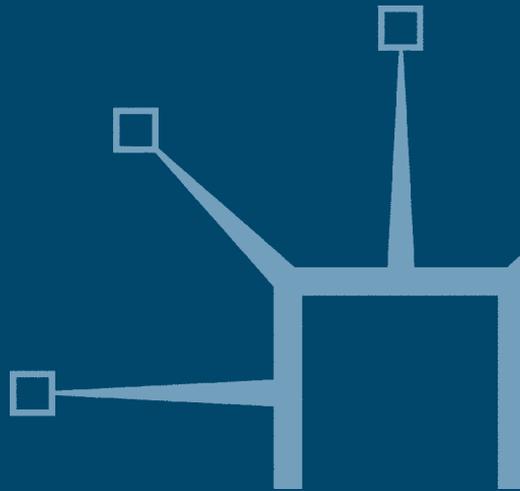


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Inward Investment, Technological Change and Growth

The Impact of Multinational Corporations
on the UK Economy

Edited by
Nigel Pain



INWARD INVESTMENT, TECHNOLOGICAL CHANGE
AND GROWTH

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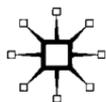
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1 The growth and impact of inward investment in the UK: introduction and overview

Nigel Pain¹

This volume contains a collection of papers from a conference held at the British Academy in September 1999. The objective of the conference was to help identify the channels through which inward investment can affect host economies and provide some quantitative evidence on the impact of foreign-owned firms on the size and industrial structure of the UK and other developed economies over the last decade.

There is considerable interest in government and academic circles in the extent to which international transfers of technology and knowledge by multinational companies may affect the performance of host economies. The location of economic activity could be an important endogenous influence on the size of host economies. Many new theoretical models view the creation and exploitation of knowledge as two of the key factors driving the process of economic growth. The Competitiveness White Paper issued by the UK government in 1998 argued that foreign direct investment is one of the main transmission mechanisms behind the diffusion of knowledge, both codified and tacit, across national borders (DTI, 1998). This appears to be supported by empirical evidence that international openness raises economic growth in the UK and other Western European economies (Proudman and Redding, 1998; Barrell and Pain, 1997, 1999b; Hoeller *et al.*, 1998). Foreign investments by multinational companies can provide a channel through which new ideas, working practices and technologies can arrive in host economies, as well as a means by which indigenous companies are exposed to greater competitive pressures. Previous competitiveness White Papers had also suggested that the high level of inward investment into the UK during the 1980s played an important role in the transformation of the production process (Eltis and Higham, 1995; Eltis, 1996).

The desire to attract inward investment is one of the few industrial policies pursued consistently by successive UK governments over the past 25 years.

Similar interest in the behaviour of multinational corporations is apparent in other advanced economies, with intergovernmental agencies such as the OECD, the World Trade Organisation and the Bank for International Settlements all having undertaken studies exploring the impact of foreign direct investment on trade and employment in host and home economies. The collection of papers in this volume will help in the evaluation of the net benefits of inward investment for host economies and the design of appropriate national policies and institutions to maximise the potential size of those benefits.

There is a particular focus on three key issues: whether foreign-owned firms have specific, ownership advantages compared to indigenous companies, the extent to which such advantages subsequently become available to improve the performance of indigenous companies, and whether there are spillovers across industries and regions as well as within the industry and region in which investment takes place. The majority of papers focus in detail on the quantitative impact of foreign-owned companies in the British economy, which has long been the primary location for inward investment within Europe. However the methodologies employed can readily be applied to other host economies, and the empirical papers are complemented by a synoptic paper from Magnus Blomström, Ari Kokko and Steven Globerman which provides a comprehensive overview of the existing literature on spillovers into productivity and employment in developed economies and highlights a number of issues worthy of further research.

Comparatively little is known about the quantitative importance of spillovers from inward investment in industrialised economies, despite the interest of policymakers in this issue. This is especially true of Britain, which even lacks a comprehensive official data source on the activities of foreign-owned firms throughout the economy as a whole.

There is some indication from qualitative survey evidence that new technologies and standards have been adopted by UK producers as a result of inward investment. In a study of the impact of technology transfer by US multinational companies, Mansfield and Romeo (1980) found that over half of the UK firms in their survey had introduced new products or processes more quickly because of a transfer of a new product or process by a US-based firm to its overseas subsidiary, with around

two-thirds of the UK firms indicating that their technological capabilities had been raised by such transfers. However there were doubts about the strength and durability of the linkages established by many overseas investors in the UK at that time, particularly in some regional economies (Young *et al.*, 1988). More recent evidence suggests that inward investment in the UK has helped to bring about a significant improvement in the product quality of suppliers (Dunning, 1988; PACEC, 1995).

The quantitative importance of such findings is not clear. The detailed statistical and econometric analyses in the papers in this volume help to fill this gap by providing a comprehensive overview of the relative performance of foreign-owned firms in the UK and the extent to which their presence has had a sustained impact on the performance of UK-owned firms over time.

