

**Corporate Headquarters in Scotland: Their Nature and Contribution to  
Scotland's Economic Development**

**A Report for Scottish Enterprise**

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# Executive Summary

## ***Aims and Objectives***

The purpose of this study is to describe and, as far as possible, quantify the direct and indirect contribution of corporate headquarters (HQs) to Scotland's economic development. The brief stipulates that the analysis should incorporate indigenous HQs and mobile HQs and other 'high value' functions.

The study brief also sets out more specific objectives as follows:

- To describe the nature of corporate HQs and the factors driving change in the nature and size of HQs.
- To identify the locational requirements of corporate HQs and locational trends.
- To assess the relative contribution of indigenous and non-indigenous HQs to Scotland's economic development, and
- To draw out the operational and policy implications for Scottish Enterprise and, in particular, to suggest possible HQ market segmentations.

Finally, the brief requests guidance on what might constitute 'high value' inward investment.

The study is exploratory. It is based on a literature review, analysis of available data including the Ernst & Young Investment Monitor (for mobile HQs) and the Business Insider List of Scotland's Top 500 companies, a limited number of interviews with senior corporate executives in Scotland and telephone interviews with 20 recent 'high value' inward investors in South East England. As a starting point, 'high value' has been taken to mean HQ, R&D and Sales/Marketing (S&M) projects.

## ***The Changing Nature and Location of HQs***

All businesses, even the smallest, have HQ functions. As the business grows, HQ functions become increasingly differentiated from day to day operations with the emergence of an identifiable, perhaps 'stand alone', HQ. However, there is no self-evident or correct size at which companies can be said to have a HQ. Consequently, defining the concept of corporate HQs is problematic.

Research on corporate HQs generally relates to large companies (with, say, over 2,500 employees). Over the past 30 years, the dominant trend for such businesses has been the downsizing of their corporate HQ. Employment in most corporate HQs is now relatively small. This reflects three factors. First, decentralisation to subsidiary HQs to create flatter, more flexible structure. Second, the application of IT to improve productivity and third, increased outsourcing.

Decentralisation itself has created problems (e.g. loss of economies of scale, duplication of services) which set in motion yet further change. For example, having been decentralised to subsidiaries, many services have been recentralised into shared service centres in low cost locations away from the corporate HQ. An under-explored question is whether these are the 21<sup>st</sup> century white collar equivalent of the 20<sup>th</sup> century branch plant?

To augment their competitive advantage many multinationals (MNCs) have decentralised more R&D and HQ functions overseas. This is to 'tap into' overseas sources of innovation (e.g. R&D) and to enhance their responsiveness to local market conditions. This is reflected in, for example, the growing number of European HQs and the increased number of Centres of Excellence.

However, employment in European HQs is small and the extent to which management functions and autonomy is being decentralised is limited and should be kept in perspective. Furthermore, overseas HQs (or from a Scottish perspective, inward investment HQs) remain subsidiaries reporting to their parent company HQ.

For most areas outwith London, the main determinant of the number of HQs is the birth, growth and decline of indigenous businesses. New HQs are created at the company's place of birth. Consequently, any strategy to increase the number of corporate HQs must incorporate policies to increase the business birth rate and growth of indigenous business.

Corporate HQs generally remain at the company's place of birth for many years. However, with growth, the HQ often becomes a stand alone function located away from day-to-day operations. This is most likely to occur in companies which expand via product diversification (with the creation of subsidiaries) and/or via acquisitions.

In the UK, this generally means a drift of HQ functions to London and the South East. The majority of large UK companies have their HQ in these regions. They also attract the majority of internationally mobile HQs and S&M projects locating in the UK. The strength of these regions reflects the key locational requirements of corporate HQs. These are:

- Access to customers which often means other corporate HQs.
- Access to a wide range of specialist financial and business services.
- A wide range of frequent national, European and inter-continental air services.
- An extensive and deep managerial and professional labour market and specialist skills (e.g. software, languages).
- An ability to attract in talent from around the world (which is largely determined by the depth of the managerial and professional labour market).
- Substantial and internationally competitive clusters.
- Rapid employment and population growth.
- Proximity to policy makers and a prestigious address.

Evidence from outwith the UK shows that a small number of corporate HQs re-locate into strong industrial clusters (rather than the nation's capital or major commercial centre).

While HQ functions continue to drift to London, there is also a small counter flow from London into the South East. This is driven by cost savings (e.g. on property) while maintaining ready access to London. Long distance decentralisation remains rare because of additional travel costs (which includes the opportunity cost of time spent travelling). As yet, there is little evidence from either the UK or US that communication and information technology is changing these locational constraints.

## **Scotland's Headquarters**

Scotland has fewer limited companies per head of population than the national (GB) average. In other words, Scotland has relatively few corporate HQs. Nevertheless, a large number of companies have their HQ in Scotland. There are 53,400 limited companies with a Scottish HQ. Of these:

- 47,350 are independent Scottish businesses and a further 3,800 are subsidiary companies with a Scottish parent. These are referred to throughout the report as either Scottish businesses or the indigenous sector.
- 2,200 are externally owned subsidiaries. Approximately 60% have an English parent and 40% (900 businesses) an overseas parent.
- The vast majority are SMEs. Just 760 have over 200 employees, 113 over 1,000, 19 over 5,000 and 4 have over 50,000 employees.
- Of the companies with over 200 employees, 55% are Scottish, 29% are foreign owned and 16% have an English parent.
- However of the largest companies with over 5,000 employees, 17 out of 19 are Scottish.

An analysis of Scotland's Business Insider Top 500 companies found 64% are indigenous, 26% are subsidiaries with an overseas parent and 10% are externally controlled from an English HQ. A surprisingly large proportion (31%) of the Top 500 are SMEs with under 200 employees.

Scotland has 5 companies in Business Week's Top 1,000 global companies (including two in the Top 75). While somewhat lower than the US and UK, per head of population this is on a par with Japan, Eire and Finland and well ahead of Germany.

Over the past decade, the number of companies in Scotland's Top 500 with over 1,000 employees has declined by 11 to 91. However, the number with over 50,000 has increased from zero to four. The number of medium-sized companies has grown.

With an increase of 6% (304 to 321 companies) the indigenous sector has increased its market share. However, the largest increase (17% growth) has been in the foreign-owned sector. These increases have been offset by a 40% fall in the number of non-Scottish UK (i.e. mainly English) companies in the Business Insider Top 500.

Headquarters located in Scotland (and especially indigenous HQs) are concentrated in traditional manufacturing, utilities, retail/wholesale/automotive dealerships and transport/logistics. The largest indigenous businesses are in financial services. Both electronics-related manufacturing and the offshore sector are also important, but consist mainly of externally controlled companies.

The number of companies with a Scottish HQ has declined in traditional manufacturing and, to a lesser extent, in financial services. Growth has occurred in the offshore sector, electronics, business services and retail/automotive dealerships. There is little evidence of HQs being created in the new economy, information or 'high tech' sectors.

There are a number of well known and long established companies with their HQ in Scotland (e.g. RBS, HBOS, Standard Life, Scottish & Newcastle). On the other hand, as elsewhere in

both the UK and US, there is much churn and turbulence in the stock of HQs. This is particularly true for subsidiary HQs. Of the Top 500 companies in 1994, 50% of Scottish companies, 68% of overseas owned and 80% of English subsidiaries had disappeared by 2004.

The main reason for the loss of HQs is corporate restructuring via mergers and acquisitions. For example, of the indigenous Scottish companies in the 1994 Top 500, just over 20% had been acquired by non-Scottish companies by 2004. These include several well known names especially in the financial sector.

Of the new entrants, 60% are Scottish (including the First Group with over 60,000 employees worldwide) and 31% are overseas owned subsidiaries. The majority of new entrants were existing companies which grew largely via acquisition.

### ***Inward Investment***

There has been an increase in the number of internationally mobile HQs and R&D projects since the early 1980's. The UK continues to attract a substantial share of such investments. However:

- The pool of mobile HQ and R&D projects is relatively small. Nor is there evidence of significant growth since the mid-1990's. Average employment in these projects is relatively small.
- For HQs and S&M projects, London and the South East are the dominant destinations. Access to customers is an important reason for this. Furthermore, London appears to have increased its attractiveness in recent years. Scotland attracts less than 5% of the UK's projects.
- With 16% of UK projects, Scotland is more competitive in the R&D sector. However, the number of projects is small; the UK's share of European projects appears to be declining and the number locating in Scotland has fallen in the last two or three years.
- The factors influencing the location of HQs and S&M projects are similar. In contrast, the factors influencing the location of mobile R&D are very different. At least for mobile projects, HQs and R&D are not strongly interdependent.
- The software industry is now the major source of 'high value' (i.e. HQs, S&M and R&D) projects. While attracting a reasonable share of R&D, Scotland has attracted few HQ or S&M projects in software.
- Electronics-related manufacturing remains an important source of UK HQ, S&M and R&D investment. For HQs/S&M, business services are now the second largest sector (after software). With the exception of the software industry, R&D projects remain largely concentrated in manufacturing industries.

Based on the 'high value' projects attracted, Scotland's strengths are in electronics-related industries and offshore oil and gas. It also attracts larger projects with the vast majority of smaller projects locating in London and South East England.

A large majority of projects locating in London and the South East are initially very small. There is also much churn and turbulence. Many close fairly quickly but a few develop into much larger businesses. S&M projects, in particular, appear to be set up almost as small

'independent' firms with the ability to grow with successful market entry. In this context, they contribute to the entrepreneurial environment of South East England.

### ***Economic Contribution and Impact***

The direct contribution of HQs to the Scottish economy is limited. It is estimated that Scotland's Top 500 companies employ around 6,000 people in their HQs. It is widely believed (although we have no specific evidence) that these are well paid jobs. Nevertheless, regardless of income levels, the indirect consumer multiplier effects are, at least, modest.

The main contribution of HQs (and other 'high value' inward investment) is their longer term developmental effects. However, there is surprisingly little empirical evidence on such effects. This is an issue worthy of further research. Nevertheless, the following conclusions can be tentatively drawn from the available evidence:

- Spillovers are most likely to arise from indigenous company HQs rather than from subsidiary HQs of inward investors.
- These spillovers include potentially beneficial effects on the business birth rate, the attraction and retention of talent, sponsorship of economic development events and initiatives (e.g. local firms played an important role in sponsoring the creation of the Edinburgh Festival) and demand for business, financial and, in particular, IT services.
- Because of their purchasing, HQs play an important role in the development of business and financial service industries and software/IT services (which are under-developed in Scotland).
- Companies with their corporate HQ in Scotland are more likely to develop and retain production and day-to-day operations and their associated employment in Scotland.
- Within the context of inward investment, spillovers are most likely to arise from R&D projects, subsidiaries with substantial purchasing autonomy and/or when management is responsible for networks and relationships external to the company (especially marketing and customers) rather than when responsibility is for plant management and intra-company relationships.
- Only a small minority of HQs and 'higher value' inward investment projects have substantial developmental spillovers. Most HQs and R&D centres, for example, have few such effects.
- Spillovers depend upon both the nature of the company and its 'fit' with the local environment. For example, spillovers are more likely within reasonably well developed industrial clusters (and, in turn, such spillovers further enhance the success of the cluster).

An important implication of the available evidence is that major customers (i.e. HQs and organisations with purchasing autonomy) play a critical role in the economic development process. This arises from their actual purchases (i.e. demand) and their potential impact on innovation as 'demanding customers'.



## ***Strategic and Operational Implications for Scottish Enterprise***

This study has not undertaken a review of Scottish Enterprise strategy and operations nor of the wider strategic context. Consequently, it does not offer recommendations. Rather, it offers suggestions for further consideration.

While (especially indigenous) HQs are important, it is suggested there is little justification for an explicit HQ strategy. This is because the HQ concept is too imprecise, the issues are part of wider agendas such as the priority given to large companies or the financial sector and are already (or best) dealt with through other strategic themes.

For the indigenous sector, strategies for the start-up and growth of Scottish businesses implicitly aim to increase the number of corporate HQs in Scotland. In this context, businesses in all sectors (especially businesses with substantial purchasing) can make an important contribution to economic development.

As companies grow, there is a tendency for their HQ functions to 'drift away' from Scotland while others are acquired by non-Scottish companies. At least in some cases, Scottish companies 'sell out' to overcome growth constraints. This raises the question of whether more can, or should, be done to enable Scotland develop and retain indigenous businesses and their HQ functions.

Scottish Development International is increasingly focusing on 'high value' inward investment. This is defined as R&D and projects with wage rates at least 20% above the Scottish average. It is suggested that more explicit consideration should be given to potential spillover and developmental effects in the definition of 'high value' fdi.

The available evidence suggests that developmental effects are most likely to arise from R&D, subsidiaries with autonomy over substantial purchasing and ones in which management is responsible for external relationships (e.g. marketing). They are also more likely to arise from projects which 'fit' the local environment.

The issues involved in attracting, and the potential developmental effects from, R&D and HQs/S&M are very different. The link between mobile R&D and mobile HQs/S&M projects is less than might be initially assumed.

While both HQs and S&M projects can have developmental spillover effects, it is suggested that a strategy and marketing campaign specifically targeting such projects is unlikely to be effective. These functions might be most effectively targeted in the context of cluster strategies. The companies most likely to locate projects in Scotland are those with existing or potential customers and/or existing facilities in Scotland.

Given its stronger competitive position in R&D, this should continue to be a priority. As with HQs/S&M projects, Scotland is most likely to be successful, and obtain more developmental effects, by building on its strengths. Based on recent evidence, these are in the offshore sector, electronics/communication, information technology and, as a major customer, the financial sector.

Finally, three other issues are worthy of consideration. First, can (and should) more be done to enable Scotland compete more effectively for the larger number of small R&D, HQ and S&M projects which currently locate in South East England?

Second, should more attention be devoted to the software and computer services sector? This is now the largest inward investment sector in terms of new projects. Scotland has a reasonable position in the attraction of software R&D but attracts few of the many HQ and S&M projects (often including much technical support) locating in the UK.

And third, should further work be undertaken to identify major customers in Scotland and how their contribution to economic development can be maximised?

# 1 Introduction

## 1.1 Background

It is widely argued that corporate headquarters (HQs) make an important contribution to economic development. They typically employ highly qualified and paid people providing career opportunities. This helps retain and attract talent which, in turn, strengthens and deepens the local labour market. They control corporate strategy with beneficial implications for local investment and the long term prospects of the business. They may also have spillovers to the rest of the economy via, for example, their purchasing power and links to activities such as R&D.

While HQs are seen as potentially beneficial, not surprisingly, the loss of HQs is seen as potentially detrimental to economic development. This is reflected in, for example, concerns over the possible adverse effects of the acquisition of Scottish companies by non-Scottish companies. Scottish interests have regularly made submissions to the Monopolies & Mergers Commission in response to bids for large Scottish businesses such as the Royal Bank of Scotland (by HSBC) and Scottish & Newcastle (by the Australian Elders IXL Ltd).

Discussion of HQs is linked to wider policy issues and debates. There are four such issues. First, there are longstanding concerns over the 'branch plant' characteristics of the Scottish economy. In addition to the acquisition of Scottish companies, it is often argued that the attraction of foreign direct investment has aggravated the problem. Many of the projects attracted to Scotland are assembly operations with little managerial autonomy (i.e. branch plants). In response, efforts are being made to attract 'higher value' inward investment. This raises the question of what constitutes 'high value' and whether mobile HQ functions (such as European HQs) fall into this category.

The second, related, debate is between inward investment and/or indigenous business development models of economic development. The beneficial effects claimed for HQs are essentially the same as the arguments put forward to support an indigenous business development strategy. However, there are two differences. Discussion of HQs are generally concerned with the benefits of large company HQs rather than with all indigenous businesses which are, of course, mostly SMEs. The second difference is that those arguing for indigenous business development are concerned with the entire range of corporate functions and not just HQs per se.

The third debate concerns the appropriate emphasis and priorities for business development policy. Discussion of HQs is implicitly or explicitly about large companies. In this context, arguments that HQs contribute much to the Scottish economy merge into the argument that large companies contribute much and should be given greater policy priority.

The fourth linked policy issue is the identification of sectoral or cluster priorities. For example, Monitor's cluster study in the early 1990's identified financial services as a priority because Scotland has several major indigenous companies with their HQ and decision making

functions in Scotland<sup>1</sup>. More recently, those involved in the sector have argued that it should be taken more seriously because of these large indigenous companies<sup>2</sup>. While the existence of indigenous businesses with a local HQ is believed to contribute to cluster strength, their absence is seen as a weakness. Electronics is the obvious example of such a weakness.

Within this context, following discussion with Scottish Financial Enterprise and the Scottish Executive, Scottish Enterprise commissioned this study to review the nature of Scotland's HQs and their direct and indirect contribution to economic development in Scotland.

## 1.2 The Brief

Based on the brief and subsequent discussion with Scottish Enterprise, the aims of the study were clearly set out by the client. These are:

- To describe and quantify HQ functions in Scotland and their direct and indirect contribution to the Scottish economy.
- To analyse the contribution of indigenous and externally controlled HQs to the Scottish economy.
- To set out the factors driving change in the nature and role of corporate HQs and identify emerging HQ models.
- To identify the factors which determine the location of HQs and their potential mobility.
- To suggest an HQ market segmentation to inform Scottish Enterprise's operations.
- To draw out the strategic and operational implications for Scottish Enterprise and identify topics requiring further research.

In the context of inward investment, the brief refers to HQs and related 'high value' functions such as R&D. However, it does not define 'high value' and requests, based on the available evidence, suggestions on how the consultants would define the concept<sup>3</sup>.

The study is to inform Scottish Enterprise operations. It does not examine the potential effectiveness of national policy options or make policy recommendations. Consequently, the pros and cons of, for example, changes in the legislative environment governing the market for corporate control or tax regimes are not explicitly examined.

## 1.3 Some Issues

This is a wide ranging and demanding research agenda which raises both conceptual and methodological challenges. Here we highlight five issues. The first is what to include under the heading HQ. This, itself, is a multi-faceted question. There are over 100,000 VAT registered businesses in Scotland and perhaps around 250,000 businesses if the self-employed with sales under the VAT threshold are included. The vast majority of these are directly owned by Scottish residents, are controlled and managed from Scotland, and, therefore, have their HQ in Scotland.

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<sup>1</sup> Monitor (1993). *The Competitive Advantage of Scotland: Volume One*, Scottish Enterprise.

<sup>2</sup> Peat, J. (2002). *Financial and Business Services*. In Hood, N. et al. *Scotland in a Global Economy*, Palgrave Macmillan, Basingstoke.

<sup>3</sup> For operational purposes, Scottish Enterprise currently defines high value inward investment as R&D projects plus those with wage rates at least 20% above the Scottish average.

However, the vast majority (even of VAT registered businesses) have little formal management structure and no separate, identifiable HQ site. Indeed, senior management may also perform the business' day-to-day operations. Research on corporate headquarters normally relates to large company HQs. However, this leaves open the question of an appropriate size 'cut off'. There is no self-evidently correct way of determining which businesses to include and exclude from the analysis.

Further uncertainty arises with regard to which functions and type of HQ to include in the analysis. For example, companies have very different management and organisational structures. Some are highly centralised with all management, strategy and support services at one corporate HQ site. All such functions and employment could logically be counted as a HQ contribution to the economy. However, should the company decentralise support services into a 'stand alone' shared service centre and some management functions into subsidiary companies, employment at the corporate HQ shrinks and the apparent role of the HQ becomes smaller. However, in reality, there has been little change in the contribution of HQ functions to the economy.

