



# Inward Investment Evidence Review Final Report

Scottish Enterprise



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## **Executive Summary**

### **Introduction**

To support its Policy Evaluation Framework (PEF), Scottish Enterprise (SE) commissioned DTZ to undertake independent research to review the evidence underpinning Scottish Development International's (SDI) inward investment and talent attraction activities. The research reviewed SDI and suitable Investment Promotion Agency (IPA) comparators, as well as relevant academic literature.

The review considered evidence provided by SE and SDI before undertaking a literature review looking at academic theories, research and evidence on the performance of a range of IPAs identified as suitable comparators to SDI. In our search we were assisted by Professor Mark Casson, professor of Economics at the University of Reading. Professor Casson specialises in inward investment and advises both the UKTI and central government in this area.

This evidence review is the first stage in the process of the "Policy Evaluation Framework" (PEF) being implemented by SDI. The evidence review will inform the primary research phase of the PEF by synthesising existing knowledge, identifying any gaps and ultimately recommending improvements in policy and practice.

In addition to this report an evidence database has been completed in the form of an Excel spreadsheet to summarise the main sources and key findings. A separate Annex Report on Comparator IPAs has also been produced which provides information on target sectors, overseas offices, the source of investment, investor experience and an overarching critical assessment.

The evidence review has found that SDI performs well in terms of the number of investment projects that are attracted to the country and against comparator areas and regions - it is one of Europe's top IPAs as measured by projects per capita. In addition, it is clear that in identifying the need for this evidence review that SDI is ahead of many other IPAs in terms of its recognition of the need to demonstrate the impact of its interventions.

### **Strategic Rationale and Market Failure**

Section Two considers the strategic rationale behind inward investment, and explored the benefits of FDI and the market failures associated with FDI. It is generally accepted that the attraction of FDI can bring benefits to the host economy. FDI can bring additional jobs and profits as well as a series of positive externalities and spillover effects that would not result had the investment not been made.

However, in order to establish the strategic rationale for public investment in this area it is important to consider market failure. Market failure in the case of inward investment is evident, predominantly in the form of imperfect information. Issues of equity can potentially, also be addressed through inward investment.

SDI has set out a clear rationale for intervention based around the objectives of the Scottish Government's GES and the targets and goals set out by Scottish Enterprise

## **Interventions**

Section Three looks at the typical roles of an IPA, along with the specific roles of SDI. It is established that IPAs have several core roles and activities which include investor facilitation, image building, investment generation and policy advocacy. In addition some IPAs offer incentives in the form of financial and fiscal incentives.

SDI adheres to the common goals of an IPA and also provides a strong aftercare service. Evidence from the literature argues that successful IPAs are those that take account of the characteristics of a country, build a positive image through pro-active means and provide facilitation support to investors.

## **Effectiveness and Impact**

Section Four documents the evidence from the literature on the effectiveness of IPAs. It is clear that there is no evidence to show that any IPA has looked at its overall performance in terms of its role in attracting investment and the attribution of any subsequent impact. SDI is evidently ahead of many of its competitors in terms of the information that is collected.

It is generally accepted that the attraction of FDI brings benefits, but there is no consensus in the literature on the benefits brought to a country through FDI. Typically FDI is thought to bring about a series of benefits including higher wages, knowledge spillovers and increased competition. However there is a significant body of academic work that suggests the overall positive impact of FDI may be overstated. Both empirical and academic evidence relating to the overall impact of IPAs is limited, with very few studies carried out into the effectiveness of IPAs.

Some studies have been carried out in the UK on the effectiveness of UKTI, and while some of the findings from these studies suggest that the impact of UKTI services was often limited in terms of influencing the destination country, they found the services to be very helpful in facilitating the investment process. Furthermore, in the cases where they have influenced the investment decision there is evidence of a significant impact in terms of spillovers and behavioural changes.

Other studies carried out in Scotland, such as the evaluation of TalentScotland and the recent research into SDI activities, provide some interesting findings however, impact information relating to the effectiveness of SDI cannot be obtained from either.

Additional research is needed in this area. Evidence on the impact of IPA activity is severely lacking. In order to assess whether the activities of SDI or any IPA is cost effective, it is important to monitor and evaluate the services provided both at a service level and in a holistic sense for the overall organisation.

## **Comparator IPAs**

Section Five and the Comparator Annex Report provide a number of best practice case studies. These have been carefully selected on the basis that each IPA profiled is performing well. It is apparent that SDI performs well in terms of the number of investment projects that are attracted to the country and against comparator areas and regions. It is one of Europe's top IPAs as measured by projects per capita.

## Summary and Recommendations

There are no particular gaps in the evidence in the area of strategic rationale or market failure.

### **Assessment – No action required**

The review of evidence found that no IPA had looked at its overall performance including SDI and therefore additional research and activity is required in order to fill this gap. This will have to take account of the additionality of the support provided. SDI has started this process through the PEF. **Assessment – Significant action required.**

The issue of the impact of IPAs should be investigated further, potentially in a more extensive case study exercise than was possible within the scope of this evidence review. **Assessment – Some action required.**

There are a number of actions that SDI can take forward to improve its evidence base relating to the impact of its intervention. These should be incorporated into the developing PEF wherever possible.

- **Overarching evaluation** – There is a need for an overarching evaluation to determine the net economic impact of SDI's activity. This could cover its inward and outward functions.
- **Monitoring data** – There is scope to further develop monitoring data to more accurately track the outcomes of SDI's activity from the generation of leads through to the conversion to projects and then onto the net impact generated.
- **Top-down impact data** – The total value of FDI to the Scottish economy can be estimated using existing national datasets. This will then enable SDI to establish the proportion of the total investment it has had a role in attracting in net economic impact terms.
- **Bottom-up impact data** – There is a case for company-level evaluation of impact. This would be used selectively to understand the nature and scale of impacts for key inward investors. This would be at a level of detail beyond what would normally be captured in an overarching evaluation.
- **Comparator IPA Case Studies** – There is little evidence to determine whether an identified innovative approach by an IPA actually changes the overall level of investment attracted in net economic impact terms. There is scope to further investigate this issue by undertaking further research into the impact of comparator IPAs.

## 1. Introduction

To support its Policy Evaluation Framework (PEF), Scottish Enterprise (SE) commissioned DTZ to undertake independent research to review the evidence underpinning Scottish Development International's (SDI) inward investment and talent attraction activities. The research reviewed SDI and suitable Investment Promotion Agency (IPA) comparators, as well as relevant academic literature. The review of evidence was structured around four broad areas:

- The nature and characteristics of SDI's activities
- The rationale for SDI's activities
- The nature and extent of market failure(s) that apply
- The effectiveness and value-for-money of SDI's interventions

The research methodology was designed to deliver the following research outcomes:

- The extent to which SDI is intervening in areas that can be justified in **rationale and market failure** terms. Is there the evidence and is it supportive of such interventions?
- The extent to which there is robust evidence which can determine the organisation's impact in terms of **effectiveness** and **value-for-money**, and the conclusions we can reach on impact.
- Where there is insufficient evidence in either of these areas, define the nature of such **information gaps** which can inform further PEF research and analysis.
- The identification of **innovative approaches** and 'lessons learned' from the analysis of comparators

The review considered evidence provided by SE and SDI before undertaking a literature review looking at academic theories, research and evidence on the performance of a range of IPAs identified as suitable comparators to SDI. In our search we were assisted by Professor Mark Casson, professor of Economics at the University of Reading. Professor Casson specialises in inward investment and advises both the UKTI and central government in this area.

This report summarises the available evidence relating to inward investment promotion in order to provide answers to the research questions outlined above. The report is not meant to provide an extensive critique of the literature and data, but rather to act as a guide on what evidence is readily available, what the key messages from this evidence are, and where there are gaps in the existing evidence base. The remainder of the report is structured as follows:

- Section 2: The **strategic rationale** behind inward investment promotion and the main **market failures** associated with inward investment
- Section 3: Types of **interventions**
- Section 4: Evidence of **effectiveness** of IPAs
- Section 5: Overview of **comparator IPA** review
- Section 6: **Summary of evidence** and identification of information **gaps**.

In addition to this report an evidence database has been completed in the form of an Excel spreadsheet to summarise the main sources and key findings. This database is designed to be used as a reference tool to assist SE and SDI in the further development of the PEF. A separate Annex Report on Comparator IPAs has also been produced which provides



information on target sectors, overseas offices, the source of investment, investor experience and an overarching critical assessment.

## 2. Strategic Rationale and Market Failure: Inward Investment Promotion

Inward investment promotion has become a standard function of many governments, embassies, trade bodies and agencies around the world. Investment promotion is carried out at various geographical levels; national, regional and sub-regional. Indeed, it has become almost a prerequisite for governments to fund some form of investment attraction activity in order to maintain an area's competitiveness and keep up with other areas. Given the push towards funding this activity, it is important that the rationale for intervention is clearly established.

Inward investment brings a number of benefits to a country which, in itself, provides governments with a reason for spend on IPA activity. However, in order to fully justify public spending it is also necessary to evidence market failure. In the case of inward investment, there is evidence of information and institutional failures. In addition, FDI can help address equity considerations such as tackling regional inequalities. These market failures provide government bodies with a sound rationale for inward investment promotion activity. This Section begins by considering the potential benefits of inward investment before going on to look at evidence of the market failures that IPAs aim to address. The Section concludes with an assessment of the strategic rationale and objectives of SDI.

### 2.1 The Benefits of Inward Investment

The global economic and political environment has changed significantly in the last few decades. This change has brought about both positive and negative developments. In terms of global trade, growing liberalisation and internationalisation of the world economy has made new forms of investment possible. One of these is Foreign Direct Investment (FDI) which has become increasingly important for governments and investors alike.

FDI can offer a variety of advantages for the host economies, such as capital inflows, technology and knowledge transfer, job creation as well as access to international markets.<sup>1</sup> As a consequence, attracting FDI has become a central component of government policy in developed and developing countries across the world.<sup>2</sup> Research for the World Bank in 2003 found that there were more than 150 IPAs worldwide.<sup>3</sup> DTZ estimates that this figure is now closer to 180 national agencies with many more sub-regional IPAs.

Academic literature relating to IPAs is extensive, from detailed studies on the techniques used by agencies, to assessments of websites and enquiry handling. Despite this, very little is known about how effective these agencies have been in influencing investors' decisions.<sup>4</sup>

This report seeks to review the evidence on the impact and effectiveness of IPAs, particularly in relation to the Scottish experience of FDI attraction. However, in order to assess the existing evidence, it is necessary first to ask a key question:

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<sup>1</sup> Gabriel, M, 2006, *Measuring the Efficiency of IPAs – An Input View Using DEA*, Vienna University of Economics and Business Administration, Vienna.

<sup>2</sup> Loewendahl, H, 2001, *A framework for FDI Promotion*, Transnational Corporations, Vol. 10 No.1, pp.1-42.

<sup>3</sup> J Morisset, World Bank Policy Research, 2003, *Does a country need a promotion agency to attract foreign direct investment? A small analytical model applied to 58 countries*, Working Paper 3028.

<sup>4</sup> Ibid.



**“Why use IPAs to attract foreign direct investment?”**

In other words, there has to be a series of benefits flowing from the provision of inward investment promotion by governments. Once the expected benefits have been established, any public sector investment has to have a strategic rationale that is based on the existence of market failure (or equity considerations). The evidence relating to market failure is set out later in this Section. First we consider the evidence relating to the benefits of FDI and inward investment promotion.

Information relating to the justification and theories behind the use of IPAs such as SDI and UKTI, is limited to a few key principles. Indeed, much of the literature relating to the benefits of IPAs points to the various positive effects of FDI itself, the main positive effects being:

- Contributions to increased productivity growth
- Contributes to dynamic competition effects
- Innovation effects
- Positive externalities associated with inflows

Each of these effects is considered in turn in order to illustrate the evidence relating to the rationale for intervention. The report highlights the themes from the evidence reviewed, using selected examples to illustrate the nature of the available evidence.

### **2.1.1 Contributions to increased productivity growth**

The argument that FDI brings increased productivity growth is recurrent across the literature. A report for the DTI (now DBERR)<sup>5</sup> refers to this as the positive effect of productive churn whereby productivity growth is stimulated by inward investment both within the firm and also externally, arguing that:

*‘There is evidence that international trade and investment can stimulate increased productivity growth by strengthening competition and innovation, and increasing access to new ideas and technologies. The opportunity to sell on world markets enables businesses to achieve growth and economies of scale which domestic markets alone would not allow, strengthening dynamic processes of competition both through expansion of high productivity businesses and through increased business exposure to new ideas and leading edge practices. Successful exploitation of overseas markets also raises the returns to innovation, thus strengthening business incentives for more investment in innovation and in research and development.’*

**Example 2.1:** B Tam, B Gangnes and I Noy, 2007, *Is Foreign Direct Investment Good for Growth? Evidence from Sectoral Analysis of China and Vietnam*, University of Hawaii, Hawaii.

This paper looks at the impact of FDI on growth using sectoral data for FDI inflows to China and Vietnam. The paper is the first to use sectoral FDI inflow data to evaluate the sector-specific impact of FDI on growth. Results show that, for the two developing-transition economies examined, FDI has a statistically-significant positive effect on economic growth operating directly and through its interaction with labour.

<sup>5</sup> Reading Business Group and Others for the DTI and UKTI, 2006, *2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report*, DTI Evaluation Report Series No. 9.

**Example 2.2:** S Contessi and A Weinberger, 2009, *Foreign Direct Investment, Productivity, and Country Growth: An Overview*, Federal Reserve Bank of St. Louis Review.

The authors review the empirical literature that studies the relationship between foreign direct investment, productivity, and growth using aggregate data. The results are mixed but the paper does point to a large body of empirical research that uses firm- and plant-level data. This documents that multinational firms and their affiliates (compared with domestic firms) are larger, are more capital intensive, make more abundant use of skilled workers, invest more in physical and intangible capital, and pay higher wages which in turn results in higher productivity.

## 2.1.2 Contributions to dynamic competition effects

Linked to the idea that FDI increases overall productivity growth is the idea that FDI can increase competition. This can in turn lead to increased productivity and growth, but also has several independent positive and negative effects. According to UKTI<sup>6</sup>:

*‘Competition is stimulated by the opportunity for young innovative and high productivity firms to grow and strengthen their performance, hence presenting stronger competitive challenges to incumbents (existing firms) in the market’.*

The idea is that FDI increases competition thereby increasing economic efficiency as establishments with higher than average productivity enter the market or increase their market share, and lower productivity establishments shrink or exit from the market. The benefit of an IPA is therefore linked to encouraging increased productivity and efficiency in the market.

**Example 2.3:** J Baldwin and W Gu 2004, *Industrial Competition, Shifts in Market Share and Productivity Growth*, Economic Analysis (EA) Research Paper Series, Statistics Canada, Analytical Studies Branch

Evidence for Canada suggests that entry and expansion of inward investors and of exporters can both contribute substantially to aggregate productivity growth through these dynamic competition effects, because both tend to have higher than average productivity. These effects are also likely to be important for the UK but have not yet been much researched.

## 2.1.3 Attraction of high value investments

Again contributing to productivity growth is the idea that FDI brings about high value jobs and skills. The literature pointed to links between productivity growth through the attraction of better paid jobs, increased skills, improved management processes and technology. This is explored further in Section Four.

<sup>6</sup> UKTI Departmental Report 2007

## 2.1.4 Positive externalities associated with inflows

Other positive externalities arising from FDI such as knowledge spillovers, networking opportunities and technological externalities are also highlighted in the literature as rationale for IPAs' inward investment activity.

*Externalities, in the context of an area-based business support intervention, are viewed as the positive indirect effects that result from firms being located together. These positive externalities may include collaboration and networking opportunities, technological externalities (e.g. spillovers, linkages), information transfer, the freeing up of internal human and financial capital (which can then be utilised in other innovative actions within the firm), the leverage of additional private sector financial support, or the range of perceived or actual benefits associated with large urban labour markets (e.g. skill sets).<sup>7</sup>*

**Example 2.4:** T Harding and BS Javorcikr, 2007, *Developing Economies and International Investors: Do Investment Promotion Agencies Bring Them Together*, The World Bank.

The study uses data on national IPAs in 109 countries to examine the effects of investment promotion on FDI inflows. Harding and Javorcikr's review of a large body of literature argues that foreign direct investment may result in knowledge spillovers and other positive externalities to the domestic industry. As foreign investors do not take into account these externalities when making their decisions, they will provide less than the socially optimal level of FDI. Public intervention is then needed to increase the amount of investment to the socially optimal level.

## 2.2 Market Failure in Inward Investment

One of the key principles behind any government intervention is the notion of 'market failure'. Market failure exists when the production or use of goods and services by the market is not efficient. Market failure is a description of a situation where, for one reason or other, the market mechanism alone cannot achieve economic efficiency. Where market failure exists, there becomes a strong argument for government intervention in order to address these inefficiencies. The market failure theory is applicable for many types of government policy and involvement and is used frequently to support the rationale for the existence of IPAs. Her Majesty's Treasury provides guidance and definitions on market failure in the Green Book<sup>8</sup>:

<sup>7</sup> M Hart, N Driffield et al for the Scottish Executive Social Research, 2008, *Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004*, The Scottish Government (Social Research), Edinburgh.

<sup>8</sup> HM Treasury Green Book, 2003, TSO, London.

## Definition of Market Failure: HM Treasury Green Book

### Lack of Public Goods

The market may have difficulty supplying and allocating certain types of products and services, such as 'public goods'. Public goods are those that are 'non-rival' or 'non-excludable' when used or consumed.

- **'Non-rival'** means that the consumption of the good by one person does not prevent someone else using or consuming that good. Clean air is an example of a non-rival good.
- **'Non-excludable'** means that if a public good is made available to one consumer, it is effectively made available to everyone. National defence is an example of a non-excludable good.

