customer–firm behaviours were correlated with supplier innovation, including whether the customer firms had explicit strategies for supplier development, whether they collaborated with other organisations on technology and innovation, and whether they had provided direct assistance.

Around 25 per cent of FDI report providing direct assistance whereas less than 10 per cent of UK–owned businesses do.

IMPLICATIONS FOR GOVERNMENT POLICY

Foreign–owned businesses are more important than ever to the UK economy with one in five private sector workers now employed by them. They also have a significant impact on the innovative capabilities of other businesses here.

The research above presents evidence that foreign firms have a significant positive impact on the innovative capabilities of their suppliers and examines the characteristics and practices of inward investors that drive these impacts.

There are two things the Government should do about this. First, it needs to recognise that some investors are more likely to impact indigenous suppliers' capabilities and target its investment promotion activities at these. And second, it needs to engage with these firms once here, to help them work closely with their UK suppliers and increase the likelihood of transferring capabilities to them. This is not easy but looking outside of the UK, countries like Singapore, Malaysia and Ireland have shown how this type of programme can be successfully delivered.

THE EXAMPLE OF SINGAPORE

Singapore has a very detailed strategy on supplier development via its 'Economic Development Board'. It runs programmes designed to harness the opportunity offered by its very large inward investment base to local suppliers. One such programme focuses on precision engineering; it seeks to link local engineering companies to foreign investors not only in supplying them with parts but also in co–design, one of the most effective ways of advancing innovation. This is one of a range of schemes built around supplier development and foreign investment in the country.

Building institutional capability to deliver these services is crucial to ensure UK businesses can benefit from the presence of innovative investors here. England presents a particular problem given that there is no one body with a specific remit to target local suppliers and work with inward investors to ensure they are engaging with them.

On a regional level, the Local Enterprise Partnerships (LEPs) may be tasked with delivering supplier development programmes that the RDAs carried out before abolition, but even where they have the inclination, they often lack the experience and resources to be successful. UK Trade and Investment (UKTI) are tasked primarily with the attraction of foreign investment to the UK and have not been given resources to address this gap.

We have seen that foreign investors are increasingly important to job growth in the UK. In addition, they have a significant positive impact on the innovative capacities of their suppliers and on the innovation system as a whole. Government, via BIS, UKTI and the LEPs should consider how best to adequately resource and prioritise supplier development services as a valuable mechanism to further develop innovation in UK businesses.

ENDNOTES

1. ERA Foundation (2012) 'The Sustainability of the UK Economy in an Era of Declining Productive Capability.' Available at: http://www.erafoundation.org/docs/ERAF_7thReport_May12.pdf
2. Hutton, W. et al. (2012) 'Plurality, Stewardship and Engagement: The report of the Ownership Commission.' 3:56, p41. Available at: http://ownershipcomm.org/files/ownership_commission_2012.pdf
3. Lord Young (2012) I welcomed Japan's car giants, but they are not our future. 'The Times' 8 March 2012.
4. The figure gives an indication of the proportions of respondents in each cohort that reported impacts. The categories of capabilities are aggregated from more granular categories which are referenced here and can be explored further in the research report.

About Nesta

Nesta is the UK's innovation foundation. We help people and organisations bring great ideas to life. We do this by providing investments and grants and mobilising research, networks and skills.

We are an independent charity and our work is enabled by an endowment from the National Lottery.

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