This raises the question of whether subsidiary HQs should be included under the definition. Large Scottish companies may have subsidiary companies with their own HQs. These can have more or less autonomy. If the focus is restricted to parent company HQs, then all externally controlled companies (e.g. inward investors) would be excluded. By definition, inward investors have their parent or corporate HQ outwith Scotland. At best, they can have a Subsidiary HQ in Scotland. This may have more or less (and even almost no) management function and autonomy.

The second issue relates explicitly to inward investment. Recent interest in mobile HQs comes from a belief that there has been an increase in their number as major multinationals take on a more decentralised organisational structure. This is reflected in, for example, the growing number of European HQs. However, there is no clear distinction between HQ functions and concepts such as subsidiaries with global product mandates or Centres of Excellence. These have more or less management autonomy and HQ functions. This aggravates the problem of defining what is meant by headquarters.

The third issue concerns data. It is very difficult to collect data on something which cannot be readily defined. There are no official data on HQs. Furthermore, large non-governmental databases such as Dun & Bradstreet are of only limited assistance. For example, of Kwik Fit's 7,000 employees, Dun & Bradstreet shows just 60 are located at the site of its registered HQ. Unfortunately, such site-specific data is given for only a minority of businesses on the database. To obtain comprehensive and reliable data, large scale survey work is required. However, in part because of the ambiguity of the HQ concept, it is argued in the concluding chapter that such work is unlikely to offer value for money.

The fourth issue is the need to differentiate between ownership and control. It should not be assumed that companies with their Corporate HQ in Scotland are owned in Scotland. Most of Scotland's family businesses are owned and controlled in Scotland. However, for most large companies with a Scottish HQ, they may be controlled from Scotland but not necessarily owned in Scotland. Scots may have a majority shareholding in a few, but the majority are

owned by shareholders located outwith Scotland (e.g. the major financial institutions)<sup>4</sup>. This affects, for example, where profits and income accrue with more being in Scotland for Scottish-owned companies. In this study, the focus is on control (i.e. HQs) rather than ownership. Nevertheless, the nature and location of ownership has some impact on the nature and autonomy of HQs. For example, a family or personally-owned and controlled business may have more management autonomy than one which needs to take external shareholders into account.

The fifth and final issue is the difficulty of measuring the contribution of HQs to economic development. This follows from the absence of data and a clear definition of HQs. Furthermore, the impact of the HQ is not the same thing as the impact of the entire business. Here the focus is on the impact of the HQ. Consequently, estimates of the HQs contribution to, for example, Gross Value Added are not meaningful or possible. Perhaps the most obvious measures of direct impact are employment and associated wages. As illustrated in the preceding paragraphs, even these are not readily defined or measured. Consequently, the best that can be achieved are 'ball park' estimates of direct employment contribution.

Furthermore, obtaining an accurate measure of the direct contribution may be relatively unimportant. As will become clear subsequently, the direct employment impact of large Corporate HQs is small. The main impacts are longer term, indirect developmental effects. These include:

- The purchasing power of HQs for intermediate goods and services such as finance, consultancy, legal and IT services. This, in turn, influences the development of these industries.
- To the extent that HQs are 'demanding customers', there could be beneficial impacts on local innovation. Customer-supplier links are known to play an important role in the innovation process.
- The attraction and retention of highly skilled individuals. A stronger and deeper local labour market itself adds to the area's competitive advantage (e.g. the attraction of higher value inward investment).
- Beneficial effects on the business birth rate. Employment in HQs perhaps provides the necessary experience and business contacts which encourage and enable individuals to spot business opportunities and set up their own business.
- The spillover of technical, managerial and strategic know-how and ideas to other local firms. Such spillovers are the essence of concepts such as the learning region.
- Private sector participation in the mechanisms of economic development. This could include participation in cluster strategies and governance or sponsorship of local events and facilities.

The range of potential indirect effects is almost endless. However, identifying and measuring them is very difficult. Nevertheless, it is these, rather than the short term direct employment impacts, which may be critical to the process of economic development.

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<sup>4</sup> Baird, S. *et al.* (2004). Ownership of Companies in Scotland. Fraser of Allander Quarterly Economic Commentary, November 2004.

## 1.4 Methodology

The study is exploratory and designed to establish what is known, potential issues and what needs to be known via further research. The methodology consists of five main components:

- A wide ranging literature review of both academic research and studies undertaken for other government agencies. There is little recent UK research explicitly on HQs. However, there is a substantial research literature (e.g. on inward investment, corporate and management structures, industrial clusters) which implicitly deals with HQ-related questions.
- An analysis of the Ernst & Young Investment Monitor. For the period 1997 – 2003, this provides data on HQ, Marketing and R&D foreign direct investment throughout Europe (including Scotland and the UK).
- An analysis of the Business Insider's list of Scotland's Top 500 companies for 1994 and 2004. This is used to describe the changing nature of Scotland's HQs. In addition, a variety of databases and press cutting services are used to analyse the reasons for the loss of HQs and the origin of new Scottish HQs.
- To examine why so many overseas companies locate HQs in South East England and the possibility of attracting some of these to Scotland, telephone interviews were completed with 23 recent South East inward investors.
- Scottish Enterprise undertook a limited number of interviews with senior Scottish corporate executives to obtain a 'feel' for how they see Scotland as a corporate HQ location and how their HQ affects the Scottish economy.

The brief refers to both indigenous business and inward investor HQs. It quickly became apparent that these are very different animals. Almost by definition, an inward investor HQ is a Subsidiary rather than Corporate HQ. Consequently, the evidence relating to inward investment is reviewed separately.

No original or systematic survey work has been undertaken in Scotland and the information obtained from Scottish companies is limited. Consequently, the study makes 'ballpark' estimates of the direct contribution of HQs to the Scottish economy based on existing data. Nor does the study have access to any specific Scottish evidence. Evidence from elsewhere is, therefore, used to illustrate the potential indirect effects which HQs are expected to generate.

## 1.5 Structure of the Report

Following this Introduction, Chapter Two examines the origins of Corporate HQs, their size and functions, the factors which determine their location and the drivers of change. The focus is on the HQs of large companies. This is followed in Chapter Three by an analysis of Scotland's HQs and, based on the Business Insider's Top 500, changes over the period 1994 – 2004. It includes an analysis of why Scotland loses HQs (and especially the role of external acquisition) and the origin of new Scottish HQs. The chapter also presents an estimate of the direct employment contribution of Scotland's HQs.

Chapters Four and Five turn to the question of mobile HQs and inward investment opportunities. The identification of such opportunities requires an appreciation of the nature and extent of mobile HQs (and other 'high value' functions), and the factors which influence

their location. Using data from the Ernst & Young Investment Monitor for HQs, Sales and Marketing (S&M) projects and R&D investments, Chapter Four sets out the European and UK context within which Scotland operates and the factors which influence the location of such investments. Within the European context, London and South East England are the dominant destinations for HQs and S&M projects. Chapter Five identifies the reasons for this dominance and offers initial thoughts on whether some of the South East's projects could be attracted to Scotland.

Having reviewed the nature of HQs, their location factors and their direct impact on the Scottish economy, Chapter Six turns to the key question of longer term developmental impacts. The analysis differentiates between the impact of indigenous Corporate HQs and inward investment Subsidiary HQs. Finally, Chapter Seven summarises the findings and draws out the policy implications for Scottish Enterprise.



## 2. Nature, Role and Location of Corporate Headquarters

This chapter describes the size and function of Corporate HQs, their origins and locational requirements and the factors driving change in their size, function and location. The analysis is based largely on a review of the literature.

### 2.1 The Origin of HQs

Discussions of corporate headquarters generally focus on the nature, role and location of long established, large company headquarters. However, this ignores the question, 'where do HQs come from?' The answer to this question is simple, but generally overlooked.

The creation of new businesses creates new HQs. For the vast majority of new firms, headquarter functions cannot be readily differentiated from business operations. Indeed, for the vast majority of businesses such a separation never emerges. However, for those businesses which achieve substantial growth, the HQ function gradually becomes differentiated from day-to-day operations. This occurs, for example, as the business takes on a more formal functional structure (e.g. business divisions) or expands via the creation (or purchase) of subsidiary companies.

It is difficult to say at what point in the growth process a separate, identifiable HQ emerges. Nevertheless, it is clear that new headquarters are created at the firm's place of birth. This illustrates a key policy conclusion. The business birth rate, and especially the creation of businesses which subsequently achieve substantial growth, is the source of most Scottish HQs<sup>5</sup>.

A small number of new companies are created from day one with an identifiable 'stand alone' HQ. These are usually set up by existing large firms. For example:

- Within the context of organisational change and strategic re-organisation, firms may spin off part of the business into an independent company.
- New businesses are created as joint ventures between existing companies. These may involve investment in new production facilities or organisational change with existing facilities 'moved' into the joint venture company.
- The firm may choose to expand (particularly when moving into new markets) via the creation of a subsidiary. This occurs, for example, when a company moves into a new overseas market via foreign direct investment. The subsidiary HQ is given more or less power.

In these cases, HQs may be set up from day one as an identifiable separate facility.

This discussion introduces an important distinction between Corporate and Subsidiary HQs. The former are responsible for the entire corporation and the latter for part of it. Subsidiary HQs, however autonomous, more or less always ultimately report to the Corporate HQ.

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<sup>5</sup> To avoid possible misinterpretation of this comment, this does not mean we believe that Scotland should reject the 'volume approach' to increasing the business birth rate and focus only on high growth new starts. It is, however, new firms which achieve growth which will create future stand alone identifiable Corporate HQs in Scotland.

However, the distribution of managerial responsibility and employment between corporate and subsidiary HQs varies greatly from company to company.

The vast majority of HQs remain where the firm was born. However, growth can lead to locational change. Four processes are of particular importance:

- Growth via product diversification with the creation of new Business Units or subsidiaries creates both the opportunity and sometimes the need for change. There may be benefits from a 'stand alone' HQ separate from the management of the company's day-to-day operations.
- Growth via acquisition may also trigger locational change. Following an acquisition, an explicit choice has to be made about the location of the enlarged company's HQ. It often remains at the site of the acquiring company. However, a decision to split the HQ function or even locate it (very rarely) at the HQ of the acquired business is possible. More likely, the opportunity is taken to set up a new 'stand alone' HQ separate from both companies.
- Going public via a stock market listing increases the need for ready access to major financial centres such as London. Consequently, following flotation, companies may feel a need to re-locate their HQ.
- Company growth outwith the 'home' region may eventually lead to the relocation of the corporate HQ. The HQ may remain at its place of birth for many years after its production and other facilities have moved elsewhere. Nevertheless, once these have gone, for areas outwith a country's major commercial centre (and, in the case of the UK, South East England) the probability of the HQ being moved elsewhere increases substantially.

As companies grow, their HQ may drift away from its place of birth into a 'stand alone' location. At least within the UK, and much of the developed world, this means a drift of HQs to the capital city. To a much lesser extent, it may also mean a drift into strong industrial clusters<sup>6</sup>.

Reflecting these processes, studies of large company HQs in the UK have found:

- The majority are located in London. For example, 75% of the 100 largest manufacturing companies have their HQ in London. While the degree of concentration is somewhat less in the US, similar patterns are found in much of the developed world.
- Depending on the specific study, between 80 and 90% of large companies have 'free standing' HQs. Between 10 and 20% have an 'embedded' HQ co-located or integrated with an operating business. Those with embedded HQs are generally single product companies or ones in which a particular product (division or business unit) dominates the company.

An obvious question which is considered subsequently is why large company HQs gradually move into major commercial centres such as London.

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<sup>6</sup> Jakobson, S. and Onsager, K. (2003). Head Office Location: Agglomeration, Cluster or Flow Nodes? Regional Studies Association Conference, 'Re-Inventing Regions in a Global Economy, 12 – 15 April 2003, Pisa.

## 2.2 HQ Size and Function

Here the focus is on corporate HQs of large firms. The analysis excludes subsidiary HQ and management functions of Business Units and operating divisions. Both the range of functions and, at least partly as a consequence, employment in corporate HQs varies dramatically from company to company.

This is illustrated in Figure 2.1. Unilever's corporate HQs has over 4,000 employees including an extensive R&D facility plus product and functional management groups. Nucor with 7,000 employees in eight mini-mills across the US has just 25 employees in its corporate HQ. They are concerned with major investment decisions, pricing policy, appointment of senior staff and the purchasing of scrap (a critical input). Everything else is the responsibility of plant management. In contrast, another steel company (Timken) runs its worldwide customer sales, production scheduling, logistics and inventory management from its HQ via an integrated IT system. Not surprisingly, its HQ, with 700 employees, is much larger. Finally, Tyco with around 140,000 employees has just 50 employees in its Corporate HQ.

**Figure 2.1: Corporate Headquarters: Illustrative Examples**

**Tyco International.** With 140,000 employees, this US company competes in six business areas (e.g. undersea cable, electronic components, security systems). Its corporate HQ has 50 employees. It allocates capital between businesses, deals with mergers and acquisitions and manages the compensation system (the critical control incentive/mechanism). It provides no services and has limited functional/operational influence.

**Nucor.** The company produces 10m ton of steel per year via a series of mini-mills spread around the US. It has 7,000 employees of which just 25 work in its Charlotte HQ. There are just 3 management layers above the 'shop floor'. HQ makes decisions on major capital investments, pricing policy, appointment of senior staff and purchasing of scrap. Everything else is at plant level (including marketing).

**Timken.** With 20,000 people, it produces speciality steel with a HQ of 700 plus. In addition to R&D, it operates the companies' IT system, co-ordinates customer sales and does the production scheduling, logistics and inventory management. Its IT group of over 400 runs a worldwide integrated order, production and distribution system. It makes more or less all policy and has a strong HR department.

**Unilever.** While having a decentralised structure, it still has a HQ with over 4,000 employees. This includes R&D, product and function management groups. It provides strategic leadership and sharing of best practice between units.

These examples show the great diversity in the size and functions of Corporate HQs. Nevertheless, average employment in large company HQs is now relatively small. For example, a recent survey found that the average UK HQ employed 100 staff<sup>7</sup>. As illustrated in Figure 2.2, HQ employment increases, as would be expected, with increasing corporate size. For UK HQs, employment varies from 24 staff for companies with under 5,000 employees to almost 340 for those with over 50,000 staff.

<sup>7</sup> Young, D. *et al.* (2000). *Corporate Headquarters: An International Analysis of their Role and Staff*, Ashridge Management Centre. Such figures are highly sensitive to the range of companies included in the sample. In this case, 72% of the companies have over 5,000 employees. In other words, the sample is disproportionately biased towards the large firm sector. Inclusion of more medium-sized firms would reduce the average figure dramatically.

**Figure 2.2: Employment in Stand Alone HQs by Company Size and Country**

Corporate Employment	Average per Company	
	UK	US
<5,000	24	50
5 – 10,000	41	177
10 – 20,000	93	189
20 – 50,000	171	264
50,000 +	338	995
<b>Average</b>	<b>100</b>	<b>359</b>

Source: Young, D. et al. (2000).

Figure 2.2 also shows that US HQs are, on average, around three and half times larger than UK HQs. This is not simply because US firms are larger. Throughout the corporate size range, US companies employ more staff in their HQ. As will be illustrated subsequently, this is largely because US company HQs are more powerful and perform a wider range of functions.

In addition to corporate size, the most significant influence on HQ employment is the range of functions which the company chooses to undertake at its HQ. One way of categorising functions undertaken at the corporate HQ is:

- **Core (Mandatory) Functions.** These are required to enable the company operate legally as a single entity. The functions relate to the submission of accounts and tax returns, legal, financial controls and overall corporate strategy including, for example, definition of business portfolio, organisation structure, incentives, monitoring and Business Unit performance assessment. These functions must be performed by the HQ but require few employees.
- **Policy and Influence.** To varying degrees, this includes strategic guidance, company-wide policies and standards, corporate image and brands, corporate communication (especially links with the political process), expert advice, developing core competencies, identifying and exploiting synergies and intra-corporate co-ordination. Most of these functions can, if the company so chooses, be delegated and decentralised to Business Units.
- **Service Provision.** Headquarters may provide administrative and support services to all, or most, of its operating units. These include, for example, purchasing, IT systems, HR, training/education, financial controls and accounts, property services, R&D etc. These can be decentralised to individual Business Units or even 'bought in' from outwith the company (i.e. out-sourced).

Employment at corporate HQ depends upon how many of these activities and services the company chooses to undertake at corporate HQ and how many it chooses to decentralise or out-source.

The proportion of large companies undertaking specific functions at their corporate HQ in the UK, US and mainland Europe is shown in Figure 2.3. In the UK:

- Over 80% of HQs are responsible for corporate planning and management, legal issues, most aspects of finance (including pensions and internal audit) and public/government relations.
- In the majority of firms (i.e. over 50%), Corporate HQ has responsibility for HR policy, training and education, IT/telecom systems and property services.
- In contrast, relatively few HQs take responsibility for marketing, office services, business accounting, purchasing or R&D.

With the exception of property and pensions (reflecting the UK's company-based pension system), UK HQ functions do not vary greatly from European HQs.

**Figure 2.3: HQ Functions: % of Large Companies**

	UK	US	Europe
General Corporate Management	92	96	94
Legal/Company Secretary	100	100	94
Treasury	99	100	94
Taxation	99	94	91
Financial Reporting and Control	100	90	97
Accounting for Business Units	36	88	49
Internal Audit	82	91	74
Pensions Administration	95	90	52
HR/Personnel Policy	79	87	87
Training and Education	55	72	56
Government/Public Relations	83	86	89
Corporate Planning/Development	89	94	80
R&D	25	33	38
Marketing	28	52	34
Purchasing/In-Bound Logistics	28	70	37
Distribution/Out-Bound Logistics	5	33	9
IT/Telecom Systems	66	90	68
Insurance/Risk Management	53	17	31
Health/Safety/Environment	26	16	15
Trade Marks/Patents etc.	9	1	-
In-House Communication	9	20	6
Property Services	71	61	44
Office Services	38	84	26

Source: Calculated from Table 3.7 in Young, D. et al. (2000) op. cit.

Note: Europe is based on replies from German, French and Dutch companies.

However, US HQs undertake more functions. In particular, more US HQs take responsibility for purchasing, marketing and out-bound logistics, HR, training and education, office services and financial accounting for Business Units. This has implications for the extent to which US

companies decentralise management functions to subsidiaries (including overseas subsidiaries). As will become apparent subsequently, US company corporate HQ responsibility for purchasing limits the potential spillover effects of US inward investment projects. Compared to the UK and European companies, large Japanese firms also have more powerful HQs with both more functions and substantially more employment.

Just 25% of UK HQs are directly responsible for R&D. This is somewhat lower than in both the US and Europe. It is not known whether this is because fewer UK companies undertake R&D or because R&D is more decentralised in the UK. Whatever the explanation, it is clear that R&D is not associated with HQ locations for the majority of large companies.

In addition to company size and the balance between centralisation and decentralisation, several other factors have a systematic influence on HQ employment:

- **Industrial Sector.** For example, for any given size of company, financial service HQs are substantially larger than average.
- **Market Regulation.** Probably because of the need for greater interaction with government, companies in highly regulated markets have larger HQs.
- **Nationalised and Privatised Companies.** For similar reasons, nationalised industries have substantially larger HQs. This is also true for many recently privatised firms. These may not have adjusted fully to their new competitive environment and/or may still operate in highly regulated markets.
- **Embedded Headquarters.** These are very much larger than 'stand alone' HQs mainly because they incorporate operational management with limited management decentralisation to other Business Units within the company.
- **Product Diversification.** Companies with a diversified product portfolio generally decentralise more HQ functions to their subsidiaries than less diversified companies.