Non-excludability can give rise to a problem known as 'free-riding'. This is when some consumers fail to pay for the provision of the public good because they expect others will do so. This implies that the returns to potential suppliers will be less than society as a whole would be willing to pay collectively. So a market solution would imply too little public goods being produced to be socially optimal.

### Externalities

'Externalities' result when a particular activity produces benefits or costs for other activities that are not directly priced into the market. Externalities are associated with, for example, research and development spill-overs, and environmental impacts, such as pollution. A firm might keep down its own costs by not investing in water pollution controls, but in so doing would raise the costs of those firms and individuals relying on using clean water. As a result the polluter has imposed an external cost on other users, or alternatively, a reduction in pollution confers an external benefit upon these other users.

### Imperfect information

Information is needed for a market to operate efficiently. Buyers need to know the quality of the good or service to judge the value of the benefit it can provide. Sellers, lenders and investors need to know the reliability of a buyer, borrower or entrepreneur. This information must be available fully to both sides of the market, and where it is not, market failure may result. This is known as 'asymmetry of information' and can arise in situations where, for example, sellers have information that buyers don't (or vice versa) about some aspect of product or service quality. Information asymmetry can restrict the quality of the good traded, resulting in 'adverse selection'. Another possible situation is where a contract or relationship places incentives upon one party to take (or not take) unobservable steps that are prejudicial to another party. This is known as 'moral hazard', an example of which is the tendency of people with insurance to reduce the care they take to avoid or reduce insured losses.

### Market Power

Market power can arise as a result of insufficient actual or potential competition to ensure that the market continues to operate efficiently. High start up costs can deter entry by competitors in the first place, and therefore create market power. This situation may be exacerbated through organisations acting strategically to protect their position in the market. Examples of this are when an organisation invests in any excess capacity available in the market, or engages in a practice known as 'predatory pricing' where prices are set low (e.g. below the marginal cost of production) to drive out competitors and then raised once they have left.

Source: HM Treasury Green Book

The literature identifies particular market failures which underpin the rationale for inward investment promotional activity. These are concerned primarily with imperfect information. However, without intervention, it can be argued, a country cannot receive the positive externalities associated with FDI. The common types of market failure relating to FDI are in the category of **information barriers to entry**.

One of the strongest arguments in support of IPAs is that potential overseas investors may not be well informed about the benefits of investing internationally. They may not be aware of all the costs and risks involved in investing overseas and they may not know who or where to find this information. The consequence is that the level and value of overseas investment is lower than it should be and/or such investment is poorly targeted geographically.

In addition, those who do decide to invest overseas may not have the relevant knowledge to develop an effective marketing strategy, or to manage the risk. By providing information and contacts to potential investors, IPAs can address market failures particularly relating to information barriers:

**Missing markets:** *Through its network of overseas offices, the Government can provide access to contacts and key decision makers – and to some types of information – which private sector service providers might be unable to offer, or would not be able to offer as efficiently or as well. Government reputation, in particular for impartiality and trust, may also be an important aspect of the type and quality of help that UKTI is particularly well placed to provide. Without this unique help, UK businesses would find it more difficult to gain access to overseas market opportunities, and potential inward investors would find it more difficult to obtain the contacts and information they need about the UK.*<sup>9</sup>

**Networks and institutional failures:** *The private sector alone may not be willing or able to develop and maintain adequately the institutions and networks that support international linkages and knowledge flows. Government help may be needed to facilitate and encourage private sector co-operation in these areas, or to complement private sector roles, for example through supporting organisations such as the China-Britain Business Council, or encouraging co-operation among trade associations in related sectors to research overseas opportunities.*<sup>10</sup>

Some examples of market failure issues are shown in the example boxes below. It should be noted that these examples are primarily concerned with market failures in terms of outward investment by companies, but in this case the literature is of relevance as it is these market failures that IPAs such as SDI are seeking to address in attracting outward investment from other countries into Scotland.

## 2.2.1 Inward investment as a means of tackling sub regional inequalities

Some reference is made in the academic literature to the use of FDI in tackling regional disparities and inequalities. Inward investment can be 'incentivised' to areas of deprivation or need through the use of incentive schemes. In Scotland this is being done via the use of a Regional Selective Assistance (RSA) programme whereby businesses setting up in particular geographies in Scotland are eligible for government support provided they meet a number of

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<sup>9</sup> UKTI Departmental Report 2007

<sup>10</sup> Ibid.

pre-set criteria. Example 2.5 explores the use of inward investment incentives to tackle equity considerations.

**Example 2.5:** M Hart, N Driffield et Al for the Scottish Executive Social Research, 2008, *Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004*.

The rationale for developing and maintaining the RSA Scheme rests on the notion that the needs of the disadvantaged sub-regions within Scotland are best served by a 'state aid' that produces a wide range of effects at the firm level and, more importantly at the broader regional and national level. For the British regions at least the emphasis has been on using inward investment to reduce structural unemployment and reduce inequalities, both intra-regionally and inter-regionally via raised productivity through technology transfer and spillover effects.

**Example 2.6:** The Reading Business Group, 2006, *2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development*.

The analysis points out that when firms and individuals are heterogeneous, and information is limited, markets may not be able to function efficiently without an effective intermediary. For example, in circumstances in which all transactions involve considerable uncertainty, establishing trust between business partners is crucial. In geographically and culturally distant markets, firms may lack means of access to business or social networks, or understanding of networks that do exist. The private sector alone may not be able or willing to develop or support networks to redress this lack, particularly in circumstances where there is little or no history of bilateral trade and investment.

**Example 2.7:** International Business Strategies, 2008, *Barriers & Awareness Monitoring Survey*, OMB Research for UKTI

The research gathers evidence about trends in UK businesses' international business strategies; barriers hindering such business, and associated needs for external help as well as awareness of, and propensity to use, UKTI; and related issues. Of all 900 businesses surveyed, 79% reported 'significant barriers to entry' including information and legal barriers.

**Example 2.8:** DTI, 2006, *International Trade and Investment – the Economic Rationale for Government Support*.

Survey research on the motivations for business internationalisation find that inexperienced SME exporters who had not received support or advice from UKTI, tended to have lower assessments of the potential benefits of selling overseas. Only 58 per cent citing a strong motivation of any kind. By contrast some 79 per cent of inexperienced SME exporters who had used UK Trade & Investment services had at least one such strong motivation for selling overseas, almost identical to the results for large firms. This difference between non-user and users of UK Trade & Investment services could indicate that businesses with strong motivations for internationalisation are more likely to seek out such services.



**Example 2.9: OECD, 2006, *Removing Barriers to SME Access to International Markets: A Joint OECD/APEC Project.***

The Survey of SMEs' Perceptions of Barriers to Access to International Markets received 978 usable responses from SMEs worldwide. When asked to rank the 10 barriers considered to have the most detrimental impact on their ability to access international markets, the responding SMEs identified barriers concerned with internal capabilities and access to markets to be the most important with barriers in the business environment of less importance.

The results highlight the importance of internal barriers associated with resource constraints and weaknesses in internationalisation capabilities, including management skills and attitudes. These findings are consistent with the management literature on internationalisation, which also stresses that a firm's ability to take advantage of new knowledge and opportunities depends crucially on its self-awareness and absorptive capacity.

## 2.3 SDI: Strategic Rationale and Objectives

SDI has two main operational goals:

1. Enabling Scottish companies to increase their internationalisation either through increasing export sales or other international activities (e.g. joint ventures or overseas acquisitions)
2. Encouraging overseas-based companies to set up and expand within Scotland.

The focus of this review is on the second goal involving the attraction of inward investment. The rationale for SDI's activity in this area is clearly set out in the Business Plan for 2008/09, which outlines the strategic and operational direction for SDI over the next three years.<sup>11</sup> The activities of SDI are aligned to the Scottish Government's Economic Strategy (GES).<sup>12</sup> The contribution of SDI to the Strategic Priorities and Targets of the GES is set out below.

First introduced in 2007, GES has focused funding to support increased sustainable economic growth. The GES has not only provided funding, but as a government strategy it has been influential in bringing together the policies and initiatives at all levels of government to achieve the overall aim of the GES. The principal objective being:

*'To create a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth.'*

In order to achieve this objective, GES sets out five main strategic priorities;

1. Learning, Skills and Well-Being
2. Supportive Business Environment
3. Infrastructure, Development & Place
4. Effective Government
5. Equity

<sup>11</sup> SDI Business Plan 08/09, May 2008, Group Services SDI.

<sup>12</sup> Scottish Government, 2007, The Government Economic Strategy, Crown Copyright, Edinburgh

Under each of these priority areas, targets have been set. These include improvements to GDP levels by 2011 and 2017, targets to increase participation rates and population growth, as well as substantial reductions in CO2 emissions by 2050. Key sectors have also been highlighted as areas of high growth potential requiring targeted attention. These are:

- Creative Industries (including digital content and technologies);
- Energy (with a particular focus on renewables);
- Financial and Business Services;
- Food and Drink (including agriculture & fisheries);
- Life Sciences (including biotechnology and translational medicine); and
- Tourism
- Education

The GES is aligned to five overarching strategic objectives designed to focus all of the Government’s activity:

**Figure 2.1 – GES Strategic Objectives**



Source: Government Economic Strategy, November 2007

Clearly SDI’s activities have the strongest fit with the ‘Wealthier and Fairer’ objective. In terms of the strategic priorities, SDI’s contribution stemming from its inward investment activity is outlined in Table 2.1.

As SDI is a joint venture between the Scottish Government and Scottish Enterprise (SE), it has to fit with the strategic goals and activities of the Enterprise Network. SE plays a key role in reaching the targets set in the GES as laid out in the SE Business Plan 2009-2012.<sup>13</sup> SE also has to align its activities to the strategic priorities of the GES and Table 2.1 also summarises SE’s contribution to these priorities.

<sup>13</sup> Scottish Enterprise, March 2009, *Scottish Enterprise Business Plan 2009-12 – Working for Economic Recovery and Growth*.





**Table 2.1 – GES Strategic Priorities Supported by SDI and SE**

Strategic Priority	SDI Contribution	SE Contribution
Supportive Business Environment	The main area of contribution by SDI is through the provision of targeted support to FDI businesses. SDI aims to support the development and growth of the priority industries through targeting inward investment opportunities in these key sectors.	<ul style="list-style-type: none"> <li>- Focus on key sectors</li> <li>- Support growth companies</li> <li>- Improve access to risk capital</li> <li>- Internationalise company base &amp; attract FDI</li> <li>- Increase business innovation &amp; exploitation of IP</li> </ul>
Learning, Skills and Well-Being	SDI can make a contribution through providing access to international best practice in skills and workforce development and has a role in positioning Scotland as a location for high value inward investment.	<ul style="list-style-type: none"> <li>- Deliver organisational development &amp; leadership</li> <li>- Stimulate demand &amp; skills utilisation</li> <li>- Promote talent attraction &amp; retention</li> </ul>
Infrastructure, Development & Place	In attracting inward investment to Scotland, SDI can encourage the development of the physical infrastructure in terms of improving connections and place competitiveness in order to secure investment decisions.	<ul style="list-style-type: none"> <li>- Deliver business infrastructure &amp; national/regional regeneration</li> <li>- Facilitate industry influence over transport, planning etc</li> </ul>
Effective Government	SDI works with a number of national and local partners in the delivery of inward investment support and has been involved in the development of the Government's International Framework.	<ul style="list-style-type: none"> <li>- Deliver year-on-year efficiencies</li> <li>- SE to be an effective partner (e.g. Strategic Forum etc)</li> </ul>
Equity	In attracting investment and high value jobs to the economy, there are potential spill-over effects through the value chain. In addition, other lower skilled jobs can be created to support labour market participation.	<ul style="list-style-type: none"> <li>- Increase renewable energy &amp; business resource efficiency</li> <li>- Promote business benefits through diversity</li> <li>- Support rural growth &amp; diversification</li> <li>- Promote redistribution through RSA scheme.</li> </ul>

Source: Government Economic Strategy, November 2007, SDI Business Plan 08/09 and SE Business Plan 2009- 2012

SE has three core areas of activity:

- **Enterprise** - by helping companies to realise their growth potential; by supporting priority industries and companies to internationalise and attract added value through FDI; and by increase the impact and speed to market of high growth start-ups.
- **Innovation** – through supporting and encouraging innovation in the companies that SE works with, by focusing in particular on account managed companies and priority industries; by improving the market demand for and exploitation of new licences and collaborative ventures; by exploiting more economic value within the Scottish economy from academic spin outs; and by supporting a culture of continuous innovation.
- **Investment** - by increasing leverage from public funds by attracting more risk capital to invest in Scotland; by creating the best possible business infrastructure to promote the growth of our priority industries and high growth businesses; and by attracting specialist partners to invest in priority industries including infrastructure, direct investments and collaborative projects.

SE has set targets across these themes and by reaching these targets as well as aligning performance management to that of the GES, as well as targeting the key priority industries, SE will play a crucial role in meeting the key objectives of the GES. Through its operational goals, SDI has a strong fit with SE's three key areas of activity.

In summary, SDI aims to contribute to a number of the priorities set by the Scottish Government. The organisation does so by attracting new high value business to Scotland. SDI also aims to attract high value jobs from international firms, particularly across the key industries outlined in the GES to support the attraction of investment into those industries where Scotland can compete internationally. By attracting FDI, SDI can contribute to GDP growth and productivity, thereby linking into the strategic targets set by GES. The potential contribution of SDI to the GES strategic targets is explored in Table 2.2.

It is worth noting that since the GES was first introduced, the economic situation has changed significantly and the need to re-establish sustainable economic growth has increased. The Scottish Government has introduced an Economic Recovery Programme which points to areas of particular importance to the Scottish economy in the present circumstances. Both the GES and the recently announced Economic Recovery Programme will require the support of SE and SDI to implement these objectives through the targeted attraction of FDI into Scotland.

SDI's rationale for intervention in attracting inward investment has also recently been assessed by Cogentsi<sup>14</sup> in their report on the scope for inquiry for the Scottish Parliament (further details in section 4.6.2 of this report).

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<sup>14</sup> H Gibson, 2009, *Trade and Investment Promotion: Final Report on the Scope for Inquiry*, Cogentsi for the Scottish Parliament.

**Table 2.2 – GES Strategic Targets Supported by SDI**

Strategic Target	SDI Contribution
To raise the GDP growth rate to the UK level by 2011	The attraction of inward investment into Scotland has a direct link to economic growth.
To reduce emissions over the period to 2011	Through working with renewable energy companies in Scotland and through promoting environmentally positive practices SDI can help to contribute to this target.
To match the GDP growth rate of the small independent EU countries by 2017	As above, the attraction of inward investment into Scotland can contribute to economic growth directly and indirectly through spill-over effects.
To rank in the top quartile for productivity amongst our key trading partners in the OECD by 2017	MNEs generally demonstrate a high level of productivity as they are internationally competitive; therefore the attraction of such companies to Scotland can contribute to the productivity target.
To maintain our position on labour market participation as the top performing country in the UK and close the gap with the top 5 OECD economies by 2017	SDI aims to stimulate direct employment impacts through FDI and spill-over effects from FDI can help to increase labour market participation through the creation of additional jobs.
To match average European (EU15) population growth over the period from 2007 to 2017, supported by increased healthy life expectancy in Scotland over this period	SDI can contribute indirectly through positioning Scotland as a desirable location to live, work and study, particularly through Talentscotland and Globalscot.
To increase overall income and the proportion of income earned by the three lowest income deciles as a group by 2017	Through the stimulation of the corporate base in Scotland, SDI aims to encourage spill-over effects to help employment growth.
To narrow the gap in participation between Scotland's best and worst performing regions by 2017	Through spill-over effects from investment and the encouragement of investment through interventions such as RSA.
To reduce emissions by 80 per cent by 2050	Through the promotion of Scotland as a location for renewable energy investment.

Source: Government Economic Strategy, November 2007 and SDI Business Plan 08/09

In summary, the rationale for intervention by SDI in attracting inward investment to Scotland is well articulated and there is a strong strategic fit between the goals and activities of SDI and the strategic goals of both the Scottish Government and SE.

### 3. Inward Investment: Profile of Interventions

#### 3.1 Investment Promotion Agencies

In their ground breaking work, first published in 1990, Wells and Wint considered investment promotion in terms of "promotional techniques", describing them as:

*"providing information to potential investors, creating an attractive image of the country as a place to invest, and providing services to prospective investors".<sup>15</sup>*

Usually, inward investment promotion activities at the national level are carried out by a single agency; an IPA such as SDI and UKTI. However, some methods of promotion may be carried out in other ways, for example by other government departments, regional agencies, development agencies or country embassies. In addition, IPAs may have more than one focus or function. SDI, for example, not only carries out inward investment promotion but also seeks to encourage and support Scottish businesses looking to export.

Wells and Wint summarised the traditional roles of an IPA under the heading 'Classical IPA Tasks'. These are outlined below in table 3.1.

**Table 3.1 - The Traditional Roles of an IPA**

	Function	Description	Example of means
<b>"Classical" IPA tasks</b>	Investor facilitation	Assisting an investor and investor services to analyse their decision, establish a business and ensure it continues to operate.	Provision of information, assistance in getting approvals, assistance with sites, utilities etc.
	Image building	Creating the perception of a country as an attractive site	Advertising and public relations.
	Investment generation	Targeting specific sectors and companies in order to create investment leads.	Identification of targets, direct contact, forums, seminars etc.
<b>Policy-related activities</b>	Policy advocacy	Supporting initiatives to improve the investment climate and identifying private sector views.	Surveys, participation in task forces, policy proposals, lobbying.

Source: F Cass,2007, Attracting FDI to transition countries: the use of incentives and promotion agencies. Transnational Corporations, Vol 16 No. 2, Geneva.

