

**London and Foreign Direct
Inward Investment**
Case for London Technical Report 2
Executive Summary



Executive Summary

London Economics was commissioned by Greater London Authority (GLA) Economics to undertake a study on how London as a world city contributes to attract foreign direct inward investment (FDI) into the United Kingdom, and the factors that may reduce London's attractiveness to FDI in the future.

Generally, FDI is viewed as being beneficial to the UK economy at both the national level and the regional level. Some studies address FDI into London in specific industries, but there is none that examines the London economy across all sectors.

This report reviews recent trends in direct foreign inward investment into London, examines the impact and drivers of such investment and discusses some potential threats to sustaining recent trends.

Some facts about FDI

The United Kingdom is one of the top world destinations of FDI. In terms of the overall stock of inward investment, the United Kingdom typically ranks second or third in the world, behind the USA and in competition with Hong Kong. However, in recent years a number of EU Member States attracted a growing share of FDI inflows into the European Union, suggesting that the United Kingdom may face stiffer competition in the future in attracting foreign inward investment.

Within the United Kingdom, the foreign inward investment is heavily concentrated in a few sectors. Financial services, transport and communication services, retail and wholesale trade, mining and quarrying and real estate and business services account, according to the latest available data, for 66% of the stock of foreign inward investment and 75% of the inflows over 1998-2001. Within this, the importance of real estate and business services in attracting FDI has grown substantially.

London's contribution to the UK economy

London accounts for 16.4% of total UK gross value added, somewhat more than its shares of population and employment: 12.2% and 12.4%, respectively. This broad characterisation considerably understates the importance of London to the UK economy in a number of sectors, especially financial services, where, in 2000, London's share of national output was 32.7%, other services (sanitation, personal, etc) at 25.8%, real estate and business services at 24.4%, transport and communication services at 21.6% and hotels and restaurants at 19%.

Of note is the fact that a number of these sectors (financial services, transport and communication services, real estate and business services) are all key attractors of FDI. These three sectors accounted for just over 50% of total FDI inflows into the United Kingdom over 1998-2001. This suggests that London has made a major contribution in attracting FDI to the United Kingdom.

London a distinct city

An analysis of the networks established by major financial and business service firms shows that London is the prime global business service centre in the world and ranks with Paris, New York and Tokyo as one of the top world cities, just ahead of Chicago, Frankfurt, Hong Kong, Los Angeles, Milan and Singapore.

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In terms of the intensity and density of networks, London is substantially ahead of any other major European city. Moreover, no other city in the United Kingdom comes even close to achieving a similar status with Manchester, the second highest rated city in the United Kingdom, being ranked only 101st among the major world cities.

In short, London is a city that is highly distinct from any other city in the United Kingdom and almost all other cities in Europe. It may therefore hold special appeal for foreign investors seeking to locate business activities in the United Kingdom or, more broadly, in Europe.

FDI into London

Data from UK-Invest, the government agency responsible for promoting the United Kingdom as a business location to potential foreign investors show that, over the last three years, London accounted for 22.7% of all new foreign investment projects assisted by the agency. London's performance was particularly strong with regards to non-manufacturing inward foreign investment, which accounted for almost 32% of all new foreign investment projects. On the basis of these data, one may conclude that London exerts a particular pull on FDI, particularly in the services sector.

Unfortunately, the UK-Invest data cover only those FDI projects that, in one form or another, received some assistance from the agency. As a result, it does not represent the full universe of FDI as many projects go ahead without any assistance.

While there exists no comprehensive official source of information on the regional distribution of FDI, complementary information is provided by the *European Investment Monitor* databank that includes all new direct foreign inward investment projects into Europe announced by companies, worldwide.

Even this databank is incomplete as it excludes investments in retail, hotels and leisure facilities, utility or communications fixed infrastructures and the extraction of ores, minerals and fuels. However, because of its pan-European coverage it allows one to undertake a detailed analysis of FDI on a city-by-city or region-by-region basis, and thus uncover London's comparative advantage in certain sectors.

Unsurprisingly, London is the strongest European city in finance and business services, attracting the most FDI projects in the financial intermediation, business services, insurance and pension, security broking and software sectors. London receives the most projects in sophisticated manufacturing sectors as well, especially electronics, computers and pharmaceuticals. However, the projects in these sectors cover activities such as sales and marketing rather than production facilities. Indeed the types of projects that London attracts are almost exclusively sales and marketing and headquarters location. It does not attract many projects for manufacturing or contact centres. It is also apparent that London attracts projects that are small as measured by the number of jobs created.