However, there is little which is pre-determined about the size and function of HQs. They largely reflect corporate strategy and structure and, in particular, the degree of corporate centralisation and decentralisation.

This raises the question of the relative importance of Corporate and Subsidiary HQs. For example, what proportion of management employment is in parent and subsidiary HQs? How much autonomy is decentralised to subsidiary HQs and do they provide similar work experience to the Corporate HQ with similar economic development implications? Unfortunately, no systematic data is available to examine these issues.

## 2.3 Drivers of Change

In the late 1970's, most large companies had corporate HQs managing centralised, hierarchical organisations. With more or less all powerful HQs, the organisation could be characterised as a centre-periphery model. From perhaps the early 1980's onwards, UK companies began to introduce more decentralised, flatter corporate structures to reduce bureaucracy, empower (some) staff, increase flexibility and improve market responsiveness. Consequently, during the 1980's, the majority of large UK corporations substantially reduced HQ employment mainly (but not exclusively) via decentralising functions to Business

Units/Divisions. By 1990, a substantial majority of large private sector companies had less than 300 staff at their corporate HQ<sup>8</sup>.

The process of organisational change eliminated non-value adding functions and removed layers of middle management while strengthening management in operational HQs. Within this model, the HQ:

*“co-ordinates company wide operations, sets standards and procedures for quality control and provides strategic guidance and management for operating units... (and is)... a hub of strategic management, financial control and communication.”*

While more decentralised, the process often strengthened Corporate HQ's financial and strategic control. Decentralisation was most common amongst more diversified, multi-product businesses. Indeed, over this period HQ employment often continued to increase in 'single product' firms.

The 1980's also saw the growing use of out-sourcing and a drive to improve HQ productivity via the application of IT. However, at least over this period, these had less impact on HQ employment than decentralisation. This decentralisation itself created new organisational pressures with consequent organisational change. Some of these are illustrated by the case study of ABB summarised in Figure 2.4. For example, decentralisation raises questions of co-ordination which, in turn, resulted in the introduction of intra-corporate linking and networking mechanisms. Matrix management arrangements became more common. These reinforced the need to separate the corporate HQ from Business Units.

The nature and functions of Corporate HQs are being affected by at least four pressures for change created by decentralisation:

- Matrix management arrangements have proved difficult to operate. They are highly complex. Many companies are now seeking ways of simplifying structures. It is not clear how this will impact on the role of HQs.
- To deal with the problems of co-ordination, more companies have sought to reduce the visible hand of management with greater use of the invisible hand of the market to allocate resources and co-ordinate intra-corporate (trading) relationships. This generally means less power (and, therefore resources) in the Corporate HQ.
- With each Business Unit taking responsibility for its own activities, a decentralised structure often resulted in the duplication of effort and service provision and the loss of economies of scale. This adds cost. One response has been the creation of shared service centres bringing together support for all, or most, Business Units. These are, generally, located away from the corporate HQ in lower cost locations.
- A possible consequence of independent market driven Business Units is that the corporation cannot provide an integrated service to (especially large) clients. Indeed, the Units often compete with each other. This is leading to the emergence of front-end/back-end organisations. The front-end sells and markets for the entire corporation to major customers while the 'back-end' is concerned with technology

<sup>8</sup> Askoy, A. and Marshall, N. (1992). The Changing Corporate Head Office and Its Spatial Implications, *Regional Studies*, Vol. 28, No. 2, pp. 149 – 62.

and production. The locations of back and front-end business HQs are determined by very different requirements.

Over the past 30 years, the main drivers have been to increase flexibility, freedom of action and responsiveness. However, it is also clear that HQs are seen as a cost centre and increased competitive pressures have strengthened the drive to reduce costs. Not surprisingly, these pressures have generally resulted in the 'down-sizing' of Corporate HQs.

**Figure 2.4:**

**ABB**

Created in 1988 by a merger of a Swiss and Swedish company, its new organisational structure reduced HQ staff to just 10% of the 1988 level.

The basic unit was the local (generally national) operating company (with perhaps up to 3 profit centres). Each had about 200 employees with responsibility for a specific product/market within the country. There could be several BU's in a country. Essentially its organisation took on a SME structure.

This empowered the head of each BU giving them entrepreneurial freedom. The job became 'not simply implementing the latest corporate programme but building a viable enduring business.'

The BU reported to both a global BU and a National Company. The BU's reported to a Business Segment (represented on the company's Executive Committee). The National Company reported to the Executive Committee (and between 1993/98 a Region). Hence, ABB had a very flat structure with much autonomy/management at the local level. To obtain/exploit synergies, the structure was held together by a large number of linking mechanisms. Over time, these tended to strengthen links/relationships within BU's/Business Segments at the expense of geographic/national inter-relationships.

With more transparent performance data (e.g. each BU reporting on a unified/comparable basis), this gave the much smaller central HQ greater strategic insight/control.

No system is ideal or necessarily copes with the changing environment. For example, business opportunities were being missed in growing areas which required links between rather than within BU's (the emphasis had been on cross-border links within BU's). Also, many believe the structure led to duplication and additional costs (due to the decentralised system).

The entrepreneurship of individual BU's selling specific products did not offer integrated 'solutions' to larger (often themselves multinational) customers. Consequently in 2001, a 'front-end/back-end' structure was introduced. In part change was needed because transfer pricing becomes extremely difficult/time consuming with independent/profit orientated BU's.

It now has two back-end units (for technology, product development, and production i.e. power technology and automation technology) and four front-end units (defined by industry rather than geographic markets). BU's are being incorporated into this structure which sometimes means splitting BU's.

More recently, the company has begun to consolidate its BU's into country units (i.e. with a country HQ). It is not clear how these will fit the front-end/back-end model.

*Source:* Westney, D.E (2003). Geography as a Design Variable in Birkenshaw, J. et al. (eds) The Future of the Multinational Company, John Wiley & Sons, Chichester, pp. 128 – 42.

More recent trends in stand alone, large company Corporate HQs are shown in Figure 2.5. This shows the balance between the percentage of companies increasing or reducing staff, using more or less out-sourcing, increasing or reducing the power and influence of the HQ and the range of services provided by the HQ. For example, over the period 1995 – 2000, 19% fewer UK companies increased HQ employment than reduced employment. In other words, 19% more companies 'downsized' their HQ. Nevertheless, more companies believe the HQ is providing more services and has increased its power and influence than say its range of services and influence has declined. For example, 13% more companies say HQ



services have increased than decreased. Similarly, 15% more companies believe the power and influence of the HQ has increased than say its power and influence has decreased.

**Figure 2.5: Trends in UK and US HQs: % Net Balance**

	Past 5 Years (1995 – 00)		Anticipated Next 5 Years	
	UK	US	UK	US
Increasing Staff	-19	19	-22	-13
Bought in Services	32	37	36	40
Influence of HQ	15	27	19	20
Services Provided	13	36	3	30

Source: Young, D. et. al. (2000) op. cit.

While HQs are getting smaller, they are providing more services and increasing their influence. At first sight, these trends appear contradictory. However, at least in part, this is achieved via increased use of out-sourcing. Over 30% more UK companies say they have increased their use of out-sourcing than say they have reduced out-sourcing.

UK companies expect these trends to continue. However, there are interesting contrasts between UK and US experience. As already illustrated, US HQs are larger and undertake more functions than their UK counterparts. Furthermore, on balance, employment in US HQs has grown in recent years rather than declined. While US companies have also made greater use of out-sourcing, the range of services and the influence of US HQs has increased more than in the UK. American firms expect these trends to continue (but without the need for HQ employment growth in the future).

Companies in both countries downsizing their HQ were mainly driven by the need to reduce cost and to make HQ functions more cost effective. This is largely a productivity issue rather than a concern for decentralisation, flatter structures, greater responsiveness etc. The 1980's decentralisation agenda seems to have run its course and reducing costs (and staff) via the application of IT (and out-sourcing) was the 1990's' agenda. This latter agenda appears to be ongoing.

Companies increasing their HQ staff are mainly concerned with improving business strategy and its implementation. In the US, the 1990's saw an emphasis on developing the company via core competencies. Creating and supporting these has become a Corporate HQ role. These competencies are then used to support an increasing number of Business Units within the corporation. As long as they are underpinned by the corporation's core competencies, diversified or conglomerate corporations are again becoming acceptable and fashionable. This appears to explain (at least in part) the increasing size of US HQs. Whether these US trends will be replicated in the UK is a question worthy of further consideration.

The growth of US HQs is somewhat at odds with the widespread vision (especially in the US) of highly decentralised corporate structures enabled by the IT revolution<sup>9</sup>. Indeed, discussion of the virtual organisation and the end of the HQ continues and some (especially) US companies are setting up virtual overseas Regional HQs. A virtual European HQ might, for

<sup>9</sup> Malone, T.W. (2004). *The Future of Work: How the New Order of Business Will Shape Your Organisation, Your Management Style, and Your Life*, Harvard Business School Press, Cambridge, Mass.

example, consist of a nameplate with the RHQ staff drawn from, and located at, a multitude of sites around Europe.

On the other hand, even in Silicon Valley, at least some of the companies at the forefront of IT-driven organisational change are 'back tracking' on the more extreme versions of decentralised, paperless, virtual HQs<sup>10</sup>. Furthermore, Japan's large internationally competitive manufacturing companies have never attempted large scale HQ decentralisation believing that '*a strong HQ makes for a strong company*'<sup>11</sup>. Not surprisingly, Japanese HQs are substantially larger than even US HQs.

## 2.4 Location

### 2.4.1 The Current Situation

Corporate headquarters (and parent companies) are mainly located in major (and especially in Europe) capital cities. As already noted, the majority of large UK companies have their HQ in London. A recent study for the London Development Agency found almost 18,500 parent companies in London. Between them, they 'controlled' 10.6m jobs or almost 40% of the UK private sector workforce<sup>12</sup>.

HQs are less concentrated in a single city in the US. Nevertheless, 30% of companies with over 2,500 employees have their corporate HQ in four cities (New York, Chicago, San Francisco and Los Angeles). Almost 90% are in a large city. The larger the company, the more likely it is to have a large city (and especially New York) location<sup>13</sup>.

For the economy as a whole, the US Economic Census (1997) shows there are just over 33,950 identifiable (stand alone) HQs in the United States. Average employment in these HQs is 73. The number of stand alone HQs has increased by almost 60% since 1977. Once the complete HQ population is taken into account, the degree of concentration is much less. Nevertheless, the 10 largest US counties account for 21% of all HQs with just 5% in all rural counties. Outwith the very large cities, a few cities in the 2 – 4 million population range have developed an HQ specialism (while the majority have very few HQs)<sup>14</sup>.

A diverse range of HQs concentrate in a country's main commercial centre (e.g. London and New York). Multi-product businesses in particular are attracted to such locations. In other cities (and especially those further down the urban hierarchy), there is evidence of specialisation and industrial clustering. These cities grow or attract the HQ of less diversified

<sup>10</sup> Brown, J.S. and Duguid, P. (2000). *The Social Life of Information*, Harvard Business School Press, Cambridge, Mass.

<sup>11</sup> Kono, T. (1999). *A Strong Head Office Makes A Strong Company*, Long Range Planning, Vol. 32, No. 2, pp. 225 – 36.

<sup>12</sup> Ernst & Young (2004). *Headquarters in London: Mapping, Marketing and Business Plan*, for London Development Agency. Parent companies are companies which have at least one subsidiary somewhere in the UK. We have no similar data for Scotland. Nor do we know the proportion of UK parent companies this represents. However, it would be possible to generate similar data from the Trends Business Research database for Scotland.

<sup>13</sup> Klier, T. and Testa, W. (2002). *Location Trends of Large Company Headquarters During the 1990's: Economic Perspectives Q2*, Federal Reserve Bank of Chicago.

<sup>14</sup> Davis, J.S. and Henderson, J.V. (2004). *The Agglomeration of Headquarters*.

companies. This appears to apply to both new high tech industries and more traditional industries<sup>15</sup>.

The concentration of HQs in large cities is explained by the need for access to information, knowledge and skills. The main sources of information and knowledge are customers, units within the company and suppliers (mostly business and financial services) both within and outwith the region. The implications have long been recognised:

*“The central office (HQ) executives ‘produce’ answers to unstandardised problems, problems that change frequently, radically and unpredictably... These problems are solved quickly only by consultation with a succession of experts. But most central offices would find it inefficient if not impossible to staff themselves internally with all the specialist personnel and services that they must call on from time to time to solve these problems. Nor is it convenient to transport these experts to their plant or maintain effective contact by telephone (or e-mail?) All of these considerations dictate a concentration of central offices in a tight cluster near each other and near their suppliers.”*

(R.M. Lichtenburg, 1960)<sup>16</sup>.

This analysis relates to the 1950's. However, while ICT may have relaxed the need for proximity, there is no evidence it has eliminated it.

While the emphasis varies from company to company, this problem solving role and need for face-to-face contact translates into several practical locational requirements. These are:

- A wide range of international (and domestic) air services. While what goes on in the region (e.g. customers, the company's operational units) is important, being able to reach other places is critical. Furthermore, an international airport brings into the city conventions, suppliers, customers etc.
- A diverse range of specialist business and financial services such as media, marketing, consultants, investment bankers etc. It is both the scale and diversity (which is only possible in large cities) which influence HQ locations. There is a strong correlation between the location of business services and HQs<sup>17</sup>.
- A highly skilled workforce (with skills relevant to HQ rather than production activities). The depth of the professional and managerial workforce is much greater in, for example, London than Scotland. While demand for such skills is greater in the capital, companies generally believe that recruitment costs are lower<sup>18</sup>.
- Informal networks, meetings, conferences etc. which enable HQs to undertake their 'environmental scanning' role most effectively. Within this context, it has also been shown statistically that *'having a few other HQs nearby to learn from is extremely beneficial'*<sup>19</sup>.

<sup>15</sup> See for example, Klier, T. and Testa, W. (2002) op. cit. for the US and Jacobson, S. and Onsager, K. (2003) for Europe.

<sup>16</sup> Lichtenburg, P.M. (1960). One-Tenth of a Nation, Harvard University Press, Cambridge Mass.

<sup>17</sup> Davies, J.C. and Henderson, J.V. (2004). op. cit.

<sup>18</sup> Jacobson, S. and Onsager, K. (2003). op. cit. This is a view expressed by companies located in major commercial centres. We are aware of no empirical evidence which confirms or refutes these views.

<sup>19</sup> Davies, J.C. and Henderson, J.V. (2004). op.cit.

Within the UK (and Europe), access to political and policy making institutions is also important for many companies.

The relative importance of these factors varies between companies (as does precisely what each means in practice) and this influences where they locate their HQ. Companies with their HQs in capital cities give greater weight to accessing a diversity of business services, informal networks, political institutions and 'prestige'. This helps to explain why large and more diversified companies are more likely to be in the capital.

Companies with their HQ in an industrial cluster attach greater emphasis to sector-specific information and skills, proximity to operating units and a specific 'business milieu'. To quote one company commenting on its HQ cluster location:

*"There is a complete shipping cluster in the region. You have other shipping firms, brokers, banking and insurance companies specialising in shipping. Also producers of equipment and other services and the education institutions are important for the milieu... There is a great deal of openness. I discuss market possibilities, and the production of technology with our competitors in the region. There is a general opinion that we face some common challenges."*  
(p. 27)

The study concludes "*practical and industry-specific knowledge seems to be essential for the operation of head offices in regional centres*"<sup>20</sup>. HQs in clusters are more likely to be co-located with other activities (e.g. production, R&D, marketing, purchasing) than in the case of HQs located in the capital city.

The location of HQs is strongly influenced by externalities and critical mass. These take on two distinct forms:

- **Urbanisation Economies.** These come from the scale and industrial (and service) diversity of the city. These are most extensive in the largest cities.
- **Agglomeration Economies.** Again, critical mass is essential. However, these derive from industrial specialisation (i.e. industrial clusters).

Smaller, regional cities find it difficult to achieve significant urbanisation economies. A few can, however, achieve critical mass in specific clusters (agglomeration economies).

As already illustrated, the UK's corporate HQs are heavily concentrated in London. The capital benefits from massive urbanisation economies. However, it is also home to the UK's most internationally competitive clusters including financial and business services, advertising, computing/telecom services, property and real estate, TV/film/radio/music and publishing<sup>21</sup>. In other words, it benefits from both urbanisation and agglomeration economies making it a very attractive HQ location. It is difficult for places outwith London to compete with these advantages.

<sup>20</sup> Jacobson, S. and Onsager, K. (2003). op cit. p. 27

<sup>21</sup> Trends Business Research (2000). Business Clusters in the UK: A First Assessment, Vol. 2, DTI, London.

## 2.4.2 The Changing Geography of HQs

It can be argued that flatter, more decentralised corporate structures and greater use of ICT could, or should, lead to changes in the location of HQs. More specifically, the pull of the largest cities might be somewhat reduced with more HQs able to locate in places such as Scotland.

There is no systematic UK evidence on the changing location of HQs. However, in the US, two trends dominate. First, New York has lost (and continues to lose) market share. Its share of Fortune 500 HQs fell from 30% in 1970 to around 10% today. Second, with the exception of New York, Fortune 500 HQs have become more concentrated in major cities. They have increasingly concentrated in a few cities (San Francisco, Denver, Houston, Palm Beach, Nashville) with populations of between 2 and 4 million. Smaller cities and rural areas are losing HQs.

However, the scale of change should be kept in perspective. Over the ten years 1990 – 2000, the number of large company HQs in places such as Denver and Nashville increased by between 10 and 15. From a macro perspective, the geography of HQs is remarkably stable. This is even more true in the UK and Europe than the United States.

Nevertheless, underpinning this overall stability is considerable churn and turbulence. For example, between 1995 and 2002, 284 HQs moved into London while 420 moved out. Similarly, a recent UK study of large corporations found that one quarter had re-located their HQ over a three-year period and a further quarter had moved some HQ functions because of M&A activity<sup>22</sup>. Based on all 'stand alone' US HQs, over a five-year period, the HQ birth rate is around 60% and the closure rate just over 50%<sup>23</sup>.

Given it is generally assumed that HQs are well embedded in the local economy, this amount of 'churn' is perhaps surprisingly high. Several factors explain this apparent paradox.

- The US data incorporates all 'stand alone' HQ establishments including many SME and subsidiary HQs. As is well established, there is substantial 'turnover' within the SME stock with new businesses opening and established ones closing.
- There is more 'churn' in subsidiary HQs as companies experiment, change strategies and undergo more or less continuous corporate restructuring.
- A substantial minority of large corporations (perhaps around 40% in the UK) have never changed the location of their corporate HQ<sup>24</sup>. These generally own their HQ property. The rest are much more mobile. These companies generally lease rather than own their HQ property. Mergers and acquisitions also generate change in the HQ location of large companies.

However, with a few exceptions, the overwhelming majority of Corporate HQ moves are short distance. They do not affect the broader inter-city or inter-regional distributions of HQs.

In the UK, the pattern appears to be 'long distance' drift into London with short distance moves out into the South East. For many London companies, a short distance move into the

<sup>22</sup> GVA Grimley (2002). The HQ Question.

<sup>23</sup> Davies, J.C. and Henderson, J.V. (2004). Op. cit.

<sup>24</sup> Askey, A. and Marshall, N. (1992). Op. cit.