In addition to the classical role of an IPA, some IPAs also provide incentives to attract businesses to a country which may include fiscal, financial and other stimulants:

<sup>15</sup> Wells, Louis T. and Alvin G Wint, 2000, *Marketing a Country: Promotion as a Tool for Attracting Foreign Investment*, Washington, D.C.: IFC, MIGA and World Bank (Revised Edition).

**Table 3.2 - Incentives Used by IPAs**

Incentives	Definition	Examples
<b>Fiscal</b>	Direct or indirect subsidies or tax relieves	Permanent or temporary tax reductions. Investment allowances. Tax deductions. Exemptions from import or export duties.
<b>Financial</b>	Measures for financing new foreign investments	Government grants. Government credits. Government equity participation. Government insurance at preferential rates. Depreciation methods.
<b>Others</b>	Measures that give an advantage to foreign firms	Subsidized infrastructure or services. Market preferences. Preferential treatment on foreign exchange. Labour training support. R&D support.

Source: M T Gabriel, 2006, Measuring the Efficiency of IPAs – An Input View Using DEA, Vienna University of Economics and Business Administration.

Each IPA will vary according to the differing needs and objectives of the country as well as the particular rules and regulations governing their activity, such as EU legislation on FDI activity. More detail on best practice is given in Section Five and in the separate Annex Report. However, from DTZ's experience in providing global location advice to investors and in dealing with IPAs there are a number of standard elements of good practice that IPAs should be aiming to cover. These are summarised in Figure 3.1.

In order for an Investment Promotion Agency (IPA) to deliver the most appropriate services to investors it is important to understand how companies make location decisions. The information and assistance provided by IPAs to potential inward investors should vary at each stage of the process.

Getting this delivery right in terms of the quality and quantity of information is critical for an IPA. If an investor perceives an IPA to have provided a poor level of service it is highly unlikely that this will be the sole reason for them not to select a location. However, in a competitive globalised economy it is critical that IPAs support the case for their area as best as possible.

At **Stage 1** of the corporate location decision, companies are developing the key drivers that will enable them to deliver their overall strategy. IPAs need to understand what companies are trying to achieve. In general, two or more of the following drivers are likely to be behind the location decision:

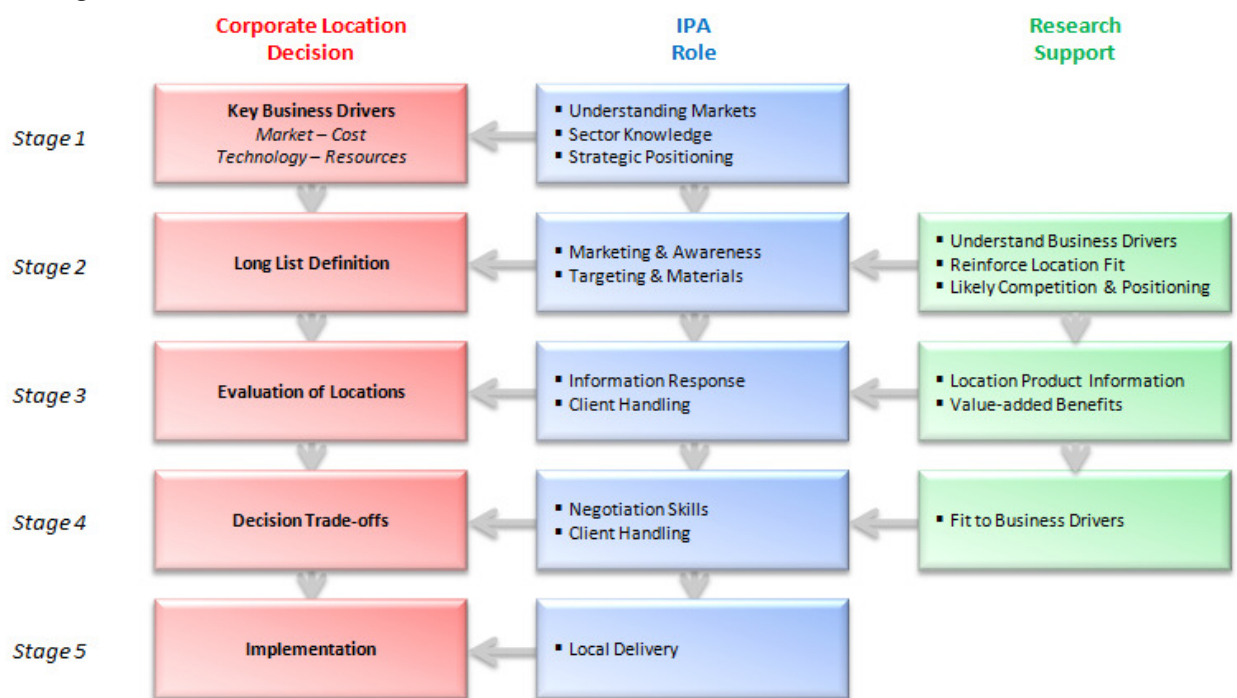
- Market access;
- Cost reduction;
- New technology and processes; and
- Access to specific resources.

The increase of globalisation in corporate activity has led to an increasing number of geographic options for delivering cost reduction and new market opportunities. Specific resources may be physical or human capital. New technology enables process

reengineering, as was the case with development of call centres and shared service centres. Initially both were generally co-located within existing parts of company property portfolios. However, with the evolution of the market for both, companies now tend to establish them as separate entities for a variety of reasons.

At this stage, it is important for an IPA to understand the nature of the potential opportunities in their target sectors and assess whether they are genuinely contestable for their area. If they are not, then there may be a challenge to realign the target sectors. If they are, then IPAs need to understand the markets and develop their sector knowledge. They also need to look at the strategic positioning of their offer, in the context of the location drivers.

**Figure 3.1 – Elements of IPA Good Practice**



Source: DTZ

At **Stage 2** of the decision, an IPA has to ensure that its area will be included in the company's initial long list of location options. If an IPA feels that it is losing out at this stage then marketing efforts need to raise awareness of the location as a potential option. This may involve challenging and mitigating negative perceptions of a location as well as reinforcing the location fit.

The targeting of promotional efforts should also be highly focused on those companies who are most likely to invest, for example, which origin countries will be likely to invest. IPAs need to understand their competitors for projects in their target sectors and position their messages accordingly.

During **Stage 3**, the company will be undertaking a detailed evaluation of locations. IPAs need to provide information in a timely manner that is relevant, up-to-date and highly focused to enable the company to make their decision using the best information available. Client relationship management is important to ensure delivery of this information and to provide anecdotal support. Proof of concept, in the form of testimonials from existing investors and measures of local productivity and value added reassure potential investors that their project will work in a location.

Companies tend to take their decision at **Stage 4**, using information supplied from the previous stage as well as their own independent research. It is important that IPAs understand how the business drivers are transposed to location criteria and what the relative trade-offs between these will be. In a corporate location decision there is rarely a clear winner, and the final decision on which location is generally a trade-off between competing costs and benefits. IPAs need to ensure that they are transparent about any shortcomings and maximise focus on the benefits of their area.

If the IPA is successful then **Stage 5** involves the physical delivery and implementation of the project. The extent to which they should assist varies greatly between companies. Those with little knowledge of the country may require assistance with 'national' issues, such as taxation or business registration. Local factors, such as property and recruitment may also need IPA support. It is also important to show that the relationship between the IPA and investor will be ongoing. Investors are also likely to provide feedback to their own management and other companies about the ease of doing business in a location, so Stage 5 forms the natural link between decision support and aftercare.

**What makes a 'good' IPA?**

There is an extensive and ever-expanding literature covering the setting up and successful running of an IPA. However, there is a risk that adopting a one size fits all approach loses some of the subtleties of the geography of areas and may not fit where the agency has a remit greater than solely promoting inward investment, or where there are multiple overlapping agencies promoting the same area. The UN has developed a summary table showing the type of features that are important to a high performing IPA:

**Table 3.3 - Points for Best Practice: IPAs**

Best Practise Examples
<p><b>Taking account of the unique characteristics of every country-</b> No single best practice can be identified as generally applicable to all countries: what is good practice in one country may be superfluous or unnecessarily costly in another, if it is not based upon the particular strengths and weaknesses of the country concerned</p>
<p><b>The fundamentals of building a positive image-</b> Through the provision to the general public of timely, accurate information in the form of websites, brochures, newspaper articles etc and; focusing activity on the business community in particular and on making contact with private firms for a specific or general purpose. Directories and referrals, as well as investment fairs, trade shows and trade missions, are tools that support the process of initiating and securing contacts with private firms.</p>
<p><b>Being proactive in attracting investment projects-</b> Best practice in investment promotion would seem on the available evidence to require a targeted approach. In the first place, an IPA which is proactive in targeting investment will be better able to attract the kind of investment that is most appropriate to the country's longer-term development objectives than to those IPAs that are reactive.</p>
<p><b>Facilitating the entry of new investment and the operations of established investors-</b> The various agency approvals required can in many cases amount to an investment constraint. Thus, the third and perhaps most important component of an investment promotion programme concerns investment facilitation activities. This is the provision of services to prospective investors in order to facilitate their start-up as well as to established foreign firms in order to keep them in the host country.</p>

Source: UNCTAD, 1997, World Investment Report: FDI and Competition Policy.



In addition to these factors, it is clearly important that IPAs have knowledge on the decision-making processes of investment firms they wish to attract. It is useful therefore to have knowledge of the different academic theories on FDI at the firm level. While this is not directly related to this piece of work, the information is nonetheless of relevance. Hence a summary of the main academic theories of FDI is provided in Appendix A.

## 3.2 Profile of SDI

Scottish Development International (SDI) was formed in 2001, a combination of the former Locate in Scotland and Scottish Trade International. Today SDI's role is to attract direct foreign investment to Scotland. However, as with other IPAs around the world, the organisation also contributes to expanding opportunities for Scottish-based companies to engage in international trade. In essence, SDI is the Scottish government's international economic development arm. The areas of activity that are part of SDI are:

- Trade and Investment offices overseas split into three regions – Americas; Europe, Middle East and Africa; and Asia-Pacific;
- Trade and Investment Scotland covering internationalisation support within Scotland as well as support for inward investing companies already located here;
- Group Services covering Ministerial support, planning, and reporting and;
- Parts of International Marketing covering events and overseas missions, proposition development and investor support.

These activities are also part of Scottish Enterprise's International Operations Directorate. In addition, covering only the Scottish Enterprise International Operations area, there are:

- Scotland Europa covering member representation in Brussels and accessing European monies for Scottish Enterprise and;
- TalentScotland whose remit covers talent attraction, in particular for Scottish Enterprise's Priority Industries<sup>16</sup>.

### 3.2.1 SDI: Type of Intervention

As outlined by Wells and Wints, SDI conforms to the classical functions of an IPA, carrying out investor facilitation, image building and investment generation. In addition, SDI offers a series of incentives:

- **Regional Selective Assistance Schemes (RSA)** - RSA is the main investment grant scheme for businesses within certain areas of Scotland designated for regional aid under European Community law. Dependent on the scale of the project, the majority of RSA grants represent 10–20 per cent of the capital expenditure of a project, and all awards are negotiated individually. Qualifying companies can apply for funding to create or safeguard jobs, whether they are Scottish-owned or are an inward investor. (See Maps 3.1 and 3.2).

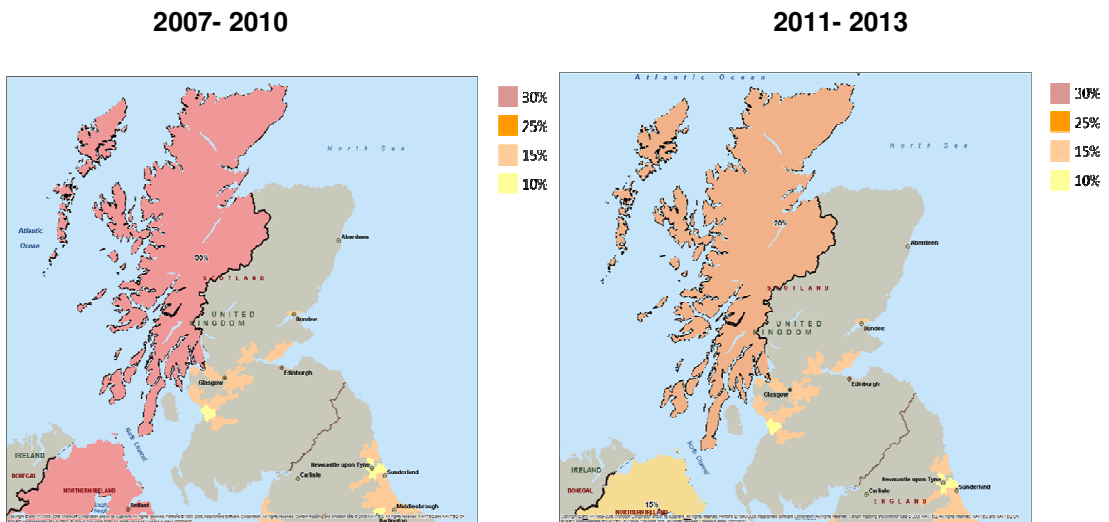
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<sup>16</sup> SDI Business Plan 08/09, May 2008, Group Services SDI.



- **R&D tax and credits** - Substantial tax relief is available for research and development (R&D) companies in Scotland to support SME research. Further tax credits are available for larger companies.

### Maps 3.1 and 3.2 Areas of Scotland Eligible for RSA support



- **R&D Plus** - R&D companies may be eligible to receive Scottish Enterprise's Research and Development Grant. This scheme, the first of its kind in the UK, assists companies which demonstrate potential for global commercial success by helping them develop new products and business practices. Awards are open to firms who meet the specified criteria. Additional support is available for large companies, through the provision of discretionary grants of up to 25 per cent of eligible costs.
- **Training Plus** – Training Plus is available to businesses undertaking a mobile direct investment project anywhere in Scotland. Training Plus is, however, only available towards projects that are considered mobile and contestable, i.e. there must be genuine competition for the project from outwith Scotland. This can include competition within a group or the attractiveness of an alternative non-Scottish location. It can also include projects that support the retention of operations in Scotland that would be lost overseas if the project did not go ahead. Account managed and priority industry companies are given priority.

### 3.2.2 SDI: Inward Investment Process

As part of our research we spoke to a number of officers within the SDI inward investment service to obtain a full understanding of the SDI investment process. This is laid out in Figure 3.2. Although each step in the process is clearly defined in the diagram, it is important to note that each step in the process is, in practice, very fluid and flexible, with officers interacting at every level. Furthermore, each investment is dealt with on an individual basis, with bespoke services offered to each. To summarise:

- **Step 1: Marketing Team** - This is the first stage in the inward investment support process. Officers in the marketing team are responsible for proactively promoting Scotland as a



destination through the production of promotional materials and events. Any enquiries are taken forward and directed to the relevant field office.

- Step 2: Field Offices - Each team specialises in a particular geography. The field office co-operates closely with the sector teams to provide information and guidance to potential investors. It will follow up leads and organise visits to Scotland where investors will be informed about the area.
- Step 3: Sector Team - Sector teams perform a similar role to the field team offices but they will specialise in a key sector, relating to the GES key sectors. Again the sector team will provide information and guidance specific to the investor and will organise a programme of events for the investor.
- Step 4: Investor Support - Ongoing support is provided by SDI who will remain in contact with the investor. This process links in with the SE Account Management system.

Figure 3.2 - Inward Investment Process SDI



## 4. Effectiveness of IPAs

### 4.1 Impact of FDI

This section outlines some of the evidence from the literature on the effectiveness and value for money of inward investment promotional activity. Empirical evidence directly relating to the impact of IPAs is limited - this is true across the UK and indeed globally. As a result data has been augmented with theoretical models relating to the impact of FDI.

As already touched on in Section Two, FDI can bring about many positive benefits to a host country as well as some negative and detrimental effects. The overall impact of FDI on a host country will be dependent on a number of different factors including the type of investment, the state of the local economy and the capabilities of local firms. The impact of one single investment can therefore vary greatly making it difficult to surmise an overall benefit or cost of FDI into a country.

It is apparent from the literature that there is no clear agreement on the overall impacts of FDI. Furthermore, little work has been done into the impact of IPAs. This is a reflection of the difficulties that arise from collecting detailed information on a case by case level. Despite this, there are a number of recognised **potential** benefits arising from FDI and consequently the activities of IPAs.