In order to understand the growing impact of foreign-owned firms and the importance attached to inward investment by the policy community it is useful to review briefly the factors behind the global growth of inward investment and the particular characteristics of inward investment in the UK. This serves to highlight some of the most important channels through which inward investors might influence the performance of indigenous companies.

THE GROWTH OF GLOBAL FOREIGN DIRECT INVESTMENT

The rapid growth of foreign direct investment over the last 25 years has made an important contribution to the ongoing globalisation of economic activities. Of course by some measures, such as the ratio of total trade and capital flows to income, it might be said that many industrialised economies are no more open at present than they were a hundred years ago. However changes in the feasible span of managerial control and the nature of technical progress mean that the implications of, and the motivations for, dispersed production are quite different now. New business advances are increasingly knowledge-based, arising from specific ideas and organisational innovations, both tacit and codified. The potentially infinite expansibility of knowledge means that many of these assets can be utilised simultaneously across multiple establishments under common ownership, generating economies of scale for the firm as a whole.

Empirical evidence for countries such as the United States, the UK and Germany suggests that outward investment is more likely to occur in industries with a high level of R&D expenditure in the home country (Barrell and Pain, 1999b; Pain, 1997; Hubert and Pain, 1999), suggesting that new ideas and technologies are being utilised in host economies. Foreign direct investments are no longer dominated by the establishment of free-standing subsidiaries operating mining, agriculture and transportation facilities in emerging markets or producing finished goods at sub-optimal scale in host economies with significant barriers to external trade.

Whilst there continues to be a net capital flow from the industrialised economies to the developing ones, postwar capital market integration has been characterised by the high level of gross flows between the industrialised economies. Business strategies have changed, with many multinational firms choosing to reorganise their activities on a regional or global basis. Many leading brand names now have global recognition. Investments in non-manufacturing sectors such as financial services and public utilities have expanded rapidly, helped by widespread use of privatisation policies by many governments and the need for a local presence in foreign markets in activities which rely heavily on professional expertise, personal contacts and international reputation as well as price competitiveness.

In recent years national and regional governments and local development agencies have actively competed to attract inward investment through policy inducements and promotional campaigns in so-called 'location tournaments'. If product markets were perfectly competitive such policies would be unlikely to have permanent effects. Location patterns would be driven by geographical endowments, transport costs and production costs in different regions. Investment incentives might succeed in attracting new industries, but these would soon depart if subsidies were withdrawn (Wheeler and Mody, 1992; Barrell and Pain, 1999b).

Developments in the theories of international trade and economic geography under imperfect competition have quite different implications for the organisation of firms, as Lionel Fontagné and Michael Pajot discuss in their paper. Temporary differences in national or regional characteristics, such as investment incentives, can have permanent effects on the location of activities if firms are drawn to particular regions by the availability of agglomeration economies (Fujita *et al.*, 1999). Such economies arise from any location-bound economic activity in an area

Table 1.1. *The global stock of foreign direct investment by recipient area*

	1960	1973	1985	1990	1998
World (\$ billion)	54.5	166.7	782.3	1,768.5	4,088.1
of which (%):					
Developed countries	67.3	72.9	69.7	78.8	68.1
Western Europe	22.9	36.5	32.4	44.4	38.4
UK	9.2	8.9	8.2	12.4	8.0

Sources: Dunning (1988, Table 3.2) and UNCTAD (1999, Annex Table B3).

that generates positive externalities for nearby firms. If the new technologies and ideas brought by foreign firms do generate spillovers for host economies, there is a possibility of cumulative causation, with agglomerations attracting new investments which then influence the growth process. This suggests that the relative size of host locations is endogenous, rather than fixed by current factor endowments and access to common technologies.

Several recent studies have suggested that agglomeration effects are an important determinant of investment decisions by multinational firms. Wheeler and Mody (1992) and Mody and Srinivasan (1998) find that the global location of foreign direct investment by US and Japanese multinationals is positively related to variables reflecting the total stock of past inward investment in the host economy. In two detailed studies using plant-level data, Head *et al.* (1995, 1999) report that the location of new Japanese investments in the United States is closely related both to the location of existing investments in the industry in which investment takes place and to the location of investments by other Japanese companies. Devereux and Griffith (1998) and Barrell and Pain (1999b) find that agglomeration effects also help to determine the location choice of US multinationals in Europe. Within the UK the concentration of financial services within the City of London is an obvious example of a self-reinforcing agglomeration.

The long-term trends in the location of direct investment are shown in Table 1.1. In the first half of the 20th century some two-thirds of all investments were located in the developing economies. Over the last 40 years the picture has been quite different. Over two-thirds of all inward investments are now held within the developed economies. The rate of growth of the nominal investment stock has accelerated from an average 9 per cent per annum between 1960 and 1973, to around 13¾ per