South East reduces costs (e.g. property, wages) with relatively little increase in travel costs. However, a long distance relocation (generally referred to as a move of over 100 miles) brings few additional cost savings but a substantial increase in travel costs. This is particularly serious once the opportunity cost of the time spent travelling is taken into account. Consequently, for most companies with a London HQ, there is little cost incentive for long distance decentralisation of senior HQ staff and management functions.

As yet, there is no evidence from the US or the UK that the application of IT is changing the location of Corporate HQs. The need for (and cost of) face-to-face contact continues to concentrate HQs in larger cities and to restrict long distance decentralisation from London.

There are no UK studies explaining the changing geography of HQs. However, research from the US shows that growth in a city's number of HQs is associated with:

- Rapid population/economic growth. While this appears to be a necessary condition, it is not sufficient since many cities experienced rapid growth without attracting or growing more HQs.
- A strong and growing business and financial sector.
- A wide range of direct international air services.
- An explicit policy to attract HQs. A handful of cities have found a specific niche and created a mature commercial centre.

The ability to attract HQs is at least as much (and probably more) the consequence of economic growth as it is a cause of growth.

While in-migration of HQs has contributed to the growth of HQ activity in a few cities, over the ten years 1990 – 2000, there were only 101 large company HQ relocations in the US. At least in the US, the main determinant of change in a city's stock of large company HQs is the growth and decline of indigenous businesses.

*“Large headquarters often emerge in cities and regions in which successful new companies or industries grow... Since regions tend to specialise in certain industries, headquarter concentrations have tended to grow along with their specialised industries... This implies that the growth of stellar companies and emerging industry clusters are an important explanatory factor... This result implies that policies to assist the growth of local indigenous firms may be more beneficial than policies aimed at recruitment of footloose company HQs”<sup>25</sup>.*

It is the growth of indigenous firms which explains why the number of large company HQs increased more in San Francisco than any other US city over the past 15 years.

## 2.5 Summary and Conclusions

There is no standard HQ and their size and functions vary greatly from company to company. However, over the past 30 years, the dominant trend has been the downsizing of corporate HQs. They now employ relatively few people. This has been driven by three factors. First, decentralisation to subsidiary HQs has been used to create flatter, more flexible and

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<sup>25</sup> Klier, T. and Testa, W. (2002). Op. cit.

responsive organisations. Second, IT is being used to increase productivity and, third, increased out-sourcing is being used to reduce costs.

Decentralisation itself has generated pressures for further change. Two are of particular note. First, to reduce duplication of services brought about by decentralisation, there is a growing number of Shared Service Centres located away from HQ functions in lower cost locations. An important, but under-explored policy question, is whether these are the white collar, 21<sup>st</sup> century equivalent of the branch plant? The second consequence of decentralisation is the emergence of front-end/back-end corporate structures. It can be hypothesised that front-end subsidiary HQ location will be influenced by proximity to customers while back-end HQs may be attracted to industrial clusters with a strong technology base.

From a policy perspective, it is important to differentiate between Corporate (or parent) HQs and Subsidiary HQs. The former, more or less by definition, have greater power and autonomy. Most discussion of the economic development role of HQs implicitly or explicitly refers to Corporate HQs. With their parent company HQ located elsewhere, overseas inward investors at best create Subsidiary HQs with more or less power and autonomy.

All indigenous businesses, regardless of their size have a Corporate HQ location. The main determinant of location is the company's place of birth. At least in the US, it is the birth, growth and decline of local companies which determines the changing geography of Corporate HQs. The contribution of mobile HQs (i.e. inward investment) in most areas is small. An important strategic implication for Scotland is that the creation of more HQs in Scotland largely depends upon the creation and growth of Scottish indigenous businesses.

However, as companies grow, it becomes increasingly likely that the HQ is relocated away from the company's place of birth. This generally means a city location and, in the case of the UK, a gradual drift of large company HQs to South East England and, more specifically, London. The attraction of London reflects both urbanisation and agglomeration economies.

While there is some evidence of cost driven decentralisation of Corporate HQs out of London, this is limited to short distance moves into South East England. Longer distance decentralisation remains constrained by the need for face-to-face meetings in the capital. As yet, there is little evidence that ICT (Information, Communication Technology) is having a substantial impact on the location of HQs and enabling longer distance decentralisation or HQ growth in rural areas or smaller cities.

### 3. Scotland's Headquarters

This chapter presents an analysis of Scotland's private sector HQs. It begins with a description of the current stock differentiated by company size, industrial sector and status within the company (i.e. an independent corporate HQ or an externally controlled subsidiary HQ). It then analyses changes since 1994 identifying the reasons for the disappearance of HQs and the origin of new HQs. Finally, it presents an estimate of the direct contribution of HQs to Scottish employment.

#### 3.1 The Stock of HQs

##### 3.1.1 Number, Size and Location

There are no systematic or official data on HQs. Consequently, data on the number and characteristics of companies have to be used. The Dun and Bradstreet (D & B) database records just over 53,400 companies in Scotland. These are registered companies with limited liability. As such, all have some form of HQ in Scotland.

Of these, 51,150 are Scottish. They are managed and controlled from Scotland. Of these, 47,350 are independent companies and the rest (3,800) are subsidiaries with a Scottish parent company. There are just over 1,300 subsidiaries with their parent located in England and just under 900 subsidiaries with an overseas parent HQ.

While a large number, Scotland has fewer indigenous businesses than in the more rapidly growing parts of the UK. For example, South East England has 40% more independent limited companies per capita than Scotland<sup>26</sup>. Taking the number of businesses per capita registered for VAT, Scotland is 20% below the national (GB) average.

Nevertheless, there are a large number of businesses with their HQ in Scotland. However, it is widely assumed that there is something about large companies which differentiates their HQs from SME HQs. Following this conventional wisdom, Scotland has relatively few HQs. The D & B database records just 760 companies with over 200 employees and 113 with over 1,000 employees worldwide.

Taking the companies with over 200 employees, 29% (221) are foreign-owned subsidiaries and 16% (119) are subsidiaries of English parents. This leaves just 420 Scottish companies with over 200 employees. Of the largest companies with over 1,000 employees, there are 34 independent (i.e. parent) companies and a further 21 Scottish-owned subsidiaries. These are businesses owned by companies such as the Royal Bank. Just over 50% of the larger companies are subsidiaries with an externally located parent.

While the D & B database could be used to analyse change over time, this requires resources beyond the scope of this study. Consequently, as a more accessible data source, the subsequent analysis uses the Business Insider's list of Top 500 companies. The Top 500 are determined by a combination of sales and profitability data based on audited accounts.

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<sup>26</sup> Botham, R. (2002). The Job Creation Process: Components of Change 1995 – 99 Scotland and South East England, Training and Employment Research Unit.



Hence, all have a legal corporate presence in Scotland. While some large but non-profitable companies are excluded, the list is taken as a reasonable proxy for large companies with HQ functions in Scotland.

The ownership/control status and size of the Top 500 in 2004 is shown in Figure 3.1. The data confirms that Scotland has relatively few large company HQs. There are 91 companies with over 1,000 employees and just 19 with over 5,000 employees (the minimum size often assumed in many HQs studies).

**Figure 3.1: The Size and Status of Scotland's Top 500 (2004)**

Employment Size	Number of Companies			
	Scotland	Overseas	UK	Total
Under 200	101	43	12	156
200 – 999	167	65	21	253
1,000 – 4,999	36	20	16	72
5,000 – 24,999	12	1	-	13
25,000 – 49,999	2	-	-	2
50,000 +	3	-	1	4
<b>Total</b>	<b>321</b>	<b>129</b>	<b>50</b>	<b>500</b>

With 156 employing under 200, almost one third of Scotland's Top 500 are small firms. This raises the question of whether these companies have an identifiable HQ. A sample of these smaller businesses was examined using D & B and company websites to establish whether they have recognisable HQs. The sample included companies in sectors ranging from manufacturing, through distribution, transport and business services, to retailing and travel agencies. All were found to have one or more of the following: a separate HQ address, subsidiary companies, a formal divisional or functional structure and/or a Board of Directors. Consequently, the SMEs in the Top 500 appear to have an identifiable HQ and are, therefore, included in the subsequent analysis.

The majority (64%) of the Top 500 are Scottish with their Corporate HQ in Scotland. This includes 17(out of 19) companies with over 5,000 employees. Indeed, three (Royal Bank of Scotland, HBOS and First Group) have over 50,000 employees worldwide.

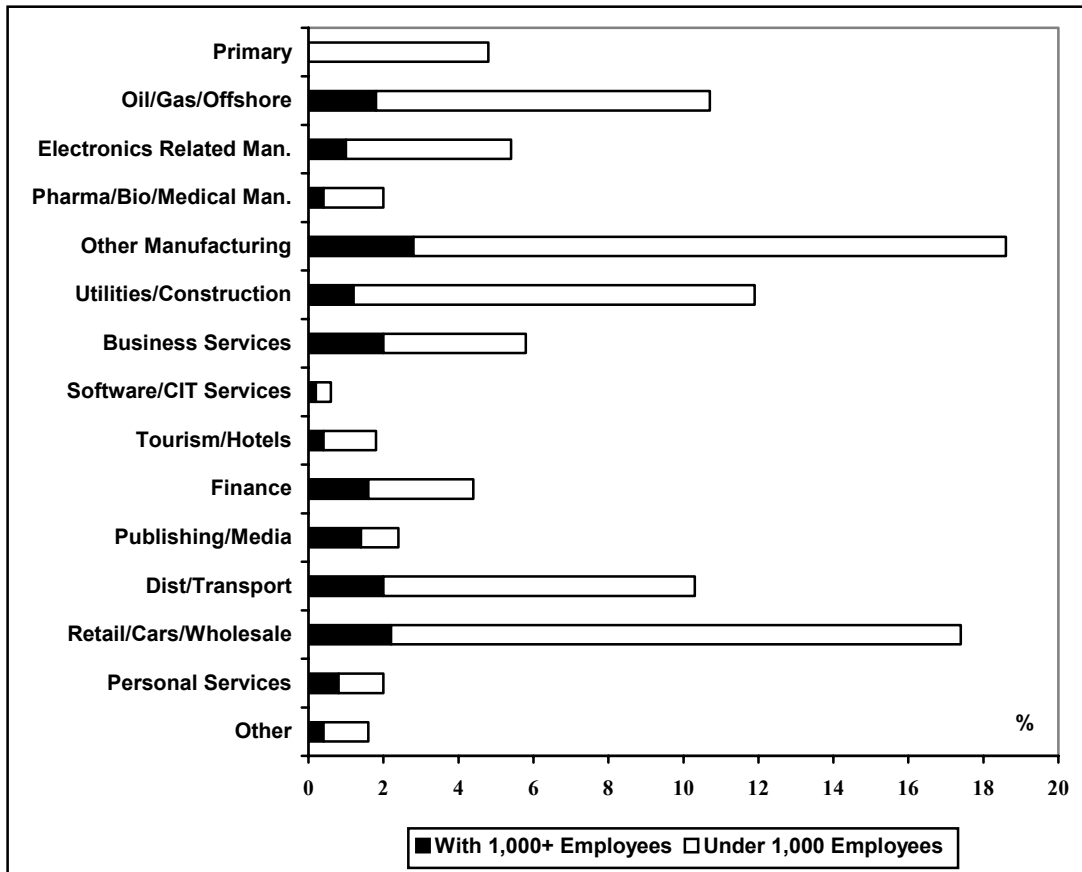
Of the Top 500, 179 are Subsidiary HQs with ultimate control located outwith Scotland. 50 have an English parent company. With one exception (James Findlay), these are relatively small. The 129 overseas controlled companies are also relatively small. This suggests that these HQs generally control the company's Scottish operations with few having control of operations outwith Scotland.

### **3.1.2 Sectoral Analysis**

Figure 3.2 shows a sectoral breakdown of the Top 500 differentiating between those with over and under 1,000 employees. The Business Insider does not allocate the companies to SICs.

Consequently, we have allocated them to a broad industrial sector based on their own description of their activity. Given that some operate in several different industries this should be seen as a broad indication of their sectoral structure.

**Figure 3.2: Percentage Sectoral Distribution of Scotland's Top 500 HQs (2004)**



Notes:

- Primary includes agricultural services, fishing, fish farming, mining (excl. North Sea).
- Oil Gas: companies from a range of industries all exclusively involved in offshore oil/gas.
- However many other companies (e.g. in distribution, construction) have a strong oil/gas orientation.
- Other Manufacturing includes a substantial number of food and drink companies.
- Utilities/Construction. The latter includes companies involved in civil engineering and property development.
- There are no software companies in the list. Those shown are telecom services (e.g. Thus).

The largest companies are spread throughout Scotland's industrial structure. However, the very largest are in the financial sector but also includes companies with little 'production' presence in Scotland (e.g. James Findlay).

Taking the Top 500 as a whole, the largest sector is Other Manufacturing which includes a substantial number of companies in traditional industries (e.g. food, drink, textiles). This is followed, with just under 17% of the Top 500, by retailing and wholesaling (including car dealerships). Other sectors with over 10% are Offshore Oil and Gas, Construction and Transport/Distribution. Just 4% are in the financial sector and there are relatively few in some of the UK's fastest growing sectors such as business services and CIT services (with none from the software industry).

### 3.1.3 The Location of HQs

The location by LEC of the Insider 500 is shown in Figure 3.3. Almost one quarter are in Glasgow with a further 20% in both Grampian and Edinburgh. Most areas (including Highlands and Islands) have a reasonable number.

**Figure 3.3: Geographic Distribution of the Business Insider Top 500: 2004**

LEC Area	Top 100	100 – 500	Top 500
Glasgow	19	96	115
Grampian	20	70	90
Edinburgh & Lothian	23	60	83
Lanarkshire	9	32	41
Tayside	3	30	33
Fife	6	25	31
Renfrewshire	8	18	26
Forth Valley	4	19	23
Ayrshire	2	21	23
Borders	1	6	7
Dumfries & Galloway	2	4	6
Dunbartonshire	3	2	5
Highlands and Islands	1	19	20

## 3.2 Changes 1994 – 2004

### 3.2.1 Overall Trends

Changes in the composition of the Top 500 by employment size and control status are shown in Figure 3.4. The number of companies with over 50,000 employees has increased from zero in 1994 to four in 2004. Three of these (The Royal Bank of Scotland, HBOS and First Group) have their Corporate HQ in Scotland. The fourth, James Findlay, now has its Corporate HQ in England.

**Figure 3.4: Changes 1994 – 2004 by Employment Size and Status**

Employment Size	Scotland	Overseas	UK	Total
Under 200	- 3	8	- 24	-19
200 – 999	30	13	- 13	30
1,000 – 4,999	- 12	1	-	- 11
5,000 – 24,999	-	-	- 3	- 3
25,000 – 49,999	- 1	-	-	- 1
50,000 +	3	-	1	4
<b>Total</b>	<b>17</b>	<b>22</b>	<b>-39</b>	<b>0</b>

Despite this, the number of companies with over 1,000 employees has fallen by 11. The fall has been in Scottish companies with between 1,000 and 5,000 employees. At the same time, the number of small firms in the Top 500 has fallen by 12% (19). The main increase has been in medium sized firms with between 200 and 1,000 employees.

Analysing the data by control status, the number of overseas controlled companies has risen by 20% (22). These are subsidiary HQs controlling relatively small companies. At the same time, the number of Scottish controlled companies has also increased by 6% (17). Most of this increase is in the medium size category of 200 to 1,000 employees.

In contrast to overseas controlled companies, there has been a decline of almost 45% (39 companies) in non-Scottish UK (i.e. essentially English) controlled companies with subsidiary HQs in Scotland. This decline has been concentrated in the SME sector. It may be that English companies are closing small Scottish subsidiaries and either serving the market from England or centralising their management function into their English HQ. This essentially leaves a branch plant in Scotland. Whatever the reason, this finding is consistent with other research using a different data source which also shows a declining non-Scottish UK sector<sup>27</sup>.

### **3.2.2 Churn and Turbulence**

While the preceding analysis shows considerable change, it is not dramatic. However, beneath these aggregate data is a much greater degree of change. A comparison of the 1994 and 2004 list shows that of the Top 500 in 1994, 297 (60%) had disappeared by 2004. The other side of the coin is, of course, that there are 297 new entrants into the Top 500. In making these estimates, self-evident name changes causing an exit (often with an associated re-named company entrant) were excluded (i.e. they counted as being in both the 1994 and 2004 lists). However, the subsequent analysis found that several exits/entrants were in fact name changes (e.g. Grampian Holdings changed its name to the Malcolm Group Plc). Nevertheless, despite these, the conclusion stands that there was great turnover (or churn and turbulence) in Scotland's Top 500 companies over the period 1994 – 2004.

These changes occur for many reasons. Companies may exit the list because, for example:

- They are acquired and lose their status as separate companies. In these cases, their HQ may be closed. On other occasions, the company may retain its separate identity but as a subsidiary company.
- A decline in sales, and, more likely, profitability means they fall out of the Top 500. In extreme cases, they may disappear because of bankruptcy.
- It moves its HQ outwith Scotland. However, some may move their HQ yet remain in the list because they remain registered in Scotland.
- The company changes its name. It may do this following a restructuring or acquisition of another business. In these cases, the new name appears in the list of new entrants.

The extent to which these exits represent a real loss of HQs (e.g. via acquisitions, out-migration or bankruptcy) or are more apparent than real (i.e. a name change) is examined further in Section 3.4.

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<sup>27</sup> Botham, R. (2002). The Job Creation Process: Components of Change 1995 – 99 Scotland and South East England, Report for Scottish Enterprise, Training and Employment Research Unit.

As already indicated, new entrants may be the flip side of exits. The new company is simply an old business with a new name. In addition, entrants could reflect:

- A new company formed via organisational change. This includes the privatisation of public sector businesses and the merger of pre-existing businesses forming a new entry into the Top 500.
- An independent high growth new start or the improved performance of an existing business.
- A large new company could be created, for example, by an existing business spinning off part of its operations or by a joint venture between established businesses.

As with exits, some of these changes are real bringing new HQs while others are more apparent than real.

### 3.3 The Loss of HQs: Exits

#### 3.3.1 Size and Structure

Figure 3.5 shows the exits analysed by their 1994 employment and control status. It also shows the exits as a percentage of the 1994 stock. The characteristics of the exits can be summarised as follows:

- The majority had less than 1,000 employees. The proportion of exiting companies is around 60% for all size categories below 5,000 employees. With just over 20% disappearing, the exit rate for larger companies is lower.
- Exits are more or less evenly split between Scottish companies and externally controlled subsidiaries.
- The exit rate is higher for externally controlled companies than indigenous Scottish businesses. Compared to 50% of Scottish companies, almost 70% of overseas and 80% of non-Scottish UK companies disappeared between 1994 and 2004.

While subject to much churn and turbulence, the data suggests that indigenous Scottish businesses (and their HQs) are more 'semi-permanent' than externally controlled subsidiaries.

**Figure 3.5: 1994 – 2004 Exits by Employment and Status**

Employment Size	Scotland	Overseas	UK	Total
Under 200	53	27	29	109
200 – 999	71	36	26	133
1,000 – 4,999	25	10	16	51
5,000 – 24,999	4	-	-	4
25,000 – 49,999	-	-	-	-
50,000 +	-	-	-	-
Total	153	73	71	297
% of 1994 stock	50.3	68.2	79.8	59.4

### 3.3.2 The Reasons for Exiting

There is a long standing concern that Scotland has lost indigenous HQs via the acquisition of Scottish companies by non-Scottish companies. Indeed, there is a long list of famous names (e.g. Anderson Strathclyde, Distillers, John Brown Shipbuilders, Arthur Bell and Son) which have disappeared following acquisition by English companies while others (especially in shipbuilding and steel) disappeared following nationalisation.