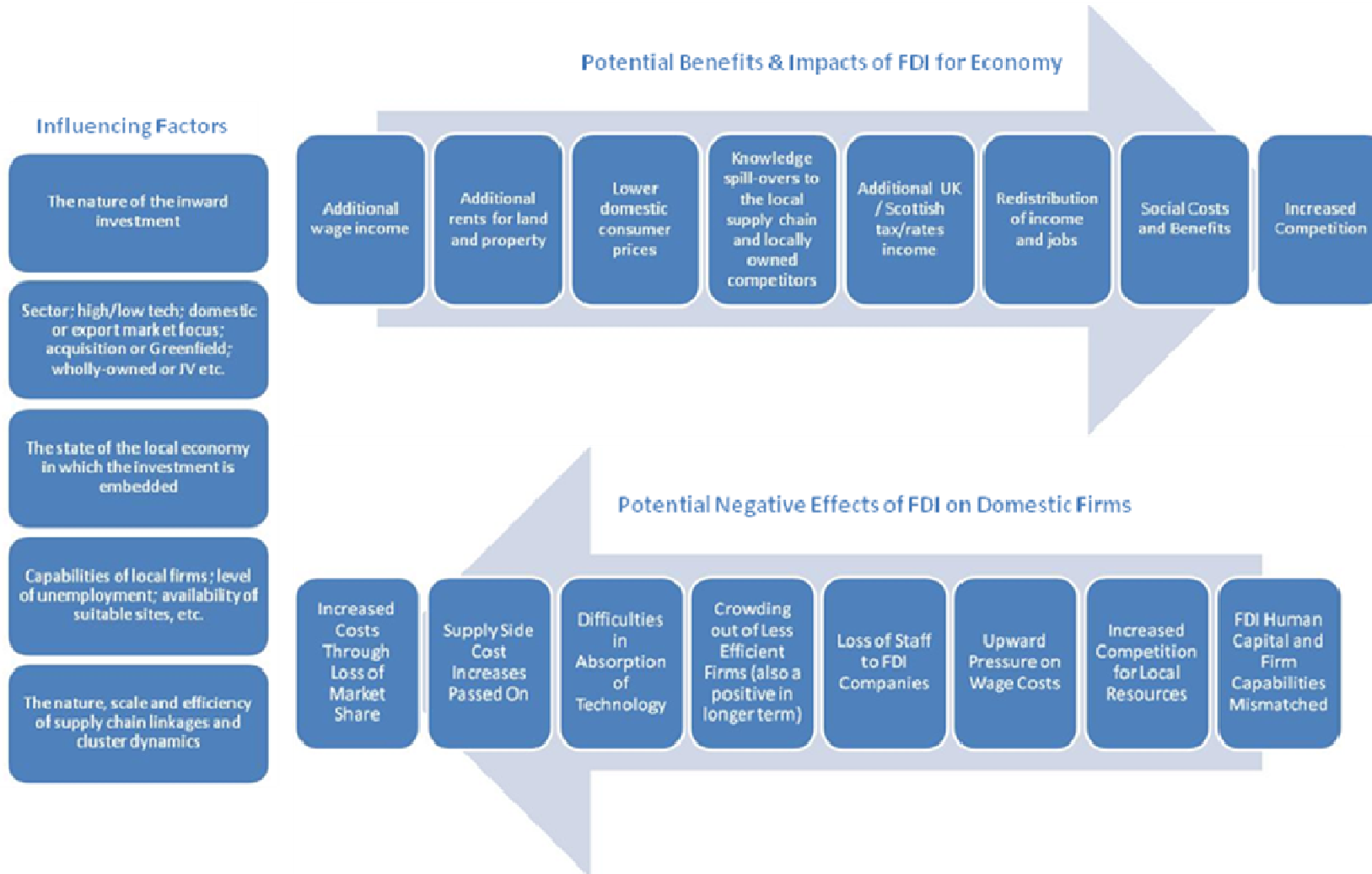
Largely, the literature points to the potential benefits of FDI being related to labour market effects such as better paid jobs and more R&D expenditure. As foreign owned subsidiaries tend to be larger in size and often operate in more R&D intensive sectors, this can lead to higher levels of productivity which in turn can increase productivity levels in the economy through a positive productive churn effect. In addition to the possible direct effects of FDI on the labour market and investment, FDI can also bring positive, and negative 'spillover' effects.<sup>17</sup>

Figure 4.1 highlights the main impacts and influencing factors of FDI and consequently IPA activity. These key impacts are then considered further in this section.

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<sup>17</sup> R Harris, 2008, *Spillover and Backward Linkage Effects of FDI: Empirical Evidence for the UK*, Spatial Economics Research Centre, Glasgow.

**Figure 4.1: The Potential Benefits of FDI**



As outlined Figure 4.1, the main potential benefits of FDI are highlighted as:

### 1. Additional wage income

With any investment into an area, be it FDI or indigenous, employment is created and with new jobs comes additional spend from employees. The Reading Business Group<sup>18</sup> define the potential direct benefits of inward investment by categorising them into:

- **Static Benefits** - These can be both internal or external and include increased profits and wages: and
- **Dynamic Benefits** - Essentially learning benefits whether knowledge or organisational that are passed on through demonstration effects or labour mobility.

An inward investor may pay a wage premium, or additional supplier profit, or property prices/rents in a domestic country as a result of being able to pay more for these inputs than the same resources would have earned in their next best alternative use. These additional wages will result in additional spend in that domestic economy. In addition, by focusing on the attraction of high value added jobs, the impact of additional wages in an economy can be amplified further.

### 2. Additional rents for land and property

Again, linked to any investment activity, additional money is created in an area through rent and property prices. This can lead to both positive and negative implications. For example, investment can make an undesirable area more desirable, but it can also increase the rents and price of land for existing businesses.

### 3. Lower domestic consumer prices

With increased competition comes lower product prices; a positive implication of FDI for consumers.

### 4. Knowledge spillovers: local supply chain and locally owned competitors

There are a number of potential benefits associated with FDI, including competition effects and labour market externalities. However, agreement has not been achieved on the degree of positive spillovers into the local supply chain brought about by FDI.

For example Hart and Driffield argue that:

*'There is a growing literature which suggests that over time, domestic firms are able to appropriate productivity spillovers from foreign [Multinational Enterprises]. This can occur directly, through the licensing of a particular technology, through supplier networks or*

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<sup>18</sup> Reading Business Group and Others for the DTI and UKTI, 2006, *2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report*, DTI Evaluation Report Series No. 9.

subcontracting arrangements, or indirectly as knowledge becomes public, and spillovers are assimilated by the domestic sector.<sup>19</sup>

However Tavares and Young<sup>20</sup> maintain that FDI is not always associated with positive impacts:

*‘Attracting inward investment does not guarantee per se a positive effect on the host country. Spillovers may be technological, on productivity, wages and entrepreneurship however there are important trade-offs and the empirical evidence of FDI impact is mixed.’*

Harris and Robinson<sup>21</sup> have summarised a number of the potential positive as well as negative spillover effects in Table 4.1, It should be noted, that many of the negative impacts highlighted, may only be short term and can in some instances, be mitigated through focused FDI attraction.

**Table 4.1 - Typology of Spillover Effects**

Transmission Mechanisms	Effect	Likely Impact
<b>Intra- industry</b>		
<b>Demonstration effects</b>	• Imitation of FDI products and processes; licensing of new technology	+
	• Difficulties in absorption of new technology due to lack of technological complementaries	-
<b>Competition effects<sup>22</sup></b>	• Reduction in costs/inefficiency in order to respond to entry (threat)	+
	• FDI market share pushes domestic firms up in their average cost curves	-
<b>Labour Market</b>	• Hiring of FDI- trained staff with improved human capital	+
	• Domestic firms mismatch between current capabilities and human capital of FDI- trained staff	-
<b>Inter-industry</b>		
<b>Forward linkages</b>	• Technology transfer and/or new management practices to upgrade quality/ lower cost of products demanded by upstream FDI	+
	• Difficulties in absorption of new technology/ practices; less efficient domestic firms are ‘crowded- out’.	-
<b>Backward linkages</b>	• Purchase of improved intermediate products; technological upgrading of own products	+
	• Difficulties in absorption of new technology/products; rising costs of domestic suppliers (due to FDI)	-

<sup>19</sup> M Hart, N Driffield et Al for the Scottish Executive Social Research, 2008, *Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004*, The Scottish Government (Social Research), Edinburgh.

<sup>20</sup> Tavares, A. and S. Young, 2005, *FDI and Multinationals: Patterns, Impacts and Policies*, International Journal of the Economics of Business, 12 (1), 3 – 16.

<sup>21</sup> Harris, R.I.D. and Robinson, C, 2004, *Industrial Policy and Its Effect on Total Factor Productivity in UK Manufacturing Plants, 1990-1998*, Scottish Journal of Political Economy, 51, 528-543.

<sup>22</sup> The sector approach SDI adopts may mitigate against some of these effects.

	competition) are passed on	
	<b>Agglomeration</b>	
<b>Labour Market</b>	<ul style="list-style-type: none"> <li>Pool of FDI- trained workers available to local labour markets; increase in entrepreneurial activity (new firm formations) +</li> <li>'poaching' of better staff to FDI (higher pay and career development offered); upward pressure on wage costs -</li> </ul>	
<b>Infrastructure</b>	<ul style="list-style-type: none"> <li>Access to greater range of business services (especially R&amp;D which is attracted to service FDI); intra/inter-industry effects stronger in cluster (diminish over space); minimisation of transport costs +</li> <li>Higher costs (e.g. premises); congestion; 'crowding out' due to FDI competition for local resources -</li> </ul>	

Source: Harris, R.I.D. and Robinson, C, 2004, Industrial Policy and Its Effect on Total Factor Productivity in UK Manufacturing Plants, 1990-1998. Scottish Journal of Political Economy, 51, 528-543.

## 5. Additional tax/ rates income

FDI can generate direct benefits such as new jobs, new technologies and, more generally, promote growth and employment. The resulting net increase in domestic income is shared with government through taxation of wages and profits of foreign-owned companies, and possibly other taxes on business such as property tax.

## 6. Redistribution of income and jobs

While it can be argued that FDI can lead to job creation and consequently higher wages and incomes, there is also an argument in the literature that FDI does not necessarily lead to lower unemployment overall. For example, a study by Driffield and Bailey, 2007<sup>23</sup> argues that:

*'Inward investment does act to improve the technological base of the UK economy, but that this is at the expense of unskilled workers who become displaced by the new technology. As a result, attracting inward investment may actually exacerbate structural unemployment by further reducing the demand for unskilled labour. These results are contrasted with the effects on skilled labour, which is boosted by the introduction of new foreign capital.'*

In order to rectify this type of negative effect it may be necessary for further government intervention, for example through bodies such as Skills Development Scotland.

## 7. Social Costs and Benefits

In his 2007 paper<sup>24</sup> Professor Casson of Reading University argues that the principal social benefit conferred by multinational enterprises (MNE) is measured by the profit it generates. He argues that the primary benefits of MNE activity accrue to the owners of the firm who receive the profits. The only other beneficiaries being the customers. The implication of this model is

<sup>23</sup> Bailey, D and Driffield, N., 2007, *Industrial policy, FDI and Employment: Still 'Missing a Strategy'?* Journal of Competition, Industry and Trade, vol 7 (3) pp 189-211.

<sup>24</sup> M Casson, 2007, *Multinational Enterprises: Their Private and Social Benefits and Costs*, The World Economy, Volume 30 Issue 2, Pages 308 – 328.



that, from a national perspective, it is better to act as the headquarters of outward investors than to host inward investors. Casson argues that in many countries, government policies towards MNEs exaggerate the benefits of inward investment and understate the benefits of outward investment:

*'There is a widespread perception that [inward] MNE activity generates production rents that can be appropriated by the local economy, but this typically assumes there is greater competition for local resources than is in fact the case. Governments can strengthen the performance of MNEs headquartered in their countries by offering advice and [offering facilitation services]. However while measures will increase the profitability of the supported firms, the external benefits will mainly accrue to foreign customers rather than domestic interests. Improving firm performance in one area can have knock on effects in other areas because the internal economy of an MNE is an interdependent system. Better understanding of these interdependencies, coupled with greater appreciation of the centrality of profit, would lead to more effective interventions by governments.'*

This is not the case in Scotland, where the dual function of SDI covering both outward and inward investment ensures a balanced approach.

## 8. Increased Competition

Investing in a country increases competition both for the firm entering the country, in order to make its product as efficient and cost-effective as possible, and for existing domestic operators in the same market as the investor. Competition can be healthy in that it can bring domestic consumer prices down and lead to more efficient work practices, but it can also have negative implications on wages and costs.

According to M Hart, N Driffield et al<sup>25</sup>, evidence suggests that:

*'FDI would have the effect of increasing competition in host country markets. The essential rationale for this, following Teece (1986), is that FDI flows are determined by the desire to internalise<sup>26</sup> across national boundaries (vertical FDI), or to exploit assets through foreign production (horizontal FDI). Teece (1986) then makes the point that, as is well known, vertical integration is seen as a response to market failure, and as such therefore, vertical FDI may facilitate foreign entry, and reduce the monopoly problem.'*

## 9. Transfer of Knowledge

Benefits can also occur through the transfer of technology and knowledge from overseas-owned MNEs to newly acquired subsidiaries in foreign countries. In their 2005 study<sup>27</sup>, J Bitzer and M Kereke look at FDI as a potential channel for knowledge diffusion. They examine data for 17 OECD countries and find that FDI-receiving countries benefit strongly from FDI-related knowledge spillovers:

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<sup>25</sup> M Hart, N Driffield et al for the Scottish Executive Social Research, 2008, *Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004*, The Scottish Government (Social Research), Edinburgh.

<sup>26</sup> Internalise: A term associated with vertical FDI where there is a movement towards the whole process of production (internalise) from owning the raw materials right through to the production of the final product.

<sup>27</sup> Bitzer and M Kereke, 2005, *Does Foreign Direct Investment Transfer Technology Across Borders? A Reexamination*, University of Berlin, Berlin.

*'Applying a standard Cobb-Douglas production function approach, we find positive and statistically highly significant knowledge spillovers stemming from inward FDI.'*

Some examples of the impact of FDI are given below.

**Example 4.1: *The Economic Footprint of Caledonian Paper Mill, DTZ Report for UPM, March 2009 – Confidential Report***

An economic impact assessment of one of the largest FDI projects in Scotland – the Caledonian Paper Mill quantifies the economic footprint of the investment in terms of the jobs, income and investment generated and the direct, indirect and induced impact. In addition, the wider footprint and strategic value of the investment is assessed in terms of:

- Supporting fragile rural communities
- Training the local workforce
- Contribution towards Scottish Government targets for sustainable economic development.

The key finding of the paper is that there is evidence of significant spillovers from the firm's existing activity and this is expected to continue in the ongoing investment that has been secured.

**Example 4.2: *Inward Investment, DTZ Paper, August 2008***

A paper by DTZ on the scale of FDI in Scotland finds that FDI is worth around £41 billion to the Scottish economy, accounting for over half of all economic growth in Scotland. Furthermore, it is responsible for around 1 in 7 jobs. Data from the Annual Business Inquiry (ABI) allows an assessment of the location of HQs and shows that Edinburgh, Glasgow & Aberdeen are in the top 10 areas for hosting operations decision-making roles. The role of the International Financial Services District (IFSD) in Glasgow is highlighted as having been key to the rapid expansion of decision making jobs in Glasgow. The key finding of the paper is the recognition that Scotland has been successful in attracting and developing high value projects with productivity more than double that of domestic companies.

**Example 4.3: *Selected Examples of FDI Impact Commissioned by IPAs***

A recent report (July 08 by DTZ) for NWDA showed that the 2000+ foreign owned companies in the NW (less than 1% of the business base in the region) accounts for 17.3% of their regional GVA, 11.6% of all jobs and these companies pay 25% higher salaries than indigenous firms.

Think London commissioned DTZ in October 2006 to inform, analyse and provide insight into the benefits of FDI in London. Examples of the conclusions of the research include: FDI contributes more than £52 billion each year to London's economy – which accounts for 27% of London's economy. Employees of foreign-owned companies are more than twice as productive as other London workers when measured across all sectors.

## 4.2 Impact of IPAs

As already stated, the evidence relating to the impact of IPAs is limited and in general, there is no real consensus to the overall relationship between IPA activity, the attraction of FDI and the overall impact of FDI. To illustrate this, three alternative views from the literature are summarised in Table 4.2. It should be noted that these viewpoints look at FDI policy in isolation rather than inward investment as an integrated approach to economic development, as is the case in Scotland.

**Table 4.2 - Three Viewpoints From the Literature**

*J Morisset, World Bank Policy Research, 2003, Does a country need a promotion agency to attract foreign direct investment? A small analytical model applied to 58 countries, Working Paper 3028.*

The finding that promotion is positively associated with FDI inflows across countries has to be qualified. Any association between the two is closely linked to the environment in which the agency operates. Investment promotion is more effective in a country with a good investment climate and a relative high level of development. The functions carried out by the promotion agency itself can influence its effectiveness. Empirical results reveal that policy advocacy is the most effective function for attracting investment, followed by image-building, and investor servicing. Investment generation appears to be the least efficient and cost effective. While the optimal level of budget that should be allocated to each function depends on the country, the results of this study suggest that most agencies would gain by devoting more attention to policy advocacy.

*L Sung- Hoon, 2008, How investment promotion affects attracting foreign direct investment: Analytical argument and empirical analyses, International Business Review.*

Findings from this study show that establishing and enhancing an IPA's promotion activities can be a FDI policy instrument for improving the FDI attracting environment of the host countries. Furthermore, the investment promotion function is more easily implemented in comparison with changes to the economic factors (e.g. market size or labour cost) that influence the overall attractiveness of a particular FDI destination, which may be difficult and time consuming, or even entirely beyond government control. The point to be understood carefully from the results is that simply increasing the resources of an IPA will not automatically lead to an impact on FDI inflows. Only with efficient IPA coordination function will FDI inflows increase. In other words, enhancing an IPA's promotion activity is not the only road to inducing FDI, but should be undertaken along with measures to develop other determinants of a location's attractiveness. This paper should be viewed as an initial attempt to examine empirically the mediating effectiveness of investment promotion agencies.

*J Morisset and K Andrew- Johnson, 2004, The effectiveness of promotion agencies at attracting foreign investment, World Bank, Washington.*

In the first chapter of their study Morisset and Andrews-Johnson (2004) deal with the question of whether IPAs are effective in attracting FDI. They estimate a regression model that attempts to identify whether a greater effort in investment promotion enhances FDI. In the equation used for the analysis FDI is dependent on external variables and IPA characteristics. With external variables they consider the fact that FDI monetary flows are also influenced by other determinants, such as market size and the quality of the investment climate. The promotional effort of IPAs is measured by the budget of each agency in US\$ and the number of professional staff. For FDI three possible definitions are presented with the aim of finding a variable that best captures the influence of IPAs on FDI. The authors define

total gross FDI inflows, FDI inflows adjusted for M&As and the number of approved projects of which they only use the first two because data for approved projects is not available. For both FDI definitions, the findings differ with the promotional effort variable used. When measured by the budget, results indicate an elasticity of 0.25. It means that for each 10 percent increase in promotion effort, the level of FDI is increased by 2.5 percent. When measured by the number of staff the results are also positive but not statistically significant. At the same time the authors stress the fact that the results have to be interpreted with caution due to the small sample size and the possibility that promotion and FDI respond to a third variable. In addition, Morisset and Andrews-Johnson (2004) point out that promotion also depends on the size of the budget. If the budget is too small numerous important activities cannot be conducted because they are too expensive, such as advertising. However, the level of the minimum budget is not indicated.