In terms of attracting FDI, the cities that seem to be London's main rivals are Barcelona, Dublin, Paris and Frankfurt. In the United Kingdom, London shows up as the prime financial centre destination even more, with other regions attracting FDI in large manufacturing projects and contact centres that are labour intensive.

Benefits of FDI

A key policy issue is whether inward FDI has any beneficial effects for the host economy besides the employment and output created by the new investment. The economic literature tends to conclude that, overall, inward FDI has wider positive effects. Employment at foreign-owned establishments seems to be more stable than at domestically-owned plants, though, in light of adverse economic developments, multinationals may be more prone to exit a host economy than a domestic firm. Inward FDI into industrialised countries also contributes to improve the trade balance. Finally, and perhaps most importantly, inward FDI is thought to have a number of positive spillover effects in terms of boosting productivity of domestic firms and making the economy more efficient.

Impact of FDI on the UK economy

There is a broad consensus that foreign-owned establishments in the United Kingdom post significantly higher productivity than indigenous establishments. Foreign-owned establishments are more capital intensive and use a more skilled labour force than their domestically-owned counterparts. However, differences in factor usage do not explain all of the difference in productivity performance. In other words, foreign-owned establishments have an inherent productivity advantage.

Regarding potential productivity spillovers, the evidence suggests that, on balance, such spillovers exist in the United Kingdom but are perhaps limited to domestic establishments where the technology gap relative to the foreign-owned establishments is small. In other words, the absorptive capacity of domestically-owned establishments is a critical factor in the materialisation of such spillovers.

Moreover, contrary to popular belief, the limited empirical evidence suggests that productivity spillovers are more likely to be found at the competitors and customers of the foreign-owned plants than at their suppliers.

Drivers of FDI

A review of the literature of the determinants of FDI shows that a number of factors may affect the level of FDI flowing to a country. These are a) geographical and economic factors such as the size of the accessible market, the distance between host and home country, relative endowments of factors, b) openness factors such as the exchange rate regime including currency union, participation in free trade areas, trade barriers, etc, c) product market regulations, d) subsidies to FDI, e) labour market legislation, f) state of the economy's infrastructure, g) agglomeration of FDI and clustering of activities and h) the quality of the national innovation systems.

Not all these factors have been conclusively found to encourage FDI. In some case opposite results were obtained by different studies. Nevertheless, the list above provides a useful checklist of factors that could influence FDI inflows and would thus need to be closely monitored.

London's attractiveness to FDI and emerging threats

London is viewed at the present time as one of the top world and European business locations. However, a number of threats are emerging that could endanger London's premier FDI status. These are the weak performance of London in the new

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knowledge economy, serious concerns about a range of quality of life issues such as state of local transportation, education, housing and medical facilities and the high cost of office space.

Policy implications

The policy implications of our review are simple.

First, and foremost, given the potential importance of agglomeration and clustering of economic activities for attracting new FDI, it will be critical to pursue economic policies that do not result in outflow to other parts of the United Kingdom or elsewhere in the world of existing foreign investment in London.

In addition to the economic and social problems that may arise directly as a result of such an outflow of existing foreign investment in London, weaker agglomeration and clustering effects could indeed reduce the attractiveness of London as a business location.

Such an outflow of foreign direct investment from London does not appear to be imminent, but it would be essential to guard against such risk in the future by pursuing economic policies that are supportive of current key agglomeration and cluster sectors.

The weak performance of London in the knowledge-economy may constitute more of a longer-term threat as it may gradually erode the incentive to locate in London. At the present time, there exist in London a number of clusters of IT and creative industries firms. Economic policies that encourage the growth of such clusters would directly contribute to attracting further FDI into these sectors. It is likely that such policies will also contribute to the broadening of London's knowledge-economy base and thus could also indirectly improve London's attractiveness for knowledge-intensive FDI.

Other existing clusters in financial services, legal services and other business services will need to be nurtured, supported and grown in the future, in part through attracting further FDI into these economic activities. Such developments are mostly within the realm of the private sector. However, concerns raised by representatives of such clusters regarding London's quality of life issues, such as the state of local transportation, housing, education and medical facilities, would need to be addressed if these clusters are expand in the future.

Obviously, any policies that address these issues will benefit new domestic and foreign investment inside and outside the cluster. In fact, they would ensure that London remains the premier business location in Europe.