During the 1960s and 1970s, many medium size businesses were purchased by companies with their HQ in Southern England<sup>28</sup>. During the 1980s, the focus shifted to the acquisition of some of Scotland's largest and most successful businesses<sup>29</sup>. Of Scotland's 50 largest manufacturing companies in 1980, 20% had been acquired by 1990. Of its 79 PLCs outwith energy and finance in 1985, 16 had been taken over by 1988<sup>30</sup>.

As far as we are aware, there is no recent research on the acquisition of Scottish companies. To establish the extent to which the external acquisition of Scottish companies continues and accounts for their exit from the Top 500 Insider list, an analysis of the reasons for exit was undertaken. Using a variety of databases and newspaper records, the reasons for exit of all Scottish companies with over 1,000 employees was analysed. A similar analysis was undertaken for a 20% sample of the smaller companies exiting the Top 500.

The results are summarised in Figure 3.6, differentiating between companies with over and under 1,000 employees. Of the 153 Scottish exits, 56% disappeared from the Top 500 because they were acquired by another business. Some 9% were purchased by other Scottish companies. For example, the First Group, Wiseman and Grampian Country Foods grew by purchasing other Scottish bus, dairy and food manufacturing companies. However, just over 70 disappeared because they were purchased by a non-Scottish company.

**Figure 3.6: Reasons for Exiting Top 500: % of Scottish Companies Leaving the List 1994 - 2004**

Reason for Exit	1995 Employment		Total
	Over 1,000	Under 1000	
External Acquisition	41.4	48.5	47.4
Acquisition by a Scottish Company	10.4	9.1	9.2
Closed/Bankrupt	3.4	12.1	10.5
Restructuring	13.8	9.1	9.8
Name Change	17.2	18.2	17.8
Other	13.8	3.0	5.3

<sup>28</sup> Ashcroft, B.K. et al. (1987). The Economic Effects of the Inward Acquisition of Scottish Companies 1965 – 1980, ESU Research Paper 11, Industry Department of Scotland.

<sup>29</sup> Henry, D. (1988). The North-South Divide: Merger Mania and Its Impact on the Regions, P.E. Inbucon.

<sup>30</sup> Henry, D. (1988). Op cit.

In addition a further 14 remain in the list but with a non-Scottish, rather than Scottish, Corporate HQ address. This occurred generally after their acquisition leaving either a Subsidiary HQ or little more than a nameplate in Scotland. Combining the exits and those shown as changing ownership, just over 20% of the Scottish companies in the 1994 Top 500 had been acquired by a non-Scottish company by 2004.

It is also clear from Figure 3.6 that the majority of the exits are real (rather than name changes). Around 10% went bankrupt and a further 10% dropped out of the list because of corporate restructuring. This took several forms including companies selling off part of the business (sometimes via MBOs) or splitting up into smaller separate businesses. The other category consists of a few companies which relocated their HQ to England. Including companies such as Christian Salvesen, these were mostly in the larger company category.

Figure 3.7 shows the Scottish companies with over 1,000 employees which exited the Top 500 and the reasons for their exit to give a feel for the type of HQs being lost. The list includes many famous names such as Stakis, Howden, Low & Bonar, Motherwell Bridge and Shanks & McEwan. It also includes four substantial financial companies (General Accident, Scottish Life, Scottish Provident and Scottish Amicable).

**Figure 3.7: Large Scottish Companies Exiting the Top 500 1994 – 2004**

Name of Company	1995 Jobs	Sector	Reason for Exit
<b>Christian Salvesen</b>	15,942	Distribution/Food Processing	Aggreko demerged from Christian Salvesen in 1997. Company still has a registered office in Edinburgh and plants in Scotland but is now based in Northampton
<b>General Accident</b>	11,908	Insurance	Merged with Commercial Union in 1998 to form CGU, which then merged with Norwich Union to form Aviva, based in London
<b>Stakis</b>	5,819	Hotel and Leisure	Acquired by Hilton Group (England) in 1999
<b>Watson &amp; Philip</b>	50,28	Food Retailer & Dist	Changed name to Alldays, relocated to Southampton in 1999. Entered receivership and was bought by the Co-operative Group (England) in 2002
<b>Howden Group</b>	4,751	Holding Co. (Engineering	Acquired by Charter plc (England) in 1997
<b>Low &amp; Bonar</b>	4,214	Packaging Plastics & Special Materials	Head office moved to London in 2000
<b>Marshall Food Group</b>	4,098	Poultry Production and Convenience Foods	Acquired by Grampian Country Food (Scotland) in 1998
<b>Scottish Hydro-Electric</b>	3,552	Electricity Generation	Merged with Southern Energy (England) in 1998 to form Scottish and Southern Energy (Scotland)
<b>Kwik-Fit Holdings</b>	3,543	Motor Parts	Acquired by Ford (UK) in 1999
<b>Amec Offshore Developments</b>	3,539	Offshore Contracting	Merged with SPIE (France) in 2003. HQ now in London
<b>AOC International</b>	3,121	Offshore Engineering, Construction and Project Management	Bought in 1997 by Brown and Root (now Kellogg Brown and Root), a wholly owned subsidiary of Halliburton (US).

Name of Company	1995 Jobs	Sector	Reason for Exit
<b>Motherwell Bridge Holdings</b>	2,866	Engineering	Went through 'revolving-door' receivership in 2003 – viable parts of business were bought out of receivership by a new company – MB Engineering Solutions
<b>WEW Group</b>	2,741	Retail	Acquired by Brown and Jackson (South Africa) in 1997. Entered receivership, wound up in 2003
<b>Sidlaw Group</b>	2,700	Oil, Packaging, Textiles	Acquired by Danisco (Denmark) in 1999
<b>SB Holdings</b>	2,443	Provision of Public Transport	Acquired By First Group (Scotland) in 1998
<b>Scottish Amicable</b>	2,368	Life Insurance, Pensions, Investment	Acquired by Prudential plc (UK) in 1997
<b>Scottish Nuclear</b>	2,060	Electricity Generation	Scottish subsidiary of British Energy, which was privatised in 1996. Merged with English subsidiary, Nuclear Electric, in 1998. British Energy has its head office in East Kilbride
<b>Grampian Holdings</b>	1,893	Manufacturing, Trading, Transport	Renamed Malcolm Group plc in 2002
<b>Morrison Construction Group</b>	1,775	Builders	Acquired by Anglian Water (UK) in 2000
<b>Richards</b>	1,739	Textiles	Went into administration in 2002, sold four subsidiaries. Was bought out of receivership by a local businessman. Still trading under Richards name.
<b>Eclipse Blinds</b>	1,687	Window Blinds	Bought in 1999 by Headlam (UK), sold to Hunter Douglas Group (Netherlands) in 2002
<b>Scottish Life</b>	1,488	Life Insurance, Pensions, Investment	Acquired by Royal London (UK) in 2001
<b>Scottish Provident</b>	1,468	Life Insurance, Pensions, Investment	Acquired by Abbey National (UK) in 2000
<b>GRT Bus Group</b>	1,464	Transport Related Services	Merged with Badgerline (UK) in 1995 to become FirstBus, now First Group
<b>David A Hall</b>	1,390	Production & Meat Distribution	Acquired by Grampian Country Food Group in 1998
<b>Shanks &amp; McEwan Group</b>	1,318	Waste Disposal/Construction	Still registered in Scotland but head office is now in Buckinghamshire
<b>Bowie-Castlebank</b>	1,210	Dry Cleaning/Film Processing	Unknown
<b>Scottish Milk Marketing Board</b>	1,108	Dairy Products	Lost statutory powers in 1994 – succeeded by Scottish Milk and Scottish Pride (dairy processing business). Scottish Pride went into receivership in 1997.

Given the importance of financial services to the Scottish economy, the external acquisition of financial companies is worthy of particular note:

- As an independent company, General Accident had its HQ in Perth. Following its merger with Commercial Union (forming CGU), its Corporate HQ functions were located in England (in part because Commercial Union's senior management would not move to Perth). Following the merger of CGU and Norwich Union, the Perth facility is now part of Aviva. The demise of General Accident was the culmination of



an ongoing trend. Between the early 1960's and 1990's, at least 8 Scottish non-life insurance companies were acquired by non-Scottish companies.

- In addition to the three life insurance businesses shown in Figure 3.7 (i.e. Amicable, Provident, Life), three other life insurers (Scottish Mutual, Equitable and Widows) had also been acquired by English companies in the early 1990's. The consequence is that the number of Scottish life insurers has declined from seven in the early 1990's to just one (Standard Life) today.

The two major retail banks have expanded via acquisitions. However, for many financial service companies 'ultimate decision making control has shifted away from Scotland'<sup>31</sup>.

### 3.4 The New HQs

#### 3.4.1 Size and Structure

The new entrants into the Top 500 by 2004 employment size and control status are shown in Figure 3.8. Almost 60% are indigenous Scottish companies. The majority of these have under 1,000 employees. However, one new entrant (First Group) now has almost 60,000 employees in the UK and overseas.

**Figure 3.8 1994 – 2004 Entrants by Employment Size and Status**

Employment Size	Scotland	Overseas	UK	Total
Under 200	70	35	9	114
200 – 999	86	46	13	145
1,000 – 4,999	15	11	6	32
5,000 – 24,999	4	1	-	5
25,000 – 49,999	-	-	-	-
50,000 +	1	-	-	1
<b>Total</b>	<b>174</b>	<b>93</b>	<b>28</b>	<b>297</b>

A further third are overseas-owned subsidiaries. Again, the majority are relatively small with under 1,000 employees. This suggests their HQ controls the Scottish operation rather than having control over, for example, European operations. Just 28 English companies entered the list. Not only did many English companies withdraw from Scotland, but relatively few felt the need to establish new Scottish subsidiaries.

#### 3.4.2 The Origin of New HQs

The origin of all companies entering the Top 500 with over 500 employees was examined. A similar analysis was undertaken for a 20% sample of the smaller entrants. The results are summarised in Figure 3.9. The analysis differentiates between companies with over and less than 1,000 employees. The figures for all entrants were obtained by combining the analysis of companies with over 500 and the grossed up 20% sample of smaller entrants.

<sup>31</sup> Deloitte (2004). Scottish Financial Services Industry: PEST/SWOT Analysis. Report for Scottish Executive/Scottish Enterprise Edinburgh and Lothian.

**Figure 3.9: Origin of Entries into Top 500 (% of Entrants)**

	Over 1,000	Under 1,000	Total
Growth of Existing Company	49	77	74
New Company; Growth from Zero	1	9	8
Company Spin Out/De-merger etc.	15	5	6
Name Change (i.e. already in 1994 list)	35	9	12

Figure 3.9 shows that almost 75% of new entrants came about via the growth of an existing business not in the 1994 Top 500. Most of these have less than 1,000 employees. To illustrate the origin of the largest new HQs, Figure 3.10 gives details of new entrants with over 1,000 employees. Growth of an existing business accounts for just under 50% of new entrants with over 1,000 employees. Most of these, for example, Macdonalds Hotels, Abbot Group, Babbie Group, Highfields Hotels and the Aviagen Group, achieved growth via the acquisition of other (usually Scottish-based) businesses. A few such as City Refrigeration and Telecom Service Centres Ltd. entered the list mainly due to organic growth.

**Figure 3.10: The Origin of New HQs with Corporate Employment of 1,000+**

Name	Country of Ownership	Sector	Total Employees	Reason for Entry
FirstGroup Plc	Scotland	Transport	57,119	Formed from merger of GRT Bus Group (Scotland, on 1995 list) and Badgerline (UK) in 1995. Bought Strathclyde Buses (Scotland, on 1995 list) in 1996.
Scottish & Southern Energy Plc	Scotland	Services & Utilities	9,474	Created by the merger in 1998 of Scottish Hydro-Electric (on 1995 list) and Southern Electric (UK).
City Refrigeration Holdings Ltd	Scotland	Retail	8,016	Growth
British Energy Plc	Scotland	Services & Utilities	7,902	Merger of Scottish and English subsidiaries (Scottish Nuclear, on 1995 list, and Nuclear Electric) into single organization in 1998
Macdonald Hotels Plc	Scotland	Hotels & Leisure	5,799	Has acquired and built a series of hotels throughout the UK
AEGON UK Plc	Netherlands	Life & Insurance	5,044	Acquired Scottish Equitable (on 1995 list) in 1999
Abbot Group Plc	Scotland	Offshore	4,892	Acquired rival firm Deutag (Germany) in 2001, and merged it with subsidiary KCA
MITIE Olscot Ltd	UK	Services & Utilities	3,614	Growth
Babbie Group Ltd	Scotland	Industrial & Manufacturing	3,468	Made a series of acquisitions – Kensall, BMT and Allott & Lomax (UK) in 2000, Rushbrook (Scotland) in 2002.
Scotrail Railways Ltd	UK	Transport	3,138	Franchise to run Scotland's trains, won in 1997 by National Express (UK)
First Engineering Holdings Ltd	UK	Engineering	2,895	MBO from British Railways Board in 1996, acquired by Peterhouse (UK) in 2002
McQueen International Ltd	USA	Services & Utilities	2,303	On 1995 list as McQueen (Scotland) Acquired by Sykes Enterprises (USA) in 1998

Name	Country of Ownership	Sector	Total Employees	Reason for Entry
<b>Highfield Holdings Ltd</b>	UK	Services & Utilities	2,284	Has made a series of acquisitions, of individual nursing homes and St Andrews Group (UK) in 1997
<b>Jabil Circuit Holdings Ltd</b>	USA	Electronics	2,129	Scottish plant opened in 1997
<b>Aggreko plc</b>	Scotland	Industrial & Manufacturing	2,111	Demerged from Christian Salvesen Group (Scotland on 1995 list) in 1997
<b>Internacionale Ltd</b>	Scotland	Retail	2,101	Formerly known as Razzle Dazzle (on 1995 list)
<b>Thus Plc</b>	Scotland	Services & Utilities	2,068	Demerged from Scottish Power (Scotland, on 1995 list) in 2002
<b>Simclar Group Ltd</b>	Scotland	Electronics	1,960	Bought majority stake in Techdyne (US) in 2001. Acquired Fullarton Computer Industries (on 1995 list) in 2002 and AG Technologies (Mexico) in 2003
<b>Expro International Group PLC</b>	UK	Offshore	1,919	Growth and acquisition of Tripoint and Kinley (both US)
<b>Petrofac Facilities Management Group Ltd</b>	UK	Offshore	1,904	Acquisition of Chrysalis Learning (Scotland) and Atlantic Power from PGS (Norway)
<b>Hewlett Packard Manufacturing Ltd</b>	USA	Electronics	1,787	Acquired Compaq (US) including Renfrewshire plant employing over 1,000 in 2002.
<b>NCR Financial Solutions Group Ltd</b>	USA	Electronics	1,787	In 1997 won contract to produce ATMs at Dundee factory - now make over a quarter of the world's ATMs there
<b>Telecom Service Centres Ltd</b>	Scotland	Services & Utilities	1,619	Organic growth – TSC have set up several new call centres since being started in 1994
<b>SMG Plc</b>	Scotland	Marketing & Media	1,611	Created by Scottish Television's purchase of Caledonian Publishing in 1996. (Both Scotland, on 1995 list)
<b>Aviagen Group Ltd</b>	Scotland	Food & Farming	1,494	Merger of Ross Breeders (Scotland) and Arbor Acres (US) in 1999
<b>Solectron Scotland Ltd</b>	USA	Electronics	1,442	Growth
<b>Malcolm Group Plc</b>	Scotland	Industrial & Manufacturing	1,415	Formerly known as Grampian Holdings (on 1995 list)
<b>Universal Sodexho Scotland Ltd</b>	France	Offshore	1,410	Acquisition of Universal Kelvin (Canada) by Sodexho Alliance Group
<b>Pan European Seafoods UK Ltd</b>	Belgium	Food & Farming	1,267	Acquired Macrae group (Scotland)
<b>Lothian Borders &amp; Angus Co-operative Society Ltd</b>	Scotland	Retail	1,182	Lothian and Borders Co-op merged with Angus Co-op in 1998
<b>USC Group Plc</b>	Scotland	Retail	1,111	Expansion – chain has grown from 6 stores in 1997 to 40 in 2004
<b>TBH Trading Ltd</b>	Scotland	Retail	1,108	Investment company, has acquired a series of retail chains
<b>TPAS (UK) Ltd</b>	USA	Services & Utilities	1,093	Growth
<b>BJ Services Co Ltd</b>	USA	Offshore	1,053	Won a series of major contracts, and profits benefited from high oil price

Name	Country of Ownership	Sector	Total Employees	Reason for Entry
<b>DCM (Optical Holdings) Ltd</b>	Scotland	Services & Utilities	1,053	Parent company of Optical Express. Acquired 36 Eyecare stores from the Co-operative Group in 2001 and bought 20 Health Clinic stores from administration in 2002.
<b>McAlpine Business Services Ltd</b>	UK	Industrial & Manufacturing	1,052	Growth
<b>Technip Offshore UK Ltd</b>	France	Offshore	1,049	Acquired Coflexip (France) in 2001
<b>Inverness Medical Ltd</b>	USA	Industrial & Manufacturing	1,045	Started in 1995, acquired in 2001 by Johnson & Johnson (US)
<b>Lexmark International (Scotland) Ltd</b>	Switzerland	Industrial & Manufacturing	1,031	Scottish plant opened in 1996

Completely new companies with no Scottish employment in 1994 account for 8% of entrants. The majority have less than 1,000 employees. Such companies account for just 1% of new entrants with over 1,000 employees. With only one or two exceptions, almost all of these (and all of them with over 1,000 employees) are inward investors creating subsidiary HQs. There is little evidence of new, independent Scottish companies set up post-1994 making it into the Top 500 by 2004.

A further 6% are new companies which have spun off from a company which was in the 1994 Top 500. Such new starts are relatively large and account for 15% of new entrants with over 1,000 employees. These include, for example, Aggreko which spun off from Christian Salvesen, Thus which came out of Scottish Power and First Engineering Holdings is an MBO from British Rail.

Figure 3.9 shows that only 12% of new entrants were because of some form of name change. Most new entrants are real. However, it also shows that 35% of the new entrants with over 1,000 employees were due to name changes. In other words, at least some part of the business was in the 1994 Top 500 under a different name. A few of these may represent little more than a name change. For example, Grampian Holdings became the Malcolm Group Plc.

On the other hand, Figure 3.10 shows that many also involved company growth via mergers and acquisitions. For example, the First Group was created by the merger of two Scottish bus companies (GRT Bus and Badgerline) in 1995 with the subsequent acquisition of Strathclyde Buses in 1996. Two of these companies (GRT Buses and Strathclyde Buses) were in the 1994 Top 500.

Other companies falling into this category shown in Figure 3.10 are Scottish & Southern Energy, British Energy Plc and SMG Plc. Several overseas companies have entered the list via the acquisition of businesses which already existed in 1994. For example, Aegon UK Plc purchased Scottish Equitable while Hewlett Packard entered the list via its acquisition of Compaq.

A review of Figure 3.10 illustrates two further important features of the large new entrants. First, several have their origins in the privatisation of energy and transport industries. Second, while companies with an English HQ account for just 9% of new entrants, they account for 16% of entrants with over 1,000 employees including some of the largest businesses such as Scotrail (owned by National Express), First Engineering and Highfield Holdings.