To summarise, the literature is not conclusive on the impacts of FDI. While there are positive benefits to countries, there are some commentators who argue that the benefits of inward investment are often overstated. This may be true, but it is also important to recognise that each individual investment will bring with it a series of differing impacts to the local economy it enters. It should also be noted that many of the academic studies are analysing broad theories on the success or failure of FDI rather than relating specifically to individual cases. The lack of consensus in the literature, along with a lack of empirical evidence, suggests that further monitoring and research is required to fully understand the implications of FDI and IPA activity.

Some practical cases studies and examples have been highlighted below:

**Example 4.3: *Tavares, A. and S. Young, 2005, FDI and Multinationals: Patterns, Impacts and Policies, International Journal of the Economics of Business, 12 (1), 3 – 16.***

This Editorial Introduction to a Special Issue on FDI and Multinationals provides a helpful overview of the impact of MNEs in different host economies, the dynamic interaction between inward and outward investment and policy in relation to MNEs. The paper notes the change in policy beyond attraction alone into the promotion of spillovers to domestic firms.

This can be further enhanced by the promotion of clusters to enhance linkages between domestic and foreign owned firms – referred to as the ‘amplifying effect’ of clusters on spillovers. The evidence on the effects of such policy is inconclusive with some evidence of positive and negative spillovers and other studies reaching no firm conclusion.

In the context of recognition of the importance of mergers and acquisitions in global investment flows, the issue of whether it is appropriate for governments to intervene in this area is discussed. It is argued in one of the papers that attraction of this type of investment can reduce the need for linkage policies because the target firms are by definition embedded. Furthermore, there can be a ‘demonstration effect’ whereby domestic firms are exposed to best practices in management etc.

One of the key findings is that initiatives targeted at indigenous firms to enhance the absorptive capacity of the local economy are recommended – FDI attraction in itself does not necessarily = impact on economy. In Scotland, this clearly links to innovation policy and interventions.

**Example 4.4: *R Harris, 2008, Spillover and backward linkage effects of FDI: Empirical evidence for the UK.***

The purpose of this review paper is to report on the empirical evidence for the UK (recent and historical) specifically related to:

- FDI plants – are they ‘better’ (i.e. have higher productivity, or more innovative, etc)?
- Are there spillovers from FDI?
- Are clusters established around FDI plants?
- In Northern Ireland, where there seems to be no real (labour) productivity advantage, foreign-owned firms actually lowered productivity growth between 1998 and 2006
- As to the size of productivity spillovers, many studies find these to be rather small (e.g. a 10% increase in FDI raises total factor productivity in domestic plants by about 0.5%), although some studies find higher spillovers associated with different types of FDI (especially when it is export-orientated).
- On the issue of whether FDI spillovers are more likely in clusters, the evidence suggests that this happens and therefore that the Assisted Areas of the UK (where clusters are less prevalent) tend to experience much lower, or even negative spillover effects. As to whether FDI locates in (pre-existing) clusters, the evidence that is available in the UK would suggest that this occurs (with most clusters being located in London followed by the South East).

The paper recommends that inward FDI should not be limited but rather there should be a targeting of the type of FDI that will receive government assistance.

### 4.3 IPA Effectiveness: Empirical Evidence

Empirical evidence relating to the impact of FDI and consequently the activities of IPAs is scant, as international investment statistics are often difficult to collect. H Gibson<sup>28</sup> points out that there can be no real differentiation between ‘direct’ investment and ‘financial’ investment. To give an example:

*‘The largest inward investment officially recorded ever, anywhere, was a mere paper transaction. When Royal Dutch/Shell switched its legal format from being a 50/50 Dutch UK company to wholly Dutch, this was treated in the Balance of Payments accounts as a massive Dutch investment in British industry’*

Some IPAs such as SDI record the number of new inward investment projects and related jobs, and this can be helpful as it can give a proxy to inward investment performance. However, it is important to recognise that the attraction of inward investment may not be directly related to the IPA. For example, a firm wishing to set up business in Scotland from overseas may have received support from SDI, but they may have invested in the country regardless. Other companies will choose to locate in a particular country or area with minimal or no assistance from an IPA but may be recorded as a project. Indeed it is extremely difficult

<sup>28</sup> H Gibson, 2009, *Trade and Investment Promotion: Final Report on the Scope for Inquiry*, Cogentsi for the Scottish Parliament.

to estimate how many inward investment projects have been attracted to one country as a direct result of relations with the IPA. This information could only be obtained from each individual investor and at present, this information is not available on an aggregate or consistent basis.

In general, information on inward investment projects and activity varies according to the country. There are two main sources on inward investment data in Europe, these are:

- Ernst and Young, European Investment Monitor (EIM)
- IBM, Global Location Trends

In addition to these, other sources of investment information include:

- Site Selection Online 2008 Global Best to Invest
- World Bank mapping of IPAs
- UNCTAD FDI Index

#### 4.3.1 Ernst and Young EIM

The European Investment Monitor is the benchmark for government and private sector organisations and corporations wishing to identify trends, significant movements in jobs and industries, business and investment. The monitor is powered by a team of foreign direct investment research specialists at Oxford Intelligence and the tool provides information on foreign direct investment projects in countries across Europe.

Table 4.3 provides a ranking of the total FDI projects received by country in 2007. As shown, the UK performs well with 713 investment projects received in the year, followed by France and then Germany.

**Table 4.3 - EIM Top 10 locations for FDI in Europe by number of FDI projects in 2007**

Rank	Country	Number of FDI Projects 2007
1	United Kingdom	713
2	France	541
3	Germany	305
4	Spain	256
5	Belgium	175
6	Romania	150
7	Poland	146
8	Russia	139
9	Hungary	135
10	Netherlands	123

Source: E & Y EIM Press Release, June 2008

The EIM also provides a more detailed breakdown of investment activity at the sub-regional UK level (see Table 4.4). This highlights the focus of inward investment activity in the South

East of England where a large proportion of projects are received. Scotland however also performs well, with the second highest number of projects across the UK.

**Table 4.4 - Ernst and Young European Investment Monitor (EIM)- Number of Investment Projects**

Region	03-04	04-05	05-06	06-07	07-08	Total
South East (UK)	156	236	300	381	412	1485
Scotland	29	66	51	65	61	272
West Midlands (UK)	23	47	42	51	51	214
North (UK)	32	50	47	32	46	207
North West (UK)	21	25	30	40	30	146
Wales	33	32	17	17	23	122
East Anglia	7	23	36	23	30	119
South West (UK)	24	21	20	27	6	98
Yorkshire and Humberside	19	27	16	13	22	97
East Midlands (UK)	14	14	24	24	13	89
Northern Ireland	10	15	21	18	22	86
<b>Total</b>	<b>368</b>	<b>556</b>	<b>604</b>	<b>691</b>	<b>716</b>	<b>2935</b>

Source: E & Y EIM 2008

Note: These figures are for financial not calendar years so the total for the UK differs slightly to Tables 4.3 and 4.5

Further information is collected by Regional Development Agency. Again this highlights the significance of London and the South East of England, but again it can be seen that Scotland, as a region is attracting relatively high levels of investment (see Table 4.5).

**Table 4.5 - EIM UK Regional breakdown – number of FDI projects recorded in 2007 by regional development agency (RDA)**

Regional Development Agency	2007
Think London	305
South East England Development Agency	83
Scottish Enterprise	69
West Midlands Development Agency	54
East of England Development Agency	51
One North East	42
Invest Northern Ireland	26
North West Development Agency	26
International Business Wales	22
Yorkshire Forward	16
East Midlands Development Agency	10
South West Development Agency	9
<b>Total</b>	<b>713</b>

Source: E & Y EIM Press Release, June 2008

### 4.3.2 IBM, Global Location Trends

IBM's Global Location Trends reports are based on analysis of data from IBM's proprietary Global Investment Locations Database (GILD). GILD records investment project announcements around the world on an ongoing basis and has information for over 70,000 projects recorded since 2003. Table 4.4 outlines the country rankings from the IBM Global Location Trends report 2008. Again the UK is highlighted as a major investment country.

**Table 4.6 - Top ranking destination countries by estimated jobs – 2007 (06)**

Rank 2007	Rank 2006	Country
1	1	India
2	2	China
3	3	US
4	4	Thailand
5	6	Mexico
6	7	UK
7	8	Malaysia
8	19	Russia
9	18	Hungary
10	12	Philippines
11	9	Poland
12	14	Romania
13	13	Brazil
14	11	France
15	5	Vietnam
16	10	Czech Republic
17	16	Morocco
18	17	Germany
19	20	Canada
20	-	Spain

Source: Global Location Trends IBM 2007

### 4.3.3 Other sources

In addition to the data obtained from the EIM and Global Location Trends, DTZ has sourced European information on inward investment by value and per Capita, summarised in Table 4.7 and Figure 4.2 below:



**Table 4.7 – Foreign Direct Investment in Europe by Value**

Country Name	Total Inward FDI 2007 (US\$ bn)	% EU total FDI
UK	\$224	28%
France	\$158	20%
Netherlands	\$99	12%
Spain	\$53	7%
Germany	\$51	6%
Belgium	\$41	5%
Italy	\$40	5%
Austria	\$31	4%
Ireland	\$31	4%
Sweden	\$21	3%
Poland	\$18	2%

Source: DTZ

Although country FDI totals are indicative of the overall performance of the country, they do not show how they perform relative to their populations – i.e. the ability to actually support further investment. The map in Figure 4.1 shows a high-level analysis of FDI per Capita across Europe in 2007. Of the large countries the UK scores highest, largely due to its position as the most attractive country in Europe for US investors. The Netherlands and Belgium both score well, thanks to their success in attracting European headquarters investment and other projects which require good connectivity and a central position in Europe. Ireland's position is helped to a large extent by the low corporate tax rate of 12.5%. Germany's performance is good overall however, it appears to underperform on a per capita basis. Italy also lags behind the other western European countries.

In Eastern Europe there is, in the long term, potential capacity for further investment (beyond the current global economic downturn). The Czech Republic has been the most successful country on a per capita basis, followed by Bulgaria. However the populations of these two countries are significantly lower than both Poland and Romania, both of whom received higher amounts of FDI but where there is potentially greater capacity for further investment. It is important to note that this country level analysis does not reflect the large differences within these countries. Certain cities perform well above the national average, but opportunities for wage cost arbitrage still exist in the less popular city destinations for FDI.



Further key sources of information are outlined below:

**Table 4.9 - Impact of FDI in the UK: Key, Historical Publications**

Issue/ Outcome?	UK
<b>New jobs, industrial diversification</b>	Yes – e.g. 1984-1991, 200,000 new jobs identified by IBB, around £25bn of investment.
<b>Overall competition effects, resource allocation</b>	Yes - Driffield (2001a) Geroski (1995).
<b>Overall productivity spillovers</b>	Yes - Barrell and Pain, 1997; 1999; Hubert and Pain, 1999 S Girma et Al, 2005 and R Harris 2008. Cumulative effects of foreign manufacturing investment in terms of UK location competitiveness.
<b>Specific value chain effects</b>	Yes - Dunning, 1993, Munday, 1995, Driffield et al. 2002. Externalities in domestic firms that purchase from the foreign sector.
<b>Profits and performance</b>	Superior performance of the foreign manufacturing sector (Davies and Lyons, 1992). Superior productivity not always reflected in profit performance (Munday and Peel, 1997).
<b>Earnings and labour markets</b>	Higher earnings, also pay spillovers identified
<b>Trade unions and industrial relations</b>	Varies, but Japanese investors connected to wider development of single union deals, and moves towards strike-free arrangements in Enterprises.
<b>HRM and Operational Techniques</b>	Japanisation of British Industry but evidence of take-up of novel personnel and operational methods by competitors (Oliver and Wilkinson, 1992)

Source: Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004, 2008, M Hart, N Driffield et Al for the Scottish Executive Social Research.

Overall, the empirical evidence relating to FDI suggests that Scotland is performing well, with relatively high numbers of projects being attracted to the country. Furthermore, comparative country information suggests that Scotland is 'punching above its weight' in terms of attracting investment. This is explored further in Section Six.

Demonstrating the relationship between IPA activity and FDI attraction through empirical evidence is even more challenging. However there are a number of sources directly relating to IPA activity and its impact in relation to attracting investment. Despite the lack of available data relating to the effectiveness of IPAs internationally, some empirical evidence is available for the UK.

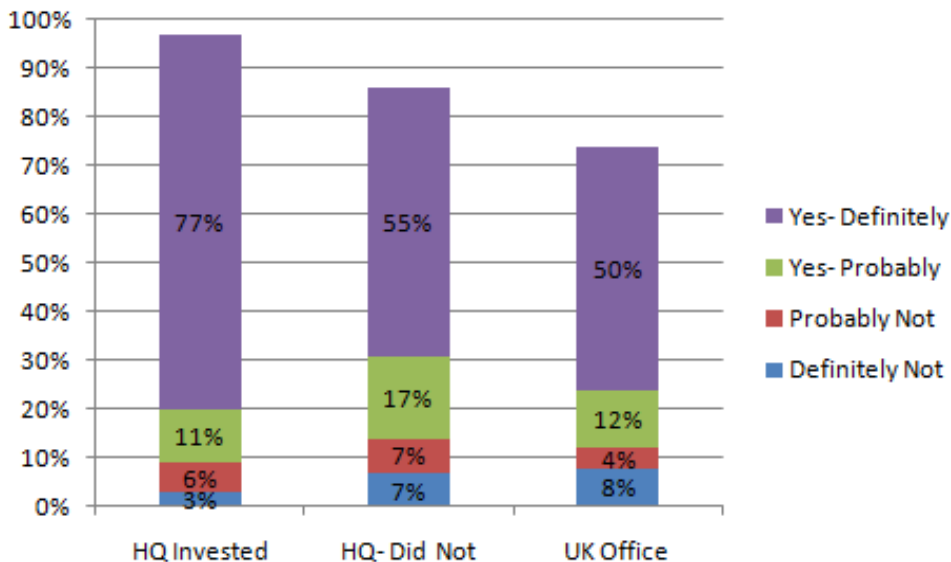
#### 4.3.4 UK Trade and Investment: OMB Research Survey 2008

UK Trade & Investment (UKTI) has recently commissioned the market research firm OMB Research to gather evidence about trends in UK businesses' international business strategies; barriers hindering such business, and associated needs for external help as well as awareness of UKTI services. Research is carried out via Performance and Impact Monitoring Surveys (PIMS - see section 4.5.2) undertaken on a quarterly basis, as well as other in-depth

studies specially commissioned by UKTI including most recently, the OMB 2008 report on 'International Business Strategies, Barriers & Awareness Monitoring'. Typically the OMB surveys target both inward and outward investors, and often the focus of analysis is on outward investment. However, in their review of the relative benefits of Inward Investment Attraction, the Reading Business Group, along with OMB Research carried out a survey specifically focussed on establishing the impact of UKTI support on users.<sup>30</sup> 90 telephone surveys were carried out with inward investment support users and 313 trade development support users (outward investment) in addition to 20 in depth case studies of both user groups. In both exercises, respondents were asked a series of questions to help ascertain, among other things, the impact of UKTI activities.

Figure 4.3 gives a summary of findings from one of the questions posed by OMB Research. Here UKTI users were asked whether they would have invested in the UK regardless of support received from UKTI. The results show that head offices that went on to invest in the UK were consistently positive about the UKTI support and typically recorded the highest levels of additionality across other measures in the survey. However it appears that in most cases (88%) UKTI support had no impact on the actual decision to locate in the UK. This suggests that for investors, the UKTI support is welcomed more as a facilitator of locating in the UK rather than a critical factor in the decision.<sup>31</sup> The survey does not ask specifically about the influence of UKTI in the decision to locate in a specific region of the UK over another region.

**Figure 4.3 - Would Still have Invested in the UK? UKTI Users**



Source: Summary extracted from 2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report, Reading Business Group and Others for the UKTI, 2006

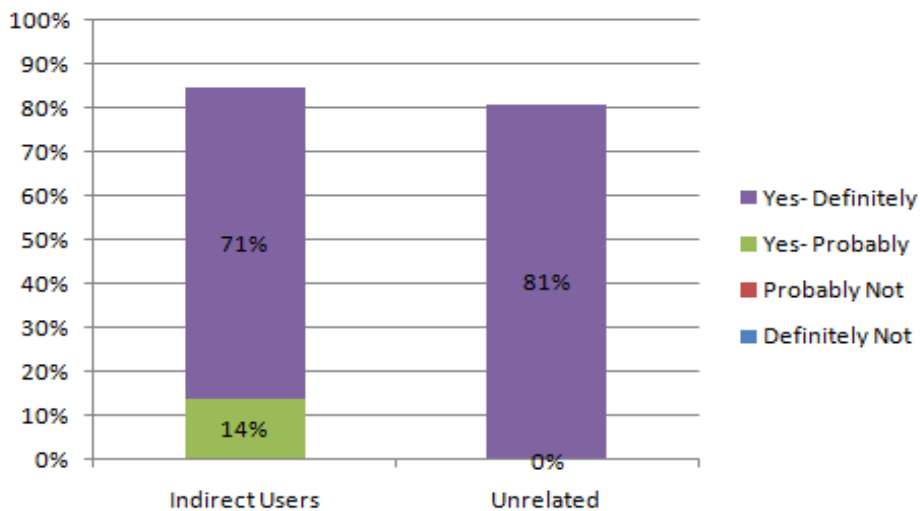
**Notes:** HQ Invested: respondents in overseas head offices which have received assistance from UKTI who then invested. HQ- Did Not: respondents in overseas head offices which have received assistance from UKTI who did not go on to invest. UK Office: UK subsidiary firms who have received aftercare support from UKTI.