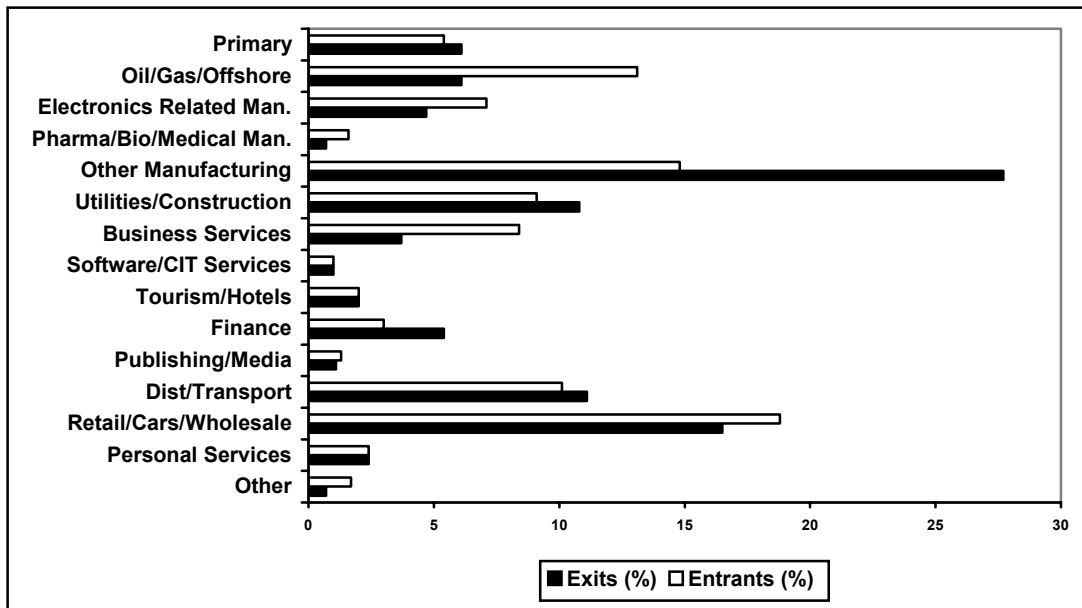
### 3.5 Sectoral Changes

To illustrate the changing sectoral structure of Scotland's HQs, Figure 3.11 shows the percentage of exits from, and entrants to, the Insider Top 500 for the period 1994 – 2004. The main trends are:

- A decline in the number of manufacturing companies (outwith electronics). Other manufacturing accounts for almost 30% of exits compared to 15% of entrants. Nevertheless, over 40 manufacturing companies entered the list (while 80 disappeared from the list).
- The number of electronics companies in the list continued to increase (mainly via inward investment).
- The North Sea Oil and Gas related sector expanded with 13% of entrants (compared to 6% of exits).
- Entrants exceeded the number of exits in Business Services and the Retail/Wholesale sector also marginally increased its share of Scottish HQs.
- Perhaps surprisingly, the number of finance companies in the Top 500 declined. More exited the list (including some large well known names) than entered.
- With the exception of one or two new entrants such as Thus and Wolfson Micro-electronics, there is little evidence of growth in the 'new economy' and no evidence of the emergence of substantial companies in the software industry.

With the exception of the decline of manufacturing (excluding electronics) and the growth of Offshore Oil and Gas, the extent of structural change in the composition of Scotland's HQs has been limited.

**Figure 3.11: Sectoral Changes 1994 – 2004: % of Exits and Entrants**



## Scotland as a HQ Location

There is little evidence of English companies moving HQ functions to Scotland. On the other hand, over the past decade a few Scottish companies have moved HQ functions to London and South East England. The study has gathered no systematic data on Scotland as a HQ location. Nevertheless, interviews with a limited number of Scottish HQs offer illustrative evidence on Scotland as a HQ location.

Several noted that their HQ is in Scotland because of a 'historical accident'. In other words, the HQ is in Scotland because the company was born in Scotland. Given a blank page some said that London and the South East would be a preferable location. Indeed, some Scottish companies have at least some HQ functions such as IT service procurement in England. On the other hand, most see Scotland as the best UK regional location outwith London.

Relative to other UK regions, Scotland's two main advantages are quality of life with beneficial implications for staff retention and air service access to London. The two main disadvantages which emerged were communications and staff recruitment. It was accepted that the low cost airlines had improved the range of available air services. Nevertheless, access to much of the UK and the relative absence of international flights are seen as a significant disadvantage.

While some of our interviewees have had no HQ staff recruitment problems, others noted that it is difficult to attract staff from outwith Scotland. At least one interviewee noted that some HQ functions are in England because, following an acquisition, staff were reluctant to move to Scotland.

Two inter-related difficulties were noted. First, the absence of a strong HQ labour market limits potential mobility and career prospects in Scotland. This makes moving to Scotland risky. This is linked to the second difficulty, namely the problem of getting back into the South East housing market should staff wish to return 'down South'. For many younger staff, such a

move is often necessary because of the weakness of the Scottish labour market. One of our interviewees suggested that policy initiatives are required to reduce the risk of moving to Scotland via mechanisms which enable re-entry into the South East housing market.

### 3.7 Direct Contribution to the Scottish Economy

The brief calls for an estimate of the direct contribution of HQs to the Scottish economy. It is not self-evident how this can, or should be, measured or, indeed, what the direct contribution actually means. It can become indistinguishable from estimates of the contribution of large businesses (rather than HQs) to the economy. For example, it has recently been claimed that Scotland's Top 100 companies (both indigenous and externally-owned) account for 56% of Scottish GVA<sup>32</sup>. At almost £41bn, they generate a great deal of wealth.

Similarly, an analysis of the Business Insider Top 500 shows that they employ 793,000. This is 257,400 more than in 1994. Most of the growth (87%) was generated by four companies (RBS, HBOS, First Group and James Findlay) which expanded into the 50,000 plus employment category.

However, these figures over-estimate the contribution of these large companies to the Scottish economy. Much of their employment and, therefore GVA, is generated outwith Scotland. Similarly, much of the income (both from employment and profits) also accrues to residents outwith Scotland. Nor does the employment growth in these companies necessarily generate growth in the Scottish economy. Much of the employment growth is both outwith Scotland and via mergers and acquisitions rather than actual job creation.

There are no data on the actual contribution of these large businesses to the Scottish economy. However, the two large banks (RBS and HBOS) account for almost 40% of the GVA generated by the Top 100. It has been estimated that around 13% of the Royal Bank's employment is in Scotland<sup>33</sup>. Consequently, most of its GVA is not generated in Scotland. Hence, the figures quoted above over-estimate the direct contribution of large companies to the Scottish economy. Furthermore, these estimates relate to the contribution of the company as a whole and not to their HQs per se.

An alternative methodology is to use Dun & Bradstreet data to estimate local employment in parent companies. On this basis, it has been claimed that 20% of London's employment is in HQs<sup>34</sup>. However, most of this is operational rather than HQ type employment. A more realistic estimate of capital city HQ employment is provided by research in New York. Based on all identifiable Corporate and Subsidiary HQs in New York, it is estimated that around 3% of the City's employment is in HQs.

As already illustrated, employment in Corporate HQs is relatively small but varies greatly between companies. For example, D&B shows that of Kwik Fit's 7,000 employees, 60 are at its HQ location. The equivalent figures for Stagecoach are 2,700 employees with 500 in Perth (i.e. its HQ location). In contrast, Rock Steady Securities, with 2,500 employees, records just

<sup>32</sup> Royal Bank of Scotland (2004). Wealth Creation in Scotland: A Study of Scotland's Top 100 Companies.

<sup>33</sup> Deloitte (2004). op cit, page 52.

<sup>34</sup> Ernst & Young (2004). Headquarters in London: Mapping, Marketing and Business Plan, London Development Agency.

6 at its Edinburgh HQ site. Unfortunately, D&B does not provide this information for the majority of companies.

To estimate Corporate HQ employment in Scotland, data on HQ staff per 1,000 employees taken from the study by Young *et. al.* have been applied to the Business Insider Top 500. As discussed in Section 2.2, the study by Young *et. al.* provides data on the average employment size of large UK company HQs and how their size varies by company size and industrial sector. Taking into account company size and the proportion of Scotland's businesses in the financial and privatised sectors (both of which have above average HQ employment), we estimate that the Top 500 have approximately 6,000 HQ staff. In broad terms, 30% of Scotland's HQ employment is in the financial sector and, 60% is in the 19 companies with over 5,000 employees. The analysis is summarised in Figure 3.12.

**Figure 3.12 Estimation of HQ Employment in Scottish Top 500 Companies**

Corporate Employment Size Band	HQ Staff per 1,000 Employees		Employment in Top 500		Estimated HQ Employment	
	All Sectors Excluding Finance	Finance	All Sectors Excluding Finance	Finance	All Sectors Excluding Finance	Finance
0 – 4,999	7.8	19.5	269,250	8,700	2,020	170
5 – 9,999	5.9	14.7	66,800		400	
10 – 19,999	6.5	16.2	59,100		390	
20 – 49,999	6.7	16.7	88,500		600	
50,000+	3.5	8.7	124,750	175,800	450	1,530
			<b>608,400</b>	<b>184,500</b>	<b>3,860</b>	<b>1,700</b>

*Sources and Notes:*

- i) HQ staff per 1,000 corporate employees is from the survey of UK companies reported in D. Young *et. al.* (2000), *op. cit.*
- ii) Employment in Scottish companies is taken from data in the Business Insider Top 500.
- iii) Estimated HQ employment is obtained by multiplying corporate employment by HQ staff per 1,000 employees.
- iv) To allow for the number of privatised companies in regulated markets, the estimate of HQ staff has been increased from 5,560 (as calculated above) to 6,000.

This 'ball park' figure excludes many working at the HQ site but not involved in HQ functions and staff working in Subsidiary HQs in Scotland (but not in the Insider Top 500). Nevertheless, even if a substantial under-estimate, the conclusion is that the direct job contribution of headquarters is small.

### 3.8 Strategic Implications

Scotland has relatively few large indigenous companies with their HQ in Scotland. Indeed, a substantial proportion of its Top 500 companies are SMEs and/or externally-owned. Between them, the HQs of these companies employ relatively few people. The importance of HQs to the Scottish economy is not their direct employment *per se*.

The largest HQs are those of companies originally born and bred in Scotland. Nevertheless, there is evidence that over time the HQ functions of these businesses drift towards South East England. While several Scottish companies have grown substantially via the acquisition of non-Scottish companies, it is also clear that the long established process through which



Scottish companies are acquired by non-Scottish companies continues. This leads to the loss of HQ functions. This process is particularly noticeable in the financial sector.

Despite the acquisition of Scottish companies, the number of indigenous businesses in the Top 500 has increased over the past decade. However, many of these are in sectors such as retailing and car dealerships. There is little evidence of 'New Economy' businesses entering the Top 500.

In contrast, the number of English companies in the Top 500 has declined substantially, while the number of overseas controlled subsidiaries in the Top 500 has increased. Relatively little is known about the HQ functions and decision making autonomy of these businesses. Given these trends, the changing nature of inward investment and, in particular, mobile HQs is examined in the next chapter.

## 4. Foreign Direct Investment

As illustrated in the previous chapter, overseas-owned companies account for a substantial and growing proportion of Scotland's Top 500 businesses. Between 1994 and 2004, their share increased from 21% to 25%. While almost 70% of the 1994 stock disappeared by 2004, over 90 new inward investors entered the Top 500 between 1994 and 2004. They accounted for 31% of all new entrants. Given their strong presence in Scotland and Scottish Enterprise's aim of attracting higher value inward investment, this chapter examines the available evidence on internationally mobile HQ functions. As a starting point, we have taken these to include HQs per se, sales and marketing projects and R&D investments.

### 4.1 'High Value' FDI

#### 4.1.1 *The Changing Nature of Foreign Direct Investment*<sup>35</sup>

It is widely argued that the nature of foreign direct investment (FDI) is changing with, in particular, an increasing number of 'high value' projects. In contrast to branch plants, these are generally seen as subsidiaries with a wider range of business functions such as marketing, product development, R&D and greater management autonomy. In this context, these more autonomous subsidiaries have a greater range of HQ functions.

Historically, companies obtained their competitive advantage from their home base which they subsequently used to exploit overseas markets via overseas investments. Many MNEs were based on a core-periphery model with an all powerful HQ and overseas implementers (i.e. branch plants) held together via a hierarchical structure.

As discussed in Chapter Two, many large companies have decentralised management and HQ functions. The factors driving this trend have also encouraged and enabled MNEs to internationalise their management structures. In addition, some MNEs are seeking to augment, or add to, their competitive advantage by tapping into overseas assets and resources.

At least in part, this trend is driven by an acceptance that geography still matters. To enhance their innovative capacity, companies are seeking to exploit differentiated, complementary or less costly overseas R&D. Markets also remain differentiated. There are few truly global products. Seeking to meet societal needs in different (rather than simply a global) geographic markets enables a wider range of product innovation. At the same time, companies are seeking to exploit economies of scale while simultaneously enhancing their local responsiveness. The latter is difficult to achieve via a business run from an all powerful central HQ.

In an attempt to reconcile the globalisation/localisation dilemma, new organisational models are emerging. These are generally variants on a theme going under such names as subsidiaries with global product mandates, regional (i.e. triad) mandates, Centres of

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<sup>35</sup> This section is largely based on Holm, U. and Pederson, T. (2000). *The Emergence and Impact of MNE Centres of Excellence: A Subsidiary Perspective*, Macmillan Press and Birkenhead, J. et. al. (2003). *The Future of the Multinational Company*, John Wiley & Sons Ltd, Chichester.

Excellence and 'multi-home based' organisations. Such subsidiaries are of strategic importance to the corporation and, while usually still an integral (rather than independent) part of the corporation, they have a wider range of management functions and greater authority (or at least influence within the corporation). Consequently, these subsidiaries have HQ functions.

Such subsidiaries often emerge from, or grow out of, existing inward investments. This may be driven by a central HQ decision to exploit a local asset or by the 'entrepreneurial flair' of local management. Ultimately, however, the process of upgrading an existing subsidiary has to be recognised and supported by the corporate HQ. This illustrates an important point. While the business may develop a wider range of management and 'higher value' functions and greater autonomy, it nevertheless remains a subsidiary company. This limits the range of HQ functions.

The probability of a subsidiary being upgraded is, in part, dependent upon the business environment. For example, dynamic local economies and competitive clusters both attract Centres of Excellence and enable existing subsidiaries to upgrade to become Centres of Excellence. To benefit from the local business environment, companies need to become 'cluster insiders'. This, in turn, requires greater local management autonomy (and, therefore, more HQ functions).

Business relationships both within the MNE and between the subsidiary and the local environment influence the upgrading process. At least one major study found that, while both are important, external relationships are perhaps more important than internal relationships. In this context, by far the most significant influence is the relationship with customers. In other words, important customers located in Scotland can help upgrade their suppliers located in Scotland.

Other relationships with, for example, suppliers, distributors, R&D organisations and even competitors can have a decisive impact on the upgrading process. However, these are much less common as a driver than upgrading driven by relationships with key customers.

While these trends generate more high value FDI and HQ functions are increasingly internationally mobile, this should be kept in perspective. The majority of overseas subsidiaries still have limited autonomy, management functions and are essentially implementers. Indeed, the idea of augmenting competitive advantage via decentralisation and exploiting overseas assets is 'best practice' being advocated in academic circles rather than established business practice<sup>36</sup>.

From a Scottish perspective, it is also important to note that these trends relate to overseas subsidiary companies and not individual plant. The subsidiary itself may have a variety of functions (e.g. production, distribution, R&D, purchasing etc.) and plant locations. A Centre of Excellence subsidiary with a wide range of HQ functions and autonomy could have, for

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<sup>36</sup> Birkenshaw, J. and Hood, N. (2001). Unleash Innovation in Foreign Subsidiaries, Harvard Business Review, Best Practice, March 2001, Vol 79(3), pp. 131 – 137.

example, production facilities in Scotland, R&D in Cambridge and its HQ in London. The extent of FDI upgrading in Scotland is perhaps less than sometimes assumed<sup>37</sup>.

Consequently, the process of subsidiary upgrading need not benefit all regions equally. As overseas investors develop more HQ functions in the UK, it cannot simply be assumed that these will be located in Scotland even when the company has production facilities in Scotland. This emphasises the need to consider the entire subsidiary company rather than single plant or those parts of the business located in Scotland.

Furthermore, a study of inward investment in Scotland found that while the range of management responsibilities in Scottish plant may be increasing, the level of actual autonomy may actually be declining<sup>38</sup>. This is consistent with the evidence reported in Chapter Two relating to the continuing role of US corporate HQs in functions such as purchasing and marketing.

#### **4.1.2 Headquarters**

Historically, the creation and ongoing re-organisation of overseas subsidiaries had little effect on corporate HQs which were essentially left intact. However, UNCTAD has recently argued that MNEs are now increasingly restructuring and relocating their corporate HQs<sup>39</sup>.

Over the 15 months to March 2003, 829 such investments were identified. With a 22% market share (181 investments), the UK was the leading destination. The other major destinations were the US (15%), China (9%), Australia (7%) and Singapore (5%). Within Europe, the leading recipients of HQ investments were Germany (4%) and the Netherlands (4%).

The projects include one or two complete relocations of a corporate HQ. These generally follow a cross-border merger. For example, following the merger of Upjohn (US) and Pharmacia (Sweden), the corporate HQ was located in London. Rather more common, but still relatively rare, the HQ of a specific business unit or division within the corporation is relocated. For example, Motorola relocated its semiconductor HQ to Austin while Philips moved its components HQ from Eindhoven to California in the early 1990's.

However, the vast majority of the investments are Regional HQs. In this context, regional means the three macro-triad regions of Europe, Asia and the Americas. The UK projects are largely European HQs while Australia (mainly Sydney) and Singapore attract Regional HQs for Asia.

The growth of Regional HQs reflects MNE's attempts to reconcile the exploitation of economies of scale (which underpins attempts to create global products and production systems) with the need for 'local' responsiveness. While varying greatly between corporations, national subsidiaries are now often of inadequate scale. On the other hand, there are few truly global products. Furthermore, market, regulatory and political

<sup>37</sup> Rugman, A.M. and D'Cruz, J.R. (2000). *Multinationals and Flagship Firms*. See Chapter 10 'The Scottish Electronics Cluster', Oxford University Press.

<sup>38</sup> Firm Crichton Roberts *et al.* (2000). *Inward Investment Benefits for the Scottish Economy*, Report for Scottish Enterprise, Glasgow.

<sup>39</sup> UNCTAD (2003). *World Market for Corporate HQs Emerging*, Press Release 21/7/03.

environments vary greatly from place-to-place. With the emergence of regional trading blocs (e.g. EU, NAFTA), it is argued that the Triad Regions offer the best opportunity for many companies to exploit scale while simultaneously being responsive to local circumstances<sup>40</sup>. Indeed, with the creation of regional structures, some MNEs are 'backtracking' on earlier attempts to create global structures.

The nature and role of European HQs varies greatly between companies. This is illustrated in Figure 4.1 which describes a selection of recent inward investment projects going under the label of European HQ. The key point is that there is no standard European HQ and each has different location drivers.



Source: Ernst & Young (2004). The UK's Competitive Position as a Location for Attracting and Retaining European Headquarters, Report for UK Trade International.

Figure 4.2 shows the findings from one of the few studies of RHQ location decisions including companies locating in all three Triad Regions. This shows the average weight (with one being minimal importance to 5 as highly important) attached to factors which influence the location of Regional HQs within the Region.

Regional Headquarters are not mobile between regions. Within the Region, many factors come into play. However, the following are towards the top end of the scale:

- Good accessibility and especially frequent and reliable air services and telecom infrastructures.
- A highly skilled workforce including language skills. An English speaking workforce and environment are highly important.
- Economic and exchange rate stability plus a favourable tax environment. Essentially, companies are looking for a low risk environment.
- Market potential and access to customers.

<sup>40</sup> Verdin, P. *et. al.* Regional Organisations: Beware of the Pitfalls. In J. Birkenshaw *et. al.* (2003). The Future of the Multinational Company, John Wiley and Sons, Chichester.

- Access to reliable suppliers including a wide range of business services and a centre of corporate finance.
- The 'cultural' and business compatibility of the location with the parent company's home country.

Towards the bottom of the scale are cost related factors relating to, for example, the cost of living, wage rates and government incentives. While explicit incentives are not ranked highly, a favourable fiscal environment is important.

**Figure 4.2: Decision Variables for Mobile Regional HQs: Mean Scores and Standard Deviations**

Location Decision Variables	Mean	Standard Deviation
Reliable communications infrastructure	4.42	0.84
Availability of high skilled staff	4.26	0.99
English-speaking workforce	4.26	1.01
English-speaking environment	4.11	0.98
Frequent and efficient international flights	4.04	1.05
Economic stability	3.98	0.92
Accessible geographical location	3.88	0.98
Local market growth potential	3.86	1.14
Presence of key technology suppliers	3.79	1.22
Commercial compatibility with home-base	3.72	1.11
Availability of reliable suppliers	3.63	1.23
Strong cultural links with region	3.61	1.05
Access to regional financial centre	3.61	1.10
Attractive company taxation regulations	3.58	1.24
Stable exchange rates	3.53	1.15
Regional telecommunications hub	3.49	1.23
Cultural compatibility with home-base	3.40	1.07
Competitively priced telecommunications	3.39	1.18
Competitively priced rent	3.37	1.17
Low operating costs	3.37	1.17
Competitively priced labour	3.30	1.13
Moderate interest rate environment	3.32	1.06
Attractive dividend withholding taxes	3.21	1.15
Low inflation environment	3.18	1.04
High quality health services	3.12	1.12
Flexibility of employment contracts	3.02	1.19
Local government tax incentives	2.96	1.22
Attractive government regulatory environment	2.91	1.27
Local government financial incentives	2.81	1.38
Central government tax incentives?	2.79	1.39
Central government financial incentives	2.75	1.37
Low-cost workforce	2.74	1.25
Local government infrastructure inputs	2.70	1.24
Local government establishment incentives	2.68	1.30
Low levels of industrial disputes	2.61	1.31
Low cost of health insurance	2.58	1.12
Low cost of cars	2.56	1.15
Low cost of schools	2.51	1.10

Source: Holt, J. et.al. (undated), Decision Factors Influencing MNE Regional Headquarters Location Selection Strategies, Conference on Strategy Management, Entrepreneurship and New Values.

Figure 4.2 also shows the standard deviation for each of the location factors. These are shown to emphasise the point that there is considerable variation between companies in the importance attached to factors. For example, the average weight attached to financial incentives (around 2.8) is relatively low. However, the high standard deviation (almost 1.4) means that a few companies attach more or less no importance to this factor while a few attach great importance to their availability.

The weight attached to the various location factors depends upon the strategic purpose of the HQ. For example:

- Companies which are largely concerned with regional responsiveness are influenced by access to customers, suppliers and accessibility. They appear to have a relatively restricted location choice with factor costs (except travel related costs) playing little role.
- Companies which require a Regional HQ to co-ordinate intra-corporate operations have a wider range of locational choice enabling cost factors to play a greater role. Consequently, they give more weight to the cost of living, government incentives and employment relations.

The origins of Regional Headquarters also affects the weight given to the various factors. For example, Japanese companies appear to attach greater weight to cost factors than US firms.

### **4.1.3 Research and Development**

Historically, MNEs undertook almost all their R&D (and all their 'blue skies' research) in their home country. For example, in the early 1970's, around 95% of R&D undertaken by US multinationals was in the US. In other words, just 5% was undertaken overseas. By the mid-1980's, this figure had risen to around 19% and perhaps it is now somewhat over 25%<sup>41</sup>. Reflecting this growth, overseas companies now account for around 40% of all UK corporate R&D.

Investment in R&D is heterogeneous. There are many ways of categorising such investments. A widely used taxonomy is as follows<sup>42</sup>:

- **Technology Transfer Units (TTUs)**. These transfer 'home based' process technology into overseas production facilities. They are generally co-located with production units.
- **Indigenous Technology Units (ITUs)**. These adapt the company's products to local/regional market conditions. They may develop into units which develop new products for the local/regional market. At least early ITUs were often located in close proximity to production facilities. However, access to customers is also important.
- **Global Technology Units (GTUs)**. In contrast to TTUs and ITUs which tend to be part of national (or regional) subsidiaries, these are generally part of a global business unit undertaking product and process R&D for the Unit/Division.

<sup>41</sup> See for example, Roberts, E.B. (1995). Benchmarking the Strategic Management of Technology, Research Technology Management, Vol. 38, No. 1, pp. 44 – 56. Kuemmerle, W. (1999), The Drivers of Foreign Direct Investment in Research and Development: An Empirical Investigation, Journal of International Business Studies, Vol. 30, No. 1, pp 1 – 24 and Foreign Direct Investment in Industrial Research in the Pharmaceutical and Electronic Industries, Research Policy, Vol. 28, No. 2/3, pp 179 – 193.

<sup>42</sup> See for example, Reddy, P. (2000). Globalisation of Corporate R&D: Implications for Innovation Systems in Host Countries, Routledge.

- **Corporate Technology Unit (CTUs).** These undertake more basic 'blue skies' research for the corporation (rather than a single Division or Business Unit). They are generally 'stand alone' laboratories with links to academic research.
- **Regional Technology Units (RTUs).** These are generally 'located' in the emerging regional (triad) corporate subsidiaries and may undertake any of the above roles for the regional market or production area.

Location requirements vary between these forms of R&D investment. Once established, links with the rest of the corporation also vary substantially again depending on the type of investment.

The vast majority of overseas R&D investments are TTUs and ITUs. They are more or less essential to enable a MNE serve any specific market successfully. Consequently, this is the first type of R&D undertaken in an overseas country and generally follows production. This type of R&D continues to dominate Scotland's stock of overseas corporate R&D.

Globally, the number of GTU, CTU and RTU investments has increased substantially since the 1970's. They have a strategic role in the corporation and it is these which are generally identified as R&D Centres of Excellence. These labs are most common in high tech sectors (i.e. ICT, pharmaceuticals and biotech).

The overseas growth of this 'more advanced' R&D reflects fundamental changes in MNE strategy.

- Historically, companies used their 'home based' competitive advantage to serve overseas markets. This only requires TTU and ITU type R&D investments.
- More recently, MNEs have sought to enhance their competitive advantage by tapping into overseas sources of knowledge and technology. Through this form of asset seeking investment, MNEs aim to augment their corporate capacity. This explains the growth in GTUs and CTUs.

The driving force behind GTUs and CTUs is to enhance innovation by tapping into overseas science, technology and ideas. The vast majority of such investments go to the developed world.

Generally this form of R&D is in 'stand alone' laboratories. Companies look for high quality research and researchers which complements their existing knowledge base. In addition to the quality of higher education, public sector research and graduates, companies look for 'star' researchers such as Nobel Prize winners. Historically costs were not an explicit driver. Nevertheless, for US companies, the UK has always been a low cost R&D location.

More recently, lower cost locations in parts of the developing world (e.g. India, Brazil, Israel, South Korea, Malaysia) have attracted an increasing amount of GTU and CTU investment. MNEs have become more concerned to control the cost of R&D. In part, this is because costs have risen in the US due to growing demand for science and technologists, and a consequent shortage of talent. This is encouraging firms to look at a wider range of potential locations. With low costs, high quality scientists and some distinctive science and technology, parts of the former Soviet Bloc have already emerged as competitive locations for R&D.



The ability of some developing and transition economies to compete for R&D has been enabled by the following factors:

- Several of these countries have a high quality academic system producing well-qualified scientists. India, for example, has several 'stars' in biotechnology. Often highly qualified expertise is not needed or utilised by indigenous industry leaving a low cost but highly skilled supply of scientists and technologists.
- The increased importance of science means MNEs are able to utilise expertise with little industrial experience. This has been made easier by the ability to sub-divide the innovation process and allocate its component parts to locations in which it can be most effectively performed. Especially in ICT and biotech, innovation has become more dependent on science with less need for industrial 'know-how' (as, for example, in engineering).
- The ability to run a 'global' R&D system has, in turn, been enabled by ICT. Historically, R&D was tied to the home base because it was difficult to control and integrate 'long distance' R&D. This is now less of a problem.
- In some countries (e.g. India) the availability of (mainly) US educated science and technologists is enhanced by the willingness of ex-patriots to return home once good jobs are on offer.

While still something of a marginal phenomena, Scotland can expect growing competition for mobile R&D from lower cost countries in the coming years. This conclusion is reinforced by the fact that governments in some of these countries (e.g. India, China) are already investing heavily in areas such as nanotechnology.

## 4.2 European and UK Context

### 4.2.1 *The Level of Mobile Investment*

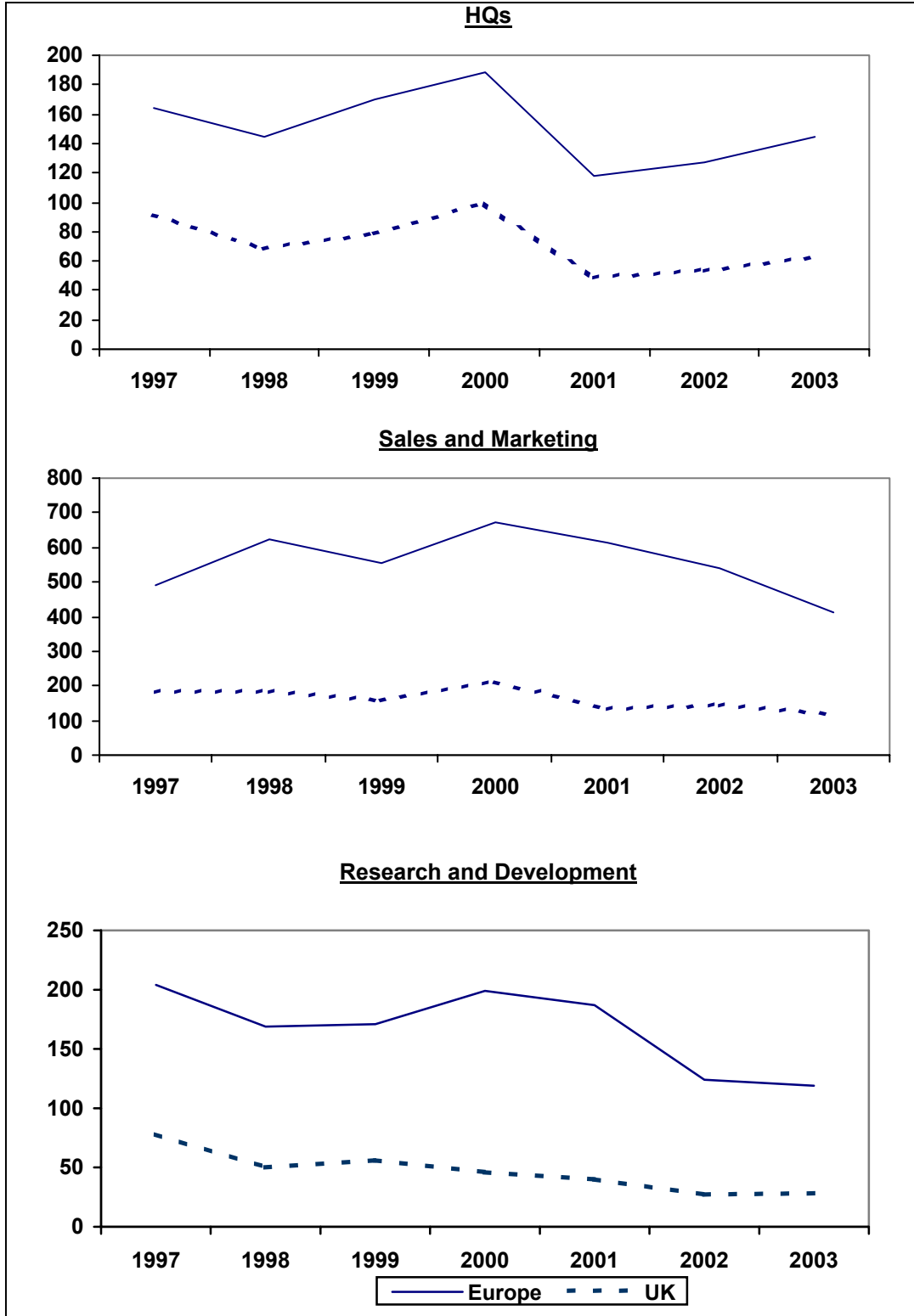
Before examining Scottish FDI, we set out an analysis of HQ, Sales/Marketing and R&D projects locating in Europe and the UK over the seven years 1997/03. This gives a feel for the size of the FDI market.

The annual number of projects locating in Europe and the UK is shown in Figure 4.3. Changes in the UK's market share are shown in Figure 4.4. Over the seven years:

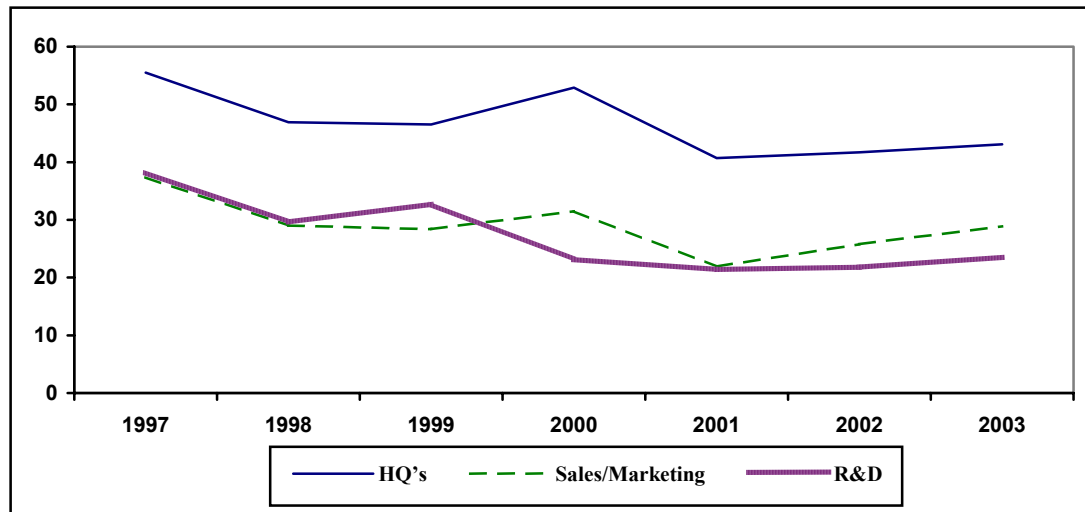
- There were almost 1,060 European HQ investments of which just over 500 (47%) located in the UK. The number fluctuates considerably from year to year. However, the number of investments is now somewhat lower than in 1997/98 (and substantially lower than in the peak year of 2000). There has also been a small decline in the UK's market share. However, both the number of HQ investments and the UK's market share is recovering from its low point around 2001.
- There were almost 3,910 Sales/Marketing projects of which just over 1,000 (25%) located in the UK. As with HQs, the number of projects has recovered from the trough of 2001 but remains below the 1997/98 investment levels.
- For R&D, the UK's market share was 28% (i.e. 325 out of 1,170 European projects). The number of European projects is well below the levels of 1997/98 (and its peak level in 2000). The UK appears to be gradually losing market share. Combined with the gradual fall in the number of R&D projects locating in the UK, this is a cause for concern.

There is little evidence here of a significant growth in the number of 'high value' fdi projects. The pool of such projects which Scotland might attract is small. For example, taking the two years 2002 and 2003, the UK attracted just 57 HQs, 28 R&D projects and 130 Sales/Marketing investments per year.

**Figure 4.3: Number of European and UK FDI Projects by Function 1997/03**



Source: Calculated from Ernst & Young's European Investment Monitor

**Figure 4.4: The UK's Percentage Market Share 1997/03**

Source: Ernst & Young op. cit.

#### 4.2.2 European Destinations

The Ernst & Young Investment Monitor does not provide data on actual project employment. However, Figure 4.5 shows the employment size distribution of projects based on expected jobs. The main conclusion is clear. While there are rather more large R&D projects, the overwhelming majority of these 'high value' projects employ less than 50 people.