<sup>30</sup> Reading Business Group and Others for the DTI and UKTI, 2006, *2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report*, DTI Evaluation Report Series No. 9.

<sup>31</sup> *ibid.*

In order to compare UKTI support with similar services offered by other organisations, supported non users were asked the same question. The results are shown in Figure 4.4. Here 80% of supported non UKTI users indicated that they would have gone ahead and invested in the UK regardless of support, a slightly higher figure than that reported by UKTI users.

**Figure 4.4 - Would Still have Invested in the UK? Supported Non- Users**



Source: Summary extracted from 2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report, Reading Business Group and Others for the UKTI, 2006

**Notes:** Indirect users are those receiving indirect support such as from friends or relatives. Unrelated support is from other sources such as banks or independent consultants.

Table 4.10 provides a summary of a range of indicators of non-additionality (and so, by inference, additionality) for inward investors (and potential investors) and firms receiving support from either UKTI or alternative sources. Around a fifth of supported UK subsidiaries and Head Offices that have invested in the UK indicate non-additionality, primarily by claiming that they could have obtained similar support to that provided by UKTI elsewhere. Amongst Head Offices that have not (as yet) located in the UK, the proportion indicating non-additionality by either of these measures falls to 1 in 10.

Table 4.11 provides a summary of the extent to which inward investors (and potential inward investors) have benefited from the support received across a range of measures of impacts and outcomes (including spillovers). Please note that in all cases figures are quoted net of non-additionality. Just over two-fifths of Head Offices receiving support from UKTI feel that it has enabled them to overcome at least one barrier to market access and a similar proportion are judged to have exhibited at least one change in behaviour as a result of the support they received. Whilst UK subsidiaries are similarly likely to have benefited in terms of barriers to market access overcome, they are far less likely to have actually changed their behaviour. However, it is this group that appear to be the most likely to provide dynamic external spillovers.

**Table 4.10 - Indicators of Additionality- Inward Investment**

	Users			Supported Non- Users	
	HQ- located	HQ- did not	UK Office	Indirect Users	Unrelated
<b>Base</b>	35	29	26	7	5
<b>Measure that suggest non- additionality</b>					
<b>Could have got similar support elsewhere</b>	17%	10%	23%	2/7	0/5
<b>Has definitely <u>not</u> been worthwhile obtaining the support</b>	3%	3%	4%	0/7	0/5
<b>Firms indicating non- additionality via either of these two measures</b>	20%	10%	23%	2/7	0/5

Source: Summary extracted from 2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report, Reading Business Group and Others for the UKTI, 2006

**Table 4.11 - Impacts, Outcomes & Spillovers – Inward Investment**

Proportion of firms experiencing...	Users			Supported Non- Users	
	HQ- located	HQ- did not	UK Office	Indirect Users	Unrelated
<b>Base</b>	35	27	26	7	5
<b>Barriers to market access overcome</b>	43%	48%	35%	3/7	4/5
<b>Changed behaviour</b>	43%	52%	8%	2/7	1/5
<b>Dynamic external spillovers</b>	34%	-	54%	-	-

Source: Summary extracted from 2004- 2005 Relative Benefits of Inward Investment Attraction and Trade Development. Final Synthesis Report, Reading Business Group and Others for the UKTI, 2006

Overall the results of the study indicate that the impact of UKTI services was greater for trade development activities compared with inward investment activities, with only a minority of users reporting an influence on either their decision to locate in the UK, or on other aspects of their project, as a result of UKTI support. However, where there has been an influence the resulting impacts and outcomes are very positive with clear evidence of behavioural changes and spillover effects.

### 4.3.5 UKTI Performance and Impact Monitoring Survey

The Performance and Impact Monitoring Survey (PIMS) is a client interview based survey carried out for UKTI that provides evidence about the quality of service and about the difference that UKTI makes to users. PIMS is carried out by OMB Research, an independent market research company specialising in business surveys on an annual and quarterly basis. The survey is based on independent telephone interviews with a sample of users of UKTI's principal services.

In the most recent survey carried out in 2008, UKTI users (both inward and outward) were asked if they would have received similar results without the help of UKTI. The results are captured in Table 4.12:

**Table 4.12 - Additionality of UK Trade & Investment offering by business size (employees)**

Question posed by survey: "Do you think you would probably or definitely achieve similar results without UK Trade and Investment support?"

Number of employees	Yes	Yes but not as quickly	Some but not all	Probably not	Definitely not
<b>0-9</b>	17	24	24	17	12
<b>10 - 99</b>	20	28	26	15	8
<b>100-249</b>	20	30	26	16	5
<b>250+</b>	19	34	22	13	7
<b>Total (%)</b>	<b>19</b>	<b>27</b>	<b>25</b>	<b>15</b>	<b>9</b>

Source: UKTI Performance and Impact Monitoring Survey (performance reported December 2008 covering, approximately, the 12 months to June 2008)

Note: 5% of respondents replied 'none of these'

Again the results suggest that without the help and assistance of UKTI, 19% of businesses would have achieved similar results with their business. Around 24% of respondents answered that they would not have seen similar results without the help of UKTI, and a further 27% on average responded that results would have been similar but not as quick. Support seems to have been most beneficial to the very small companies who responded.

### 4.3.6 Evidence from the Regional Selective Assistance Programme

RSA support is eligible to all investors into certain areas of Scotland. Investment can be from both Scottish firms already located in Scotland, or from overseas. While data on RSA impact must be heavily qualified in that it does not relate solely to FDI, it can be used as indication of the impact of investment incentives in Scotland.

Table 4.13 sets out the findings from a 2005 review of the RSA programme.<sup>32</sup> The review looked at all aspects of the RSA scheme including the impact on supported businesses. A

<sup>32</sup> M Hart, N Driffield et al for the Scottish Executive Social Research, 2008, Evaluation of Regional Selective Assistance (RSA) in Scotland 2000- 2004.

telephone survey was carried out with 157 RSA assisted firms and compared with a non assisted control group of 157 firms. This was drawn from a commercial database to reflect the size, sector and ownership distribution of the RSA assisted group. The results give a comparison of employment and turnover growth between beneficiaries and non- beneficiaries of RSA. The results are positive, particularly for employment growth. Between 2004 and 2006 for example, employment growth for RSA beneficiaries was on average 17.98% per annum, this compared to 2.47% for non beneficiaries. Similarly, over the same time period, turnover growth for RSA beneficiaries was 18.05% per annum compared to 8.05% for non beneficiaries.

**Table 4.13 - Growth comparisons for RSA scheme beneficiaries and non- beneficiaries**

	RSA Beneficiary		Non-Beneficiary	
	Mean % pa (n=122)	Median % pa (n=122)	Mean % pa (n=119)	Median % pa (n=119)
<b>Employment Growth</b>				
<b>2000 to 2002</b>	16.74	5.00	3.73	0.00
<b>2002 to 2004</b>	16.18	7.60	3.86	0.00
<b>2004 to 2006</b>	17.98	10.00	2.47	0.00
<b>Turnover Growth</b>				
<b>2000 to 2002</b>	17.01	8.33	11.68	1.67
<b>2002 to 2004</b>	24.80	12.50	10.40	5.26
<b>2004 to 2006</b>	18.05	14.29	8.05	4.17

Source: M Hart, N Driffield et al, 2008

Impacts on GVA growth are not, however, so significant (see Table 4.14). Between 2004 and 2006 the overall average GVA growth levels were higher for RSA beneficiaries; 33.95% per annum compared with 13.37% per annum. Figures for GVA per employee are actually lower for RSA beneficiaries compared with non beneficiaries and GVA per employee is only slightly higher.

**Table 4.14 - Growth comparisons for RSA scheme beneficiaries and non- beneficiaries**

	RSA Beneficiary		Non-Beneficiary	
	Mean % pa	Median % pa	Mean % pa	Median % pa
<b>GVA Growth</b>				
<b>2004 to 2006</b>	33.96	25.00	13.37	7.14
	(n=95)		(n=51)	
<b>GVA per Employee Growth</b>				
<b>2004 to 2006</b>	9.59	6.28	18.36	8.33
	(n=94)		(n=51)	
<b>GVA per Employee</b>				
<b>2004</b>	£50,920	£41,223	£47,384	£36,000
	(n=98)		(n=53)	
<b>2006</b>	£51,659	£40,540	£49,340	£40,909
	(n=105)		(n=61)	

Source: M Hart, N Driffield et al, 2008



These results may be linked to Professor Casson's<sup>33</sup> idea that the benefits of investment are largely associated with profits of the firm investing and do not necessarily contribute to overall GDP or GVA.

Another study that leads to a similar conclusion, is that carried out in 2005 by C Wren<sup>34</sup>. Wren looks at the evidence on the effectiveness of RSA schemes across the UK including the ability of these schemes to attract FDI. The effect of the grants on productivity is questioned. The paper has several interesting conclusions and finds that differences over the employment effect of the grants result from possible biases induced by the evaluation methodology and from differences in the job measure used. Overall, the paper argues that regional grants are cost-effective in employment terms, but that expenditure is small relative to the scale of the problem, so that an expansion of the grants may be desirable.

In addition, a study<sup>35</sup> matching over twenty years of data on RSA in order to investigate the impact of the policy on employment, investment and productivity has found evidence of a positive effect on both employment and investment, but found no statistically significant effect on total factor productivity.

#### 4.3.7 Evaluation of SEEDA Business Investments in the South East

An evaluation<sup>36</sup> undertaken for the South East of England Development Agency (SEEDA) in 2008 of the impact of their Business Competitiveness interventions during the period 2002/03 to 2006/07 considers the impact of inward investment intervention.

In terms of inward investment support, SEEDA uses a range of mechanisms to attract new inward investment from both foreign sources (and domestic sources via funding of Locate in Kent). The Agency has a number of Investor Development Managers working across the region, who seek to identify and support the needs of recent investors and those major companies looking to reinvest. In addition, a number of SEEDA representatives posted overseas in key market locations are tasked with identifying leads and encouraging trade and exploratory missions from these locations to the South East of England region. The Agency also invests in specific investment vehicles tasked with supporting inward investment in key locations across the South East (e.g. SEEDA's funding of Locate in Kent).

Over the period 2002/03 to 2006/07, SEEDA has invested around £4.7m on inward investment support. The cumulative impact, i.e. additional impacts that have accrued over the years between initially receiving the support and the current year, added to current year impacts, is shown in Table 4.15.

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<sup>33</sup> M Casson, 2007, *Multinational Enterprises: Their Private and Social Benefits and Costs*, The World Economy, Volume 30 Issue 2, Pages 308 – 328.

<sup>34</sup> Colin Wren, 2005. "[Regional grants: are they worth it?](#)," *Fiscal Studies*, Institute for Fiscal Studies, vol. 26(2), pages 245-275, June.

<sup>35</sup> Criscuolo, C., Martin, R., Overman, H. And Van Reenen J., 2007, *The effect of industrial policy on corporate performance: Evidence from panel data*, Conference Paper, 16 July 2007

<sup>36</sup> Regeneris Consulting, 2008, *Evaluation of SEEDA Business Investments in the South East: Business Competitiveness*, Report for SEEDA, September 2008

**Table 4.15 – Inward Investment Cumulative Impacts (Funding 2002/03 to 2006/07)**

	Jobs	GVA (£m)
<b>Gross Impacts</b>	1,662 – 2,018	£87 - 106
<b>Overall Additionality Ratio</b>	38%	43%
<b>Net Impacts</b>	632 - 767	£37 – £45
<b>Return on Investment</b>	£6,800 per additional job	£9 per £1 invested

Source: Regeneris 2008

The evaluation notes that there may well be additional impacts that might be realised over a longer period. Furthermore, it should be borne in mind that the projects covered by the evaluation represented a limited volume of the activity that SEEDA undertakes with regard to international trade and inward investment.

#### **4.4 SDI Effectiveness: Empirical Evidence**

Data relating to the effectiveness and impact of SDI investment activity on both assisted businesses and the general economy are insufficient to make any real judgment on performance. Evidence that is available is illustrated in Figure 4.4.

To summarise, evidence on inward investment activity is collected by SDI at two different levels:

- **Data collected as part of EIM monitoring**- the number of projects and jobs broken down by high value, new jobs and industry type.
- **Data collected as part of the SDI tracking system**- information obtained on enquiry to leads conversion rates and other information gathered from clients via the ongoing care service offered by SDI.

Figure 4.4 - SDI Summary of Evidence

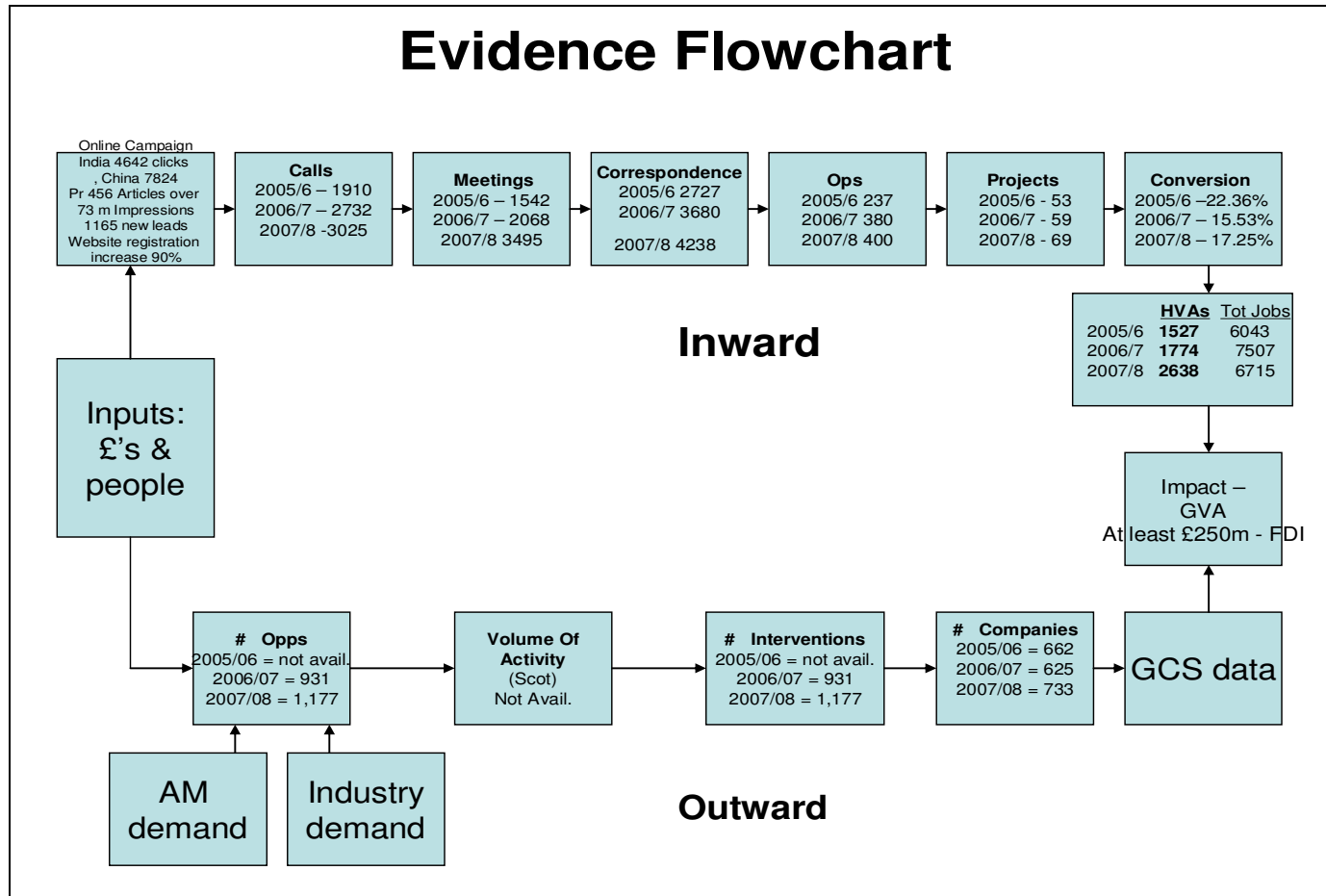


Table 4.16 provides evidence on the number of projects and jobs that SDI has supported between 2003 and 2008, this is routinely collected and is submitted to the E&Y EIM. The results indicate that SDI is performing well, the number of projects has increased since 2004 and on average 3,566 new jobs have been created every year since 2003. Furthermore, in 2007/08 SDI has attracted proportionately more high value added jobs (HVA), in line with targets set by the organisation. High value jobs are those jobs that are involved in Research & Development and Design and/or where employees earn a salary that is 20% higher than the average for Scotland. Evidence from the literature suggests that HVA jobs can be associated with higher positive externalities.

**Table 4.16 - SDI performance 2003- 2008**

TOTALS	2007-08	2006-07	2005-06	2004-05	2003-04	Annual Average 2003-08
<b>Total Projects</b>	67	59	53	46	65	58
<b>Total Investment ( £m )</b>	£263.846	£313.598	£245.566	£140.797	£231.499	£239.061
<b>Total New Jobs</b>	4470	3912	4472	3312	1665	3566
<b>Total Safeguarded Jobs</b>	1866	3595	1571	1756	3810	2520
<b>Total Jobs</b>	6336	7507	6043	5068	5475	6086
<b>Total HVA jobs<sup>37</sup></b>	2578 (40% of total)	1774 (23% of total)	1527 (25% of total)	1821 (35% of total)	1261 (23% of total)	1792

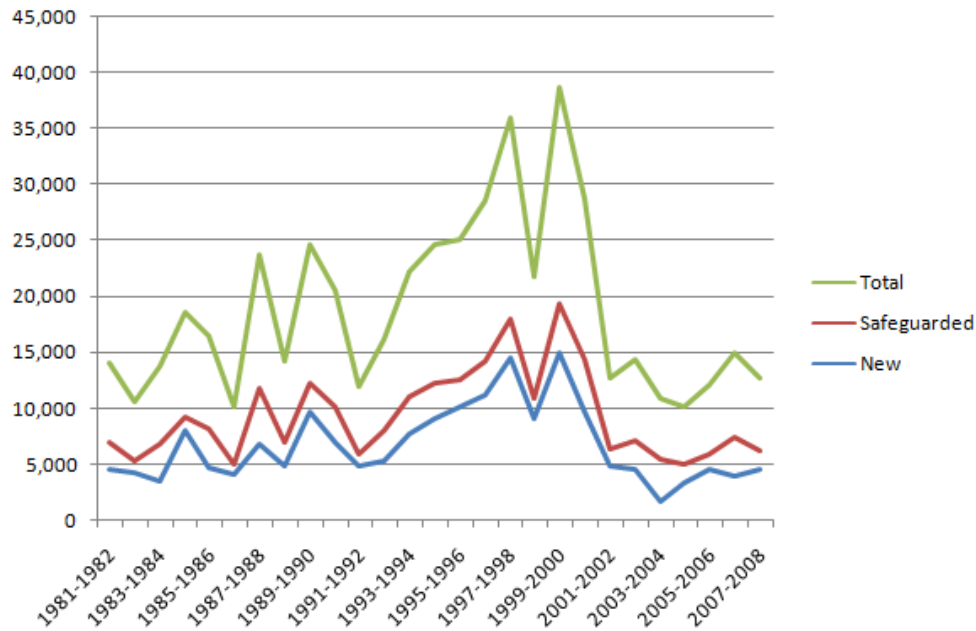
When analysing the performance of SDI over a wider time period, we can see from Figure 4.5 that investment is closely related to market conditions. For example, the increase in job numbers during the 1990s was mainly attributable to the electronics sector. The sharp fall seen in year 2001-02 highlights the migration of these same jobs to lower cost manufacturing countries.

Table 4.17, gives a breakdown of turnover, labour costs and gross value added for a cohort of 2000/01 SDI assisted companies. The figures track the growth of these companies from then until 2004 to give a measure of performance<sup>38</sup>. It shows a steady level in the number of companies supported while the turnover has gradually increased. Gross Value added per Employee has also risen steadily.

<sup>37</sup> HVA jobs are jobs with salaries 20% higher than the average for Scotland.

<sup>38</sup> This exercise is currently being repeated with other cohorts.

**Figure 4.5 - SDI Assisted Projects 1981- 2008**



**Table 4.17 - SDI Companies 2000- 2004**

	2000	2001	2002	2003	2004
<b>Number of companies</b>	29	33	34	34	34
<b>Number of Units</b>	256	282	264	271	256
<b>Total Employees (Th's)</b>	20.6	19.6	19.2	20.3	18.9
<b>Total Turnover (£m)</b>	3,549.6	4,327.9	4,355.7	5,241.0	5,500.7
<b>Purchases of goods &amp; services (£m)</b>	1,979.3	2,074.8	2,193.9	2,267.6	2,050.6
<b>Gross Value Added at Basic Prices (£m)</b>	1,598.3	2,285.8	2,219.1	2,995.6	3,468.1
<b>Net Capital Expenditure (£m)</b>	110.9	151.7	146.0	165.8	128.8
<b>Gross Wages &amp; Salaries (£m)</b>	354.1	416.6	409.6	374.3	469.6
<b>Total Labour Costs (£m)</b>	397.0	467.2	463.8	419.7	525.3
<b>Gross value Added per Employee (£)</b>	77,725	116,704	115,676	147,858	183,457
<b>Labour per Employee (£)</b>	19,307	23,853	24,176	20,715	27,788

Source: ONS, Annual Business Inquiry (Compiled by Scottish Executive)

Notes: 1. Company list supplied by SDI

2. ABI coverage excludes certain areas such as the financial sector and some of the public sector

In addition to the monitoring information provided by SDI, two evaluations are of particular relevance:

#### 4.4.1 TalentScotland Evaluation

TalentScotland is a Scottish Enterprise initiative managed by SDI. The project was launched in 2001 and is supported by a number of industry partners. The aim of TalentScotland is to attract highly skilled professionals to choose Scotland as a location to live and work. Though not directly part of the inward investment arm of SDI, TalentScotland relates closely to SDI and its objective to attract FDI into Scotland.

An evaluation was carried out over 2007 and 2008 into the activities of TalentScotland, as part of this an impact assessment was carried out.

##### Impacts

The table below indicates the directly attributable net GVA impact delivered by TalentScotland is likely to lie between £1,273,665 and £2,547,330.

	Net impact (jobs)	Net GVA (£)
Displacement assumed to be 75%	61	£1,273,665
Displacement assumed to be 50%	30	£2,547,330

##### Findings

- Progress against objectives - The evaluation found that TalentScotland has performed extremely well, exceeding many of their targets.
- Companies - Questionnaire respondents were able to point to a wider range of direct benefits to their organisations. The most frequently cited included:
  - increased productivity 72%
  - new skills/areas of expertise 68%
  - ability to meet milestones 67%
  - generation of new ideas 56%
  - ability to increase commercialisation potential 53%
  - wider background experience/knowledge base 49%
  - increased profitability 48%
- User feedback - 83% of users were actively considering Scotland as a career destination. Scotland was rated 1<sup>st</sup> choice by less than half respondents. 82% stated that TalentScotland has helped improve their understanding of Scotland as a place to live and work 74% report their perception changing since registering with TalentScotland.
- Non-user Feedback ( Counter factual group) - For non-users, Scotland was ranked as first or second choice by only 40.5%: less than half of respondents. Scotland ranked in third place alongside the USA but behind Canada and UK-England which scored 44.6% and 60.8% preference respectively as 1<sup>st</sup> or 2<sup>nd</sup> choice career destination.

Based on the overall evaluation findings the following recommendations were made:

- TalentScotland should continue –Scotland continues to under-perform in terms of attracting and retaining internationally mobile talent with the appropriate skills and experience required by businesses in the key sectors covered by the TalentScotland initiative.
- Greater visibility is required.
- Clear working relationships. What TalentScotland will do and should not do must be clear at outset.
- Recognise capacity of TalentScotland – if further resources are available then TalentScotland could consider supporting another key sector. If no additional resources are available then TalentScotland should consider whether they are able to support the sectors with which they are currently working.
- Scottish Government – there are strong strategic links and some operational links between TalentScotland and Fresh Talent. Consideration should be given to the options for exploiting these linkages.
- It will be important in the future to review and update the evaluation and monitoring framework to reflect the achievement to date as well as to assign new indicators to align with the outputs from the user and company surveys.

TalentScotland does not perform the same function as the inward investment attraction branch of SDI. However there are many similarities in the tasks set out for both organisations, whose role is essentially to make Scotland an attractive destination to locate, be it as an individual or a business. This evaluation should not therefore be used as evidence for inward investment attraction but rather the findings of the evaluation point towards the significance of Scotland as a career destination, an important consideration for any business looking to relocate. Furthermore, the evaluation gives an insight into the type of evaluation that SDI may want to undertake in future.

#### **4.4.2 Inward Investment Benefits for the Scottish Economy: An Evaluation for Locate in Scotland<sup>39</sup>**

Locate in Scotland along with Scottish Enterprise and the Scottish Executive commissioned a study into the inward investment benefits for the Scottish Economy in 2000. The study was carried out by Firth Crichton Roberts, the University of Strathclyde and the Fraser of Allander Institute. The study looked at both macro and micro quantitative evidence using the econometric modelling and this was supported by qualitative information:

- A top-down econometric modelling of FDI impacts on the Scottish economy
- Bottom-up case studies of 28 representative FDI plants operating in Scotland.

Some of the key findings from the evaluation are set out in the box below.

The findings of this study provide some evidence on the type of impacts that can occur with FDI. However this paper also highlights the need to look at a range of inward investment projects, as each individual project can bring about different impacts to the domestic economy. Furthermore, it is worth noting that the study was carried out in 2000 using data from the late 1990s, since then the Scottish economy has changed dramatically.

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<sup>39</sup> Firth Crichton Roberts Ltd, the University of Strathclyde and the Fraser of Allander Institute, *Inward Investment Benefits for the Scottish Economy*, for Locate in Scotland et Al, 2000.

### **Employment & Job Creation**

- Nearly 92,000 jobs created through manufacturing subsidiaries since start up.
- The 10 developmental subsidiaries in the study which were generally larger and longer-established in Scotland, have generated nearly 314,000 job since they arrived in Scotland, with slightly higher wage payments per employee and also with generally secure and skilled employment structures.

### **Purchasing Patterns of Scottish FDIs**

- The case study research indicates that the 22 FDIs for which data has been obtained purchase just over £3 billion of goods and services each year. However one individual firm's operation accounts for *two-thirds* of these purchases; none of the other case study FDIs makes more than £100 million of purchases each year.
- The proportion of these purchases sourced from Scottish based suppliers is relatively small.

### **Purchasing, Procurement and Local Suppliers**

- For both speciality and commodity products, low cost nations are emerging as very tough competitors to Scottish supplier companies, and there is continuing pressure from multinational customers for year-on-year cost reductions (5-10%).
- The principal positive impacts were due to employment and wage injections into the economy. While the firms have a significant impact in the generation of local (Scottish) employment and output, the results revealed considerable diversity within the group studied

### **Technology, R&D & Design**

- One of the sharpest distinctions between manufacturing and developmental subsidiaries is in the area of RD&D: Only 3 out of 12 manufacturing subsidiaries, compared to 9 out of 10 developmental affiliates, had some local RD&D activity
- Few if any spin-outs or spin-ins had taken place; and links with universities were generally small scale, if they existed at all.

### **Training, Skill Development & Social Inclusion**

- Training of the workforce has been a major positive contribution made by FDIs to Scotland

### **Scottish Managers & FDI Development**

- With the exception of the Japanese-owned companies, the numbers of expatriate managers from abroad were quite limited. The foreign-owned (especially US-owned) sector in Scotland has provided significant opportunities for the career development of Scottish managers through training, knowledge transfers and promotion opportunities

### **Corporate Venturing and Community Involvement**

- Community involvement, mainly in the form of donations to charities, community groups, and sports teams and events was fairly common. Expenditure ranged from £10K to £120K per annum.
- Both the attitudes towards, and involvement with, business groups and associations in Scotland varied substantially.

### **Involvement in Sectoral Clusters**

- Thirteen of the sample believed there was no identifiable logical Scottish cluster in their industry; few really understood this emerging concept; and most didn't see any immediate potential in pursuing the concept.
- The larger companies all saw that increasing globalisation of customers, production and technologies were making them part of global clusters where the Scottish dimension was operationally and strategically irrelevant.



### 4.4.3 Cogent Strategies Review of Trade and Investment

A further review of trade and investment promotion was produced by Cogent Strategies International in 2009 for the Scottish Parliament<sup>40</sup>. This reviewed the current qualitative evidence on Scottish trade and investment and included a series of 70 company interviews carried out with companies, organisations based in Scotland and representing Scottish interests, and other overseas organisations.

Evidence from the company consultations showed:

- Positive responses from all users on the nature of the services the consultee had requested, had been offered, and had used. Even quite large companies found this helpful, however, of all companies asked, most said they 'grew out of it' relatively quickly.
- Trade mission, exhibition and marketing assistance were common specific forms of aid sought.
- Companies and organisations were normally in contact with SDI and other international trade advisers for several months to a year or more thereafter.
- Very few respondents were willing to specify direct benefits brought to the business through the use of SDI support. Indeed very few IPAs use objective measures such as value added.
- None of the respondents could comment on comparisons with support offered in other countries from direct experience, apart from better tax conditions (Ireland), none commented negatively from their understanding of their company's position. One investor client commented positively on SDI's willingness to involve an English RDA where that was considered possibly helpful to the client.

Evidence from the non- company consultations showed:

- Observers and commentators, including membership bodies, as being more critical of SDI than individual companies. There were no firm criticisms from companies that had been assisted by SDI, whereas there were comments that could be considered critical in some of the comments from other organisations.

Overall, feedback on the services provided by SDI was positive in this piece of research, however little information was gathered on the impact of SDI services to either inward investors or exporters.

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<sup>40</sup> H Gibson, 2009, *Trade and Investment Promotion: Final Report on the Scope for Inquiry*, Cogentsi for the Scottish Parliament.

## 5. Best Practice Case Studies and Comparative Organisations

As part of the evidence review, a number of comparator organisations were selected based on their recognition as good practice agencies and/or their comparability with SDI. The comparator organisations were selected in consultation with Scottish Development International, Scottish Enterprise and the Scottish Government. **A series of case studies are presented in a separate Comparator IPA Annex Report.**

The table below provides a statistical summary of some of the characteristics of the IPAs and calculates the number of projects attracted per capita. This shows that SDI is among the top performers relative to its size, alongside the IDA, UKTI and Invest in Denmark.

**Table 5.1 – Summary of Comparator Statistics**

Country	Agency Name	Total Population (m)	# Target Sectors	# IPA Employees	# Overseas Offices	Total Projects 2007-2008	Projects per Capita 2007-2008 (millions)
Ireland	IDA	6	9	275	16	80	13
UK	SDI	5.1	12	180	20	61	12
UK	UKTI	61.6	9	2,500	150	717	12
Denmark	Invest in Denmark	5.5	4	-	13	61	11
Sweden	Invest in Sweden	9.3	10	70	4	83	9
Czech Republic	CzechInvest	10.5	9	168	8	88	8
France	Invest in France	65.1	10	154	21	533	8
UK	IBW (Wales)	3	10	-	16	23	8
Austria	ABA	8.3	12	30	2	60	7
Germany	Invest in Bavaria	12.5	5	-	20	68	5
UK	NWDA	6.9	6	431	6	30	4
UK	EMDA	4.2	4	242	6	14	3
New Zealand	Investment New Zealand	4.3	6	-	9	-	NA

\* It should be noted that the number of employees is a total rather than the number related to FDI activity only.

Whilst a more detailed study into best practise IPAs is necessarily to better understand the common characteristics of an effective IPA, this initial study has highlighted some common themes among those comparator organisations selected. These include:

- **Sector Targeting**

These ranged from just 4 priority sectors in Denmark to 12 in Scotland and Austria

- **Sectors Linked to Established Industries**  
Many IPAs chose to target those sectors that already performed well in their country, for example automotives in the Czech Republic, ITC and software in Denmark and electronics in Scotland.
- **High Value Sectors**  
Some high value industries were common to many IPAs in the selection, these included life sciences, renewables and financial services.
- **A Variety of Incentives**  
Most IPAs in the sample offered some kind of incentive programme including grants and other funding support packages usually provided through the central government.
- **Government Support for IPA activities**  
The IPAs selected were all of a high calibre, giving high quality support to users, a range of different incentives and sophisticated websites, this is indicative of official and government support for the role of IPAs in each country.
- **Aftercare Service**  
Typically an aftercare service is offered with the IPAs sampled.

The case study IPAs each offer different strengths and advantages. Some of these are outlined in table 5.2, however not all IPAs operate in the same way, there are large variations in the size of IPAs and the number of staff involved, some IPAs operate on a regional basis while others operate nationally. However, as each of these organisations is recognised as good practice agencies, they have each demonstrated the ability to recognise and successfully promote their own brand.

**Table 5.2- Summary of Comparator Strengths**

Country	Strengths of IPA
Ireland	Very professional at handling enquiries and successful at attracting projects
UK	Strong brand and enthusiastic staff who maintain close contact with investors
UK	A large, global presence and good model of co-location
Denmark	Good level of information provision
Sweden	High quality information provided to users
Czech Republic	Organised centrally and focused
France	Professional organisation with a strong regional network
UK	Good inquiry handling
Austria	Good organisation of regional offices
Germany	Good website and professional staff
UK	Good inquiry handling and clear website
UK	Professional service offered
New Zealand	Good use of case studies and promotion

## 6. Summary and Recommendations

### 6.1 Summary of Key Findings

#### 6.1.1 Strategic Rationale and Market Failure

Section Two considered the strategic rationale behind inward investment, and explored the benefits of FDI and the market failures associated with FDI.

**Key findings:**

- It is generally accepted that the attraction of FDI can bring benefits to the host economy. FDI can bring additional jobs and profits as well as a series of positive externalities and spillover effects that would not result had the investment not been made.
- However, in order to establish the strategic rationale for public investment in this area it is important to consider market failure. Market failure in the case of inward investment is evident, predominantly in the form of imperfect information. Issues of equity can potentially, also be addressed through inward investment.
- SDI has set out a clear rationale for intervention based around the objectives of the Scottish Government's GES and the targets and goals set out by Scottish Enterprise

#### 6.1.2 Interventions

Section Three looked at the typical roles of an IPA, along with the specific roles of SDI.

**Key findings:**

- IPAs have several core roles and activities which include investor facilitation, image building, investment generation and policy advocacy. In addition some IPAs offer incentives in the form of financial and fiscal incentives.
- SDI adheres to the common goals of an IPA and also provides a strong aftercare service.
- Evidence from the literature argues that successful IPAs are those that take account of the characteristics of a country, build a positive image through pro-active means and provide facilitation support to investors.

#### 6.1.3 Effectiveness and Impact

Section Four documented the evidence from the literature on the effectiveness of IPAs.

**Key findings:**

- There is no consensus in the literature on the benefits brought to a country through FDI. Typically FDI is thought to bring about a series of benefits including higher wages,

knowledge spillovers and increased competition. However there is a significant body of academic work that suggests the overall positive impact of FDI may be overstated.

- Both empirical and academic evidence relating to the overall impact of IPAs is limited, with very few studies carried out into the effectiveness of IPAs.
- Some studies have been carried out in the UK on the effectiveness of UKTI, and while some of the findings from these suggest that the impact of UKTI services were often limited in terms of influencing the destination country, but very helpful in facilitating the investment process. Furthermore, in the cases where they have influenced the investment decision there is evidence of a significant impact in terms of spillovers and behavioural changes.
- Other studies carried out in Scotland, such as the evaluation of TalentScotland and the recent research into SDI activities, provide some interesting findings however, impact information relating to the effectiveness of SDI cannot be obtained from either.
- Additional research is needed in this area. Evidence on the impact of IPA activity is severely lacking. In order to assess whether the activities of SDI or any IPA is cost effective, it is important to monitor and evaluate the services provided both at a service level and in a holistic sense for the overall organisation.

#### **6.1.4 Comparator IPAs**




Section Five and the Comparator Annex Report provide a number of best practice case studies. These have been carefully selected on the basis that each IPA profiled is performing well.

##### **Key Findings:**

- SDI performs well in terms of the number of investment projects that are attracted to the country and against comparator areas and regions. It is one of Europe's top IPAs as measured by projects per capita.
- In Europe, the UK scores consistently highly in terms of projects attracted
- IPAs conform to a similar role and function throughout Europe, with teams operating at regional and sub-regional levels, by sector and by geography.

Table 6.1 considers the research questions posed in the Introduction and reviews the extent to which the evidence available enables the question to be answered. The main gaps in the evidence base are noted.

**Table 6.1- Summary of Evidence against Research Questions**

Research Questions	Evidence	Gaps	Result
<p><b>The extent to which SDI is intervening in areas that can be justified in rationale and market failure terms. Is there the evidence and is it supportive of such interventions?</b></p>	<p>There is a strong bank of academic evidence attesting to the benefits of attracting inward investment and the market failures that underpin government intervention in this area. Furthermore, the rationale for SDI's activity is clearly articulated through links to the GES and SE's strategic goals. The market failures are linked to the key issues that the GES is trying to address.</p>	<p>There are no particular gaps in the evidence in the area of strategic rationale or market failure. <b>Assessment - No action required.</b></p>	
<p><b>The extent to which there is robust evidence which can determine the organisation's impact in terms of effectiveness and value-for-money, and the conclusions we can reach on impact.</b></p>	<p>Empirical evidence directly relating to the impact of IPAs is limited. There is a wealth of evidence on the potential impacts and benefits of attracting FDI. However, it is apparent from the literature that there is no clear agreement on the overall impacts of FDI. Critically, however, little work has been done on the impact of IPAs in the FDI process. There is evidence of the number of projects and jobs attracted by IPAs, but this is gross and there is little evidence on the net impact of IPA activity.</p>	<p>The review of evidence found that no IPA had looked at its overall performance including SDI and therefore additional research and activity is required in order to fill this gap. This will have to take account of the additionality of the support provided. SDI has started this process through the PEF. <b>Assessment – Significant action required.</b></p>	
<p><b>The identification of innovative approaches and 'lessons learned' from the analysis of comparators</b></p>	<p>Much of the information relating to the performance of IPAs is restricted to general approaches to inward investment with no corresponding assessment of the actual impact of the IPA i.e. is an identified innovative approach actually changing the overall level of investment attracted in net economic impact terms.</p>	<p>The issue of the impact of IPAs should be investigated further, potentially in a more extensive case study exercise than was possible within the scope of this evidence review. <b>Assessment – Some action required.</b></p>	

## 6.2 Recommendations

### 6.2.1 Implications for SDI

There are a number of actions that SDI can take forward to improve its evidence base relating to the impact of its intervention. These should be incorporated into the developing PEF wherever possible.

- **Overarching evaluation** – There is a need for an overarching evaluation to determine the net economic impact of SDI's activity. This could cover its inward and outward functions.

**Key Areas of Research for Overarching Evaluation:**

- Establishment of gross impact of SDI supported investment projects
- Further investigation of link to productivity improvements (direct and indirect)
- Conversion of gross to net impacts taking account of scale of additionality (full, partial or deadweight)
- Particular emphasis on capturing wider benefits and impacts, such as spillovers and both positive and negative effects
- Investigation of Strategic Added Value of SDI and inward/outward dynamic

- **Monitoring data** – There is scope to further develop monitoring data to more accurately track the outcomes of SDI's activity from the generation of leads through to the conversion to projects and then onto the net impact generated. The existing monitoring systems should be reviewed to ensure that the correct data are collected to evidence each stage of the investment process.

**Key Areas of Development for Monitoring Data:**

- Further development of CRM system to allow tracking of lead generation to project conversion
- Consideration of formal mechanism to capture outcomes and impacts beyond job creation to capture wider benefits and impacts
- Development of clear evaluation plan to ensure link to planned activity and that right data are collected to input into future work

- **Top-down impact data** – The total value of FDI to the Scottish economy can be estimated using existing national datasets. The DTZ impact paper reference in Section Four shows how this can be done and this should be given further thought in order to construct a framework for capturing the total value of all FDI on an ongoing basis. This will then enable SDI to establish the proportion of the total investment it has had a role in attracting in net economic impact terms.

**Key Areas for Development of Top-Down Impact Data:**

- Review of existing official data sources including ABI and IDBR to establish robust method for calculation total FDI impact
- Explore methods of linking/identifying SDI supported companies
- Link into other work to allow assumptions to be developed on attribution and additionality to allow ongoing monitoring of high-level data to be translated into SDI impact data

- **Bottom-up impact data** – Because of the nature of inward investment support and the fact that the support comprises a bespoke package of intervention for each investor, the only way to gather accurate impact data is from the investing companies. The framework of potential impacts used in this evidence review can be used to guide ongoing monitoring through the Investor Support process. There is also a case for company-level evaluation of impact, such as the work done by DTZ for UPM. This would be used selectively to understand the nature and scale of impacts for key inward investors. This would be at a level of detail beyond what would normally be captured in an overarching evaluation.

**Key Areas for Development of Bottom-up Impact Data:**

- Consideration of fit of this level of research with other planned work, particularly linking into planned evaluation work to ensure efficient use of resources
- Focus on enriching available evidence base through more targeted research with key investors to explore ‘true’ impact on Scottish economy through mapping of knock-on effects, spillovers etc

- **Comparator IPA Case Studies** – Table 6.1 notes that much of the information relating to the performance of IPAs is restricted to general approaches to inward investment with no corresponding assessment of the actual impact of the IPA – that is, does an identified innovative approach actually change the overall level of investment attracted in net economic impact terms. There is scope to further investigate this issue by undertaking further research into the impact of comparator IPAs.

**Key Areas for Comparator Case Studies to Explore:**

- Investigation of effectiveness of IPAs through detailed analysis of budget vs outputs and impacts if available
- Analysis of evidence relating to attribution and additionality
- Review of structure of organisations and particular interventions that have resulted in strong performance
- Consultation with policy level staff (potentially within sponsoring government departments) to explore role of IPA in supporting regional/national policy drives

## 6.2.2 Concluding Remarks - Impact of the Global Recession

The World Association of Investment Promotion Agencies (WAIPA) is predicting a global fall in FDI of between 12-15% in 2009.<sup>41</sup> The tightening of credit conditions and investors’ aversion to risk mean that the effects of the international financial crisis will hit FDI this year after a time lag that saw a 30% increase in cross-border investment in 2008.

It is DTZ’s view that WAIPA’s predicted downturn is overly optimistic in a UK context. The majority of FDI inflows to the UK are from the US. Given the economic challenges facing the US domestic economy it is likely that the level of outbound FDI will fall. The FDI effects on the UK during the previous two recessions were as follows (see Figure 6.1):

<sup>41</sup> FDI Magazine, 17 December 2008

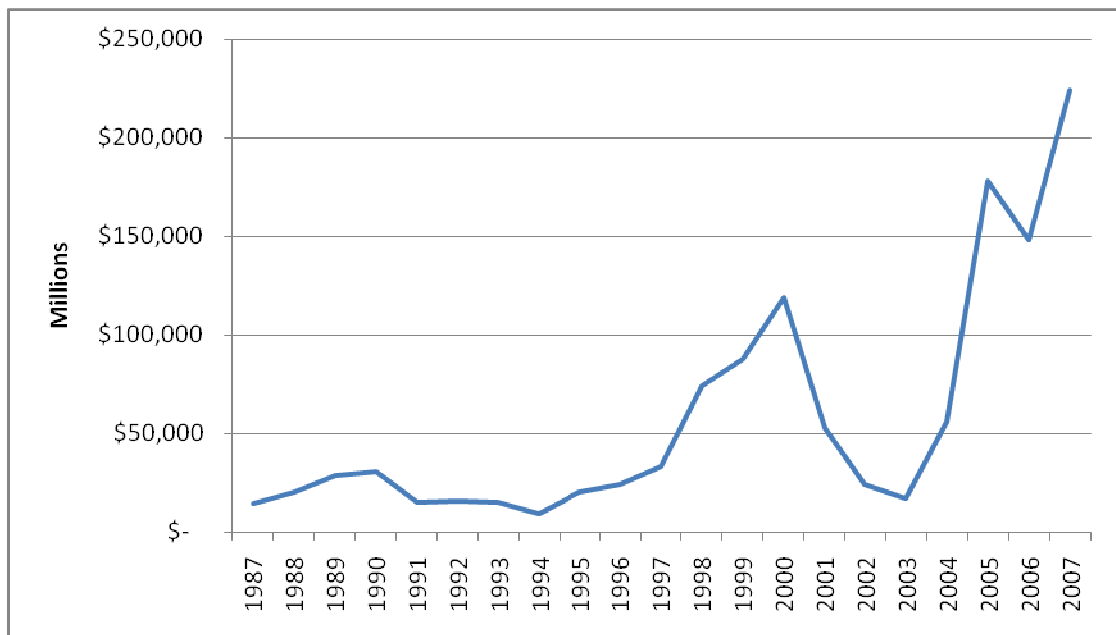
[http://www.fdimagazine.com/news/fullstory.php/aid/2595/WAIPA\\_predicts\\_drop\\_in\\_FDI\\_after\\_record\\_2008.html](http://www.fdimagazine.com/news/fullstory.php/aid/2595/WAIPA_predicts_drop_in_FDI_after_record_2008.html)



- **1990** - The percentage change in FDI into the UK 1990-1991 was -51%, from \$30 bn to \$14 bn. While the level remained nearly static for the following two years, there was a further fall in 1994 (-38%) before it recovered strongly in 1995 (+116%).
- **2000** - The percentage change of inward FDI fell in 2001 by 56%, down from \$119bn in 2000 to \$53bn in 2001. It declined further in 2002 (-54%) and 2003 (-30%) before again recovering strongly with a 234% increase in 2004 and 218% increase in 2005.

So during the previous two recessions, although the falls in inward FDI levels have been severe, the recovery has been equally spectacular. UK Inward FDI in 2007 was around \$224bn up 51% on the previous year. Given the noticeable drop in activity levels – both in terms of new projects and overseas companies with UK plant closing/downscaling activities, **DTZ predicts a fall in UK Inward FDI of at least 50% in 2008. There may well be a similar or greater fall in 2009, given the news so far this year.**

**Figure 6.1 – UK FDI Inflows (\$m)**



Source: UNCTAD

Clearly, this will constrain SDI's ability to attract FDI in the short to medium term, so it is critical that the organisation is clear on which activities are capable of delivering the best chance of economic growth. Competition for any FDI projects during 2009/10 will be fierce. In the short-term therefore, the focus is likely to move towards the support of foreign owned companies already located in Scotland to improve their chances of survival and retention of employment. This is likely to mean the aftercare process becomes even more important and SDI is in a strong position to respond to this through the processes already in place in terms of the Account Teams.

However, this projected decline does not detract from the long-term importance of FDI to Scotland and its focus on high value-added activities that are tightly embedded in the priority sectors. We know that when FDI recovers, it does so strongly and quickly often to levels higher than the previous maximum in a relatively short period of time. While there is no reason for SDI to change the overall goal of higher value-added it will be interesting to see how other IPAs respond to political and economic pressures as unemployment rises.

The economic situation raises a number of questions that SDI may wish to consider:

- *Do the criteria by which potential projects are selected or targeted have to change in light of the economic downturn?*
- *Are there particular sectors that were previously not a priority that are more attractive now due to their potential to generate a greater number of jobs?*
- *Are there new players on the investment map that have resources to invest in Scotland due to currency movements?*
- *What are the implications of this for the way in which SDI currently operates?*

In considering these questions, SDI has an opportunity to work with the Scottish Government to reorient inward investment policy ahead of competing IPAs regionally and nationally to ensure that Scotland is in a competitive position in terms of attracting investment.

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## Appendix A: Theories on FDI

While quantitative studies relating to the impact of IPA activity are relatively scarce, the academic literature on the impact of FDI is abundant. A number of key theories have evolved from academic studies since the 1960s and these are outlined below:

**Table X: Summary of Academic Theory on FDI**

Theory	Summary of theory
<b>Hymer's Contribution</b>	<p>First introduced by S Hymer in 1960, Hymer's Contribution theory is based on the idea that FDI should be differentiated between portfolio investment. Hymer notes that there are barriers to entry for a firm wanting to set up investment abroad but that despite these barriers, firms still want to engage in FDI for 2 reasons:</p> <ul style="list-style-type: none"> <li>- The firm removes competition from within the industry, by taking over or by merging with firms in other countries.</li> <li>- The firm has advantages over other firms operating in a foreign country.</li> </ul>
<b>Product Life-Cycle Theory</b>	<p>Dunning, 1981 and Vernon, 1966 look at when and where the specific advantages of multinational enterprises would be exploited. Vernon argued that the decision to locate production is not made by standard factor cost or labour cost analysis but by a more complicated process. The theory looks at the US experience and has 3 main stages:</p> <ul style="list-style-type: none"> <li>- <b>Stage 1: Product development process</b> A product becomes standardised (inputs used in the production process can be exactly calculated) through communication between the producers, the suppliers and the consumers. This communication between parties can then lead to a location decision that results in the product being situated near to its markets.</li> <li>- <b>Stage 2: Maturing product</b> As demand for the product increases, it moves through the product cycle to a greater degree of standardisation. This means that the need for the product to be situated near to its markets declines, which allows for economics of scale. These impact on the locational decision of the firm, especially as the demand for the product is likely to grow in other countries, and the firm will have to decide whether it is worth setting up production abroad.</li> <li>- <b>Stage 3: Standardised product</b> This is an extension to the manufacturing product stage, when the standardisation of the product has reached its 'zenith' and a final framework of the product has been found. The international market will now be well established and sales will be determined by price competition. The low cost of labour in less-developed countries may provide an incentive for firms to reduce costs further and set up in these areas. As less developed countries do not possess a large industrial environment, the product should be of a highly standardised nature so that inputs can be ordered with comparative ease. This argument may in turn apply to underdeveloped regions of developed countries.</li> </ul>

<b>Caves Theory</b>	Caves (1971) expanded on Hymer's theory of direct investment, and placed it firmly in the context of industrial organisation theory. Caves distinguished between firms that engage in horizontal FDI (when a firm enters into its own product market within a foreign country) and those that undertake vertical FDI (when a firm enters into the product market at a different stage of production).
<b>Internationalisation Theory</b>	This strand of FDI literature began to emerge in the 1970s based on earlier work by Coase (1937). The theory examines the role that transaction costs play in the formation of organisations. The process of internationalisation is developed to explain international production and FDI, leading proponents being Buckley and Casson (1976). They present the MNE as an extension of a multi-plant firm whereby knowledge is a key intermediate product.
<b>Locational Determinants</b>	<p>Horst (1972) examines US investment in Canada. He found that one of the most important reasons for firms investing in Canada was the prevalence of natural resources. These resources gave the firm an advantage over those firms that remained in the US. Wheeler and Mody (1992) place the main factors that determine the location of FDI into 2 categories:</p> <ul style="list-style-type: none"> <li>- <b>Ergodic Systems</b></li> </ul> <p>A system that will always return to its initial state when the exact conditions that led to the initial state are reproduced</p> <ul style="list-style-type: none"> <li>- <b>Non- Ergodic Systems</b></li> </ul> <p>Here the system will not return to its initial state even if the initial conditions are reproduced.</p> <p>Both systems can lead to the clustering of firms. However only with non-ergodic systems will agglomeration economies arise, as the presence of other firms contributes to the attractiveness of an area. According to this approach, agglomeration effects become more important over time in attracting FDI compared to the classical variables such as labour availability and geographical endowments.</p>
<b>The Eclectic Paradigm</b>	<p>Developed by Dunning (1977), the Eclectic Paradigm Approach has 3 conditions:</p> <ul style="list-style-type: none"> <li>- <b>Ownership-specific advantages</b> (internal to enterprises of one nationality)</li> <li>- <b>Location specific advantages</b> (determining the location of production)</li> <li>- <b>Internationalisation-specific advantages</b> (overcoming market imperfections)</li> </ul>
<b>Strategic Motivations of FDI</b>	The notable feature of the strategic approach to FDI is that it believes that an initial inflow of FDI into a country will produce a reaction from the local producers in that country, so that FDI is a dynamic process. Firms engaged in foreign production have certain features that 'strengthen' their ability to undertake strategic actions, such as better information from a larger array of markets, greater capacity and a large initial size, which gives them a larger market share and greater market power in their domestic country.

Source: J Jones and C Wren, Foreign Direct Investment and the Regional Economy, University of Newcastle, Ashgate Publishing Ltd, Aldershot, 2006