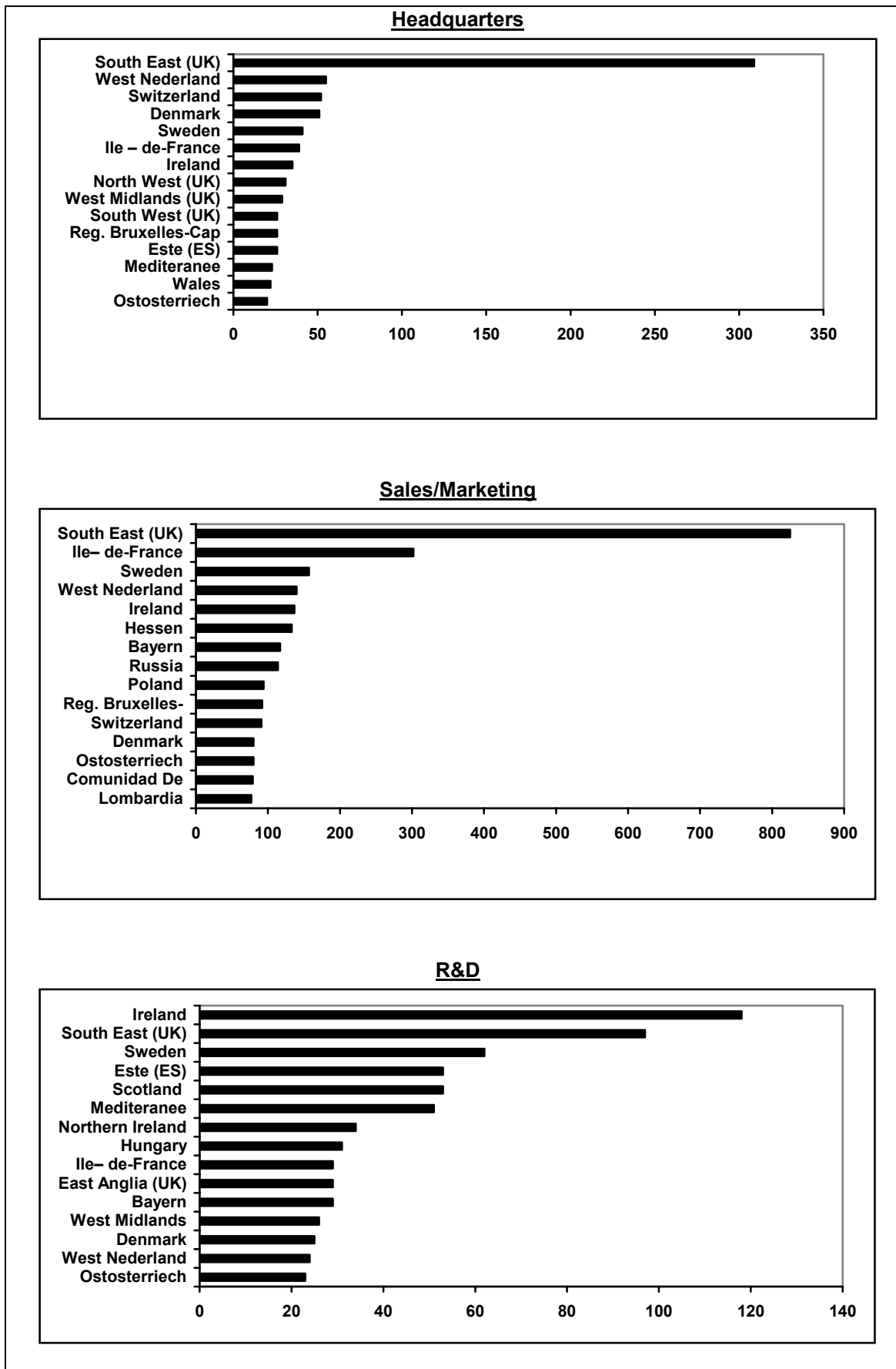
**Figure 4.5 % of UK Projects by Expected Employment Size Band**

Expected Employment	R&D	HQs	Sales/Marketing
1 – 19	44.3	56.1	73.9
20 – 49	16.3	17.8	12.9
50 – 199	28.9	14.3	9.8
200 – 499	6.8	6.7	2.7
500+	3.7	3.3	0.7
	<b>100</b>	<b>100</b>	<b>100</b>

Turning to the main destination locations for the three different types of fdi, Figure 4.6 shows the top 15 European NUTS I regional locations. The main findings are:

- For HQs, South East England dominates. It attracted almost 30% of European projects. Four other UK regions (North West, West Midlands, South West and Wales) are also in the Top 15. Scotland ranked 18<sup>th</sup> in Europe. Outwith the UK, the main locations are the Netherlands, Switzerland, Denmark, Sweden, Ireland and the Ile-de-France (i.e. Paris). However, outwith South East England nowhere obtains large numbers of projects.
- With 21% of all projects, the South East is also the main destination for Sales/Marketing projects. The regions which attract HQs also tend to attract Sales/Marketing projects. However, the growing interest in Eastern European markets is reflected in the Top 15 place for Russia and Poland with Hungary and the

Figure 4.6: Top 15 Regional Destinations 1997 – 2003: Number of Projects

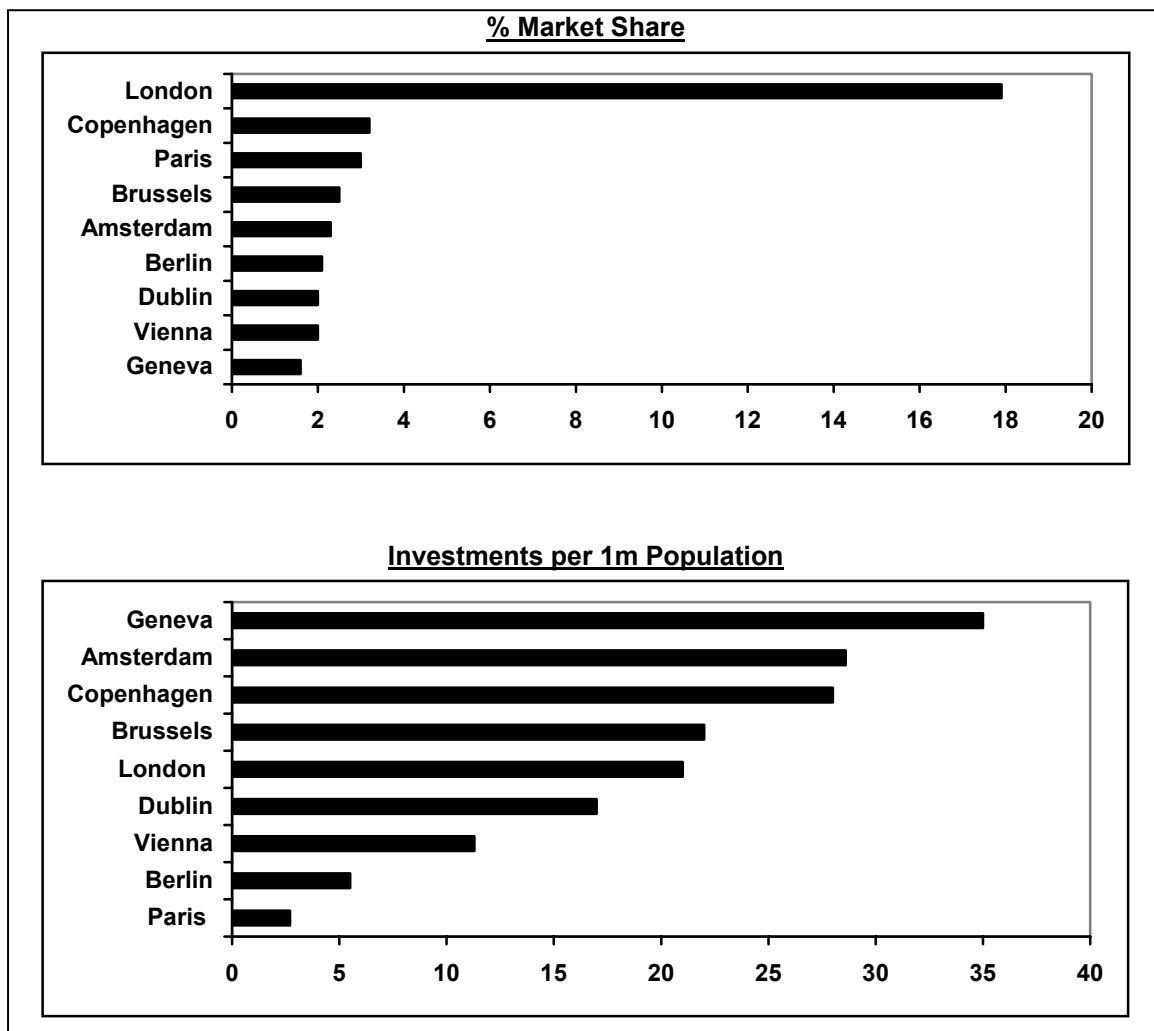


Czech Republic just outside the Top 15. In contrast to HQs, the UK regions do not appear as top locations.

- In comparison with HQs and Sales/Marketing, the top destinations for R&D are very different. The top destinations are Eire with a 10% market share followed by South East England with just 8% of all projects. Scotland ranks fifth with a 4.5% market share. R&D projects are more widely spread than HQs/Sales and Marketing projects and include both 'high tech' areas (e.g. East Anglia) and other peripheral regions (e.g. Northern Ireland and France's Mediterranean region). Hungary's top 15 position (with the Czech Republic ranked 20<sup>th</sup>) illustrates the emerging competition from Eastern Europe.

An important conclusion is that HQs and Sales/Marketing projects tend to locate in similar regions. In contrast, R&D destinations are clearly differentiated. Scotland has a much stronger position in R&D than HQs/Sales and Marketing.

**Figure 4.7: Headquarter Investments: Top City Destinations**



In contrast to R&D projects, HQs and, to a much lesser extent, sales and marketing investments generally locate in major cities. The market share of the top nine cities is shown in Figure 4.7. As would be expected from the preceding analysis, London is the dominant location with 18% of all European investments. London is followed by Europe's major capitals with Copenhagen acting as a regional centre for Scandinavia. However, expressed as

projects per capita, the ranking changes considerably. On this basis, the list is headed by Geneva followed by Amsterdam, Copenhagen, Brussels, London and Dublin. It is, however, important to note that the actual number of projects locating in cities such as Geneva is small.

### **4.2.3 Sectoral Analysis**

A sectoral breakdown of European and UK projects is shown in Figure 4.8. (See next page). Taking first HQ investments, the sectors with the most projects are software, traditional manufacturing, electronics related manufacturing and business services. While still accounting for around 15% of its projects, compared to the rest of Europe, the UK does less well in manufacturing. In contrast, it does much better in software. Indeed, the software industry accounts for over 35% of its HQ projects. It also does relatively well in business services and finance.

Throughout Europe, software is the largest sector for Sales/Marketing projects. This is followed by business services and, in contrast to HQs in which there are few investments, financial services. It is, however, important to note that there are still substantial numbers of projects in manufacturing and especially electronics related manufacturing. In the UK, 37% of all Sales/Marketing projects are in the software sector. While both business and financial services generate reasonable numbers of investments, Sales/Marketing investments are spread across most industrial sectors.

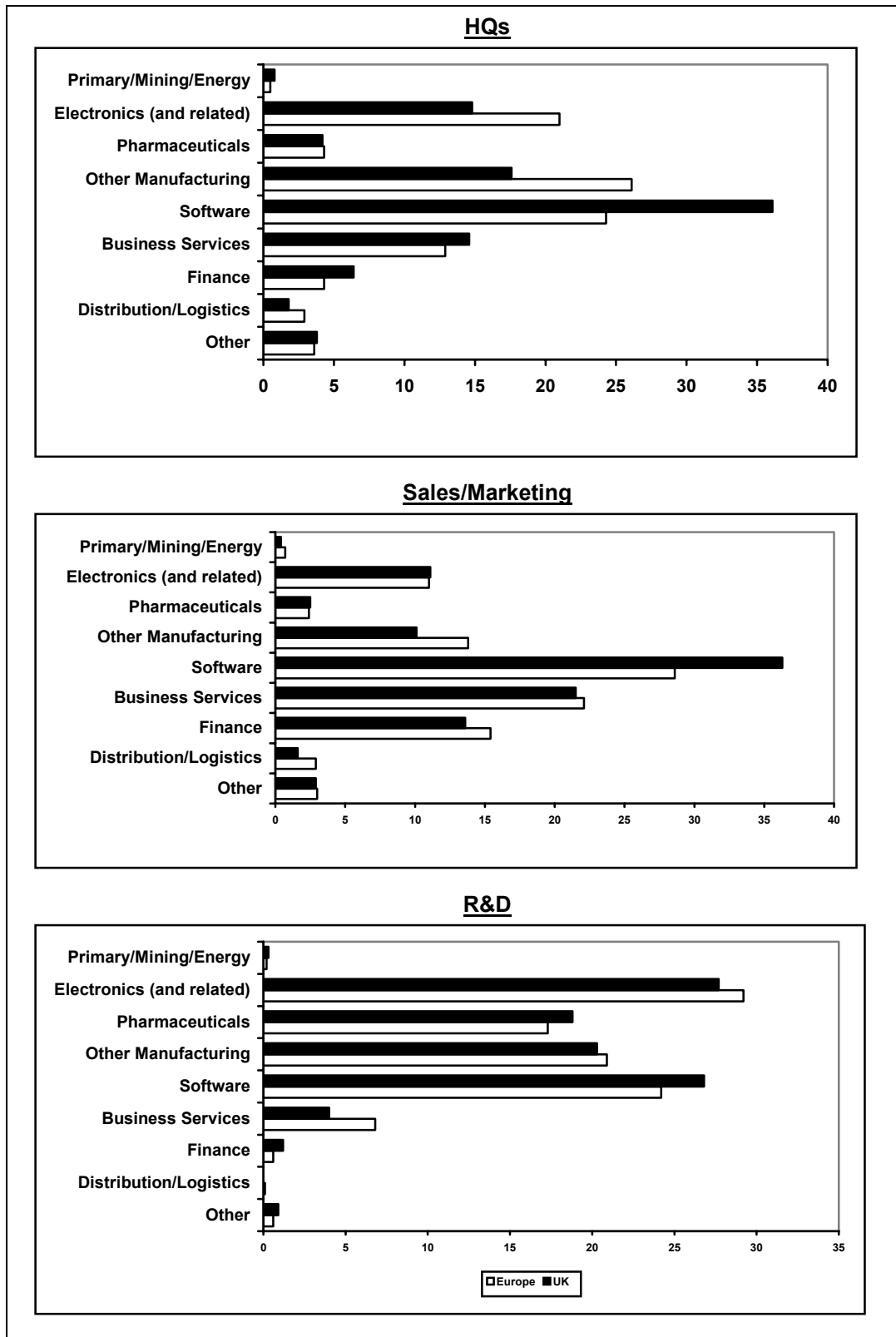
As with location patterns, the sectoral distribution of R&D fdi is clearly differentiated from that of both HQ and Sales/Marketing projects. R&D investment throughout Europe is concentrated in manufacturing. Both pharmaceuticals and electronics are important. However, several other manufacturing sectors (e.g. automotive, chemicals) are also important sources of European R&D investments. While most service sector industries generate little mobile R&D, the exception is software which accounts for 25% of all European projects. There is little difference between the European and UK sectoral breakdown of R&D projects. From a Scottish perspective, the amount of mobile R&D in electronics related manufacturing and software is worthy of note.

Figure 4.9 shows how UK investments by sector changed between 1997/99 and 2000/03. Based on the average annual number of projects:

- The number of HQ investments in manufacturing and financial services fell. The number of Software and Business Service HQs rose. While Software is by far and way the largest sector, Business Services rose to second place by 2000/03.
- The number of Software Sales/Marketing projects increased marginally between the two periods. The number declined in all other sectors with a significant fall in finance and distribution/logistics.
- The number of R&D projects fell substantially in all branches of manufacturing. There was even a small reduction in Software. Only Business/Telecom Services witnessed any growth.

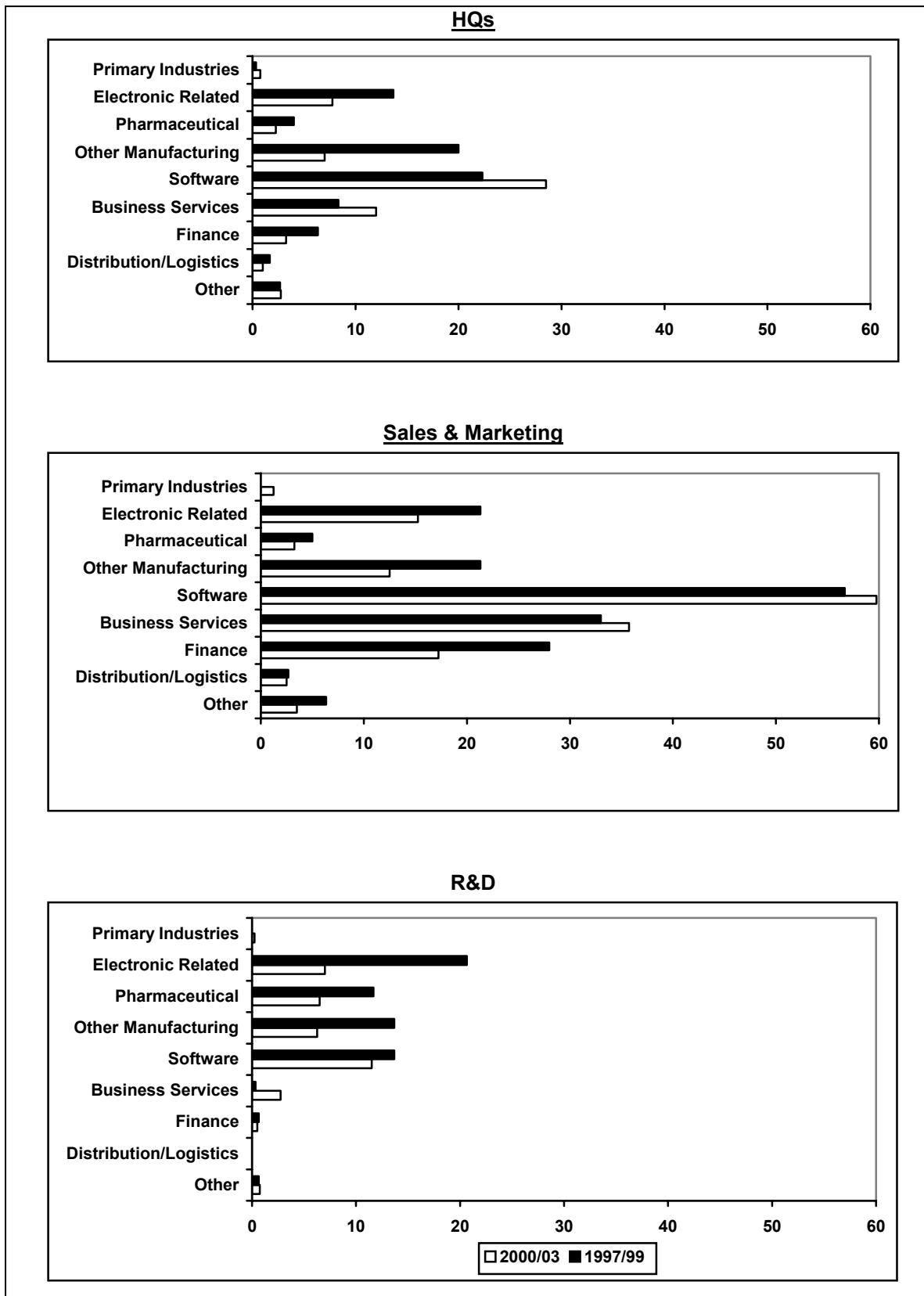
Similar patterns of change were experienced in mainland Europe. However, the fall in the number of manufacturing HQs and R&D were less severe while the annual number of Sales/Marketing projects increased in most sectors (but especially in Software and Business Services).

Figure 4.8: Sectoral Analysis of FDI Projects 1997/03: % of Projects



Note: Business Services includes telecom services

Figure 4.9: Sectoral Changes in UK FDI Projects: Average Number Per Year





#### 4.2.4 Regional Context

The UK attracts a substantial share of mobile HQ and, to a lesser extent, Sales and Marketing and R&D projects. The regional distribution of these projects is shown in Figure 4.10. With over 60% of all UK investments, South East England is the dominant location for HQ investments.

**Figure 4.10: % Market Share of UK Projects by Region 1997/03**

	HQs	Sales/Marketing	R&D
Scotland	3.6	4.1	16.3
East Anglia	3.6	2.1	8.9
East Midlands	4.0	1.5	3.1
North	2.0	1.8	3.7
North West	6.2	3.8	6.5
Northern Ireland	6.0	2.0	10.5
South East	61.7	73.2	29.8
South West	5.2	3.0	6.5
Wales	4.4	1.2	4.0
West Midlands	5.8	4.0	8.0
Yorkshire & Humber	2.8	3.3	2.8

The EY database records just 18 HQ investments in Scotland. At 3.6% of the UK total, this is well below its 9% share of UK population. However, nowhere outwith the South East attracts large numbers of project. Even in the South East, the level of investment should be kept in perspective. Over the seven years, its 62% market share represents just over 300 projects.

A comparison between the location of HQs for the three years 1997/99 with the four years 2000/03 shows that the South East increased its market share from 52% to 70%. All other regions (except Scotland) experienced a small offsetting loss in their market share.

With over 70% of UK projects, the South East is an even more dominant location for Sales/Marketing projects. With 4.1% of projects (i.e. 46 investments), Scotland ranks second behind the South East.

The location pattern of mobile R&D differs significantly from HQ and Sales/Marketing locations. Over the period, Scotland attracted over 50 projects. This is 16% of all UK investment. It ranks second behind the South East's 30% market share. While an important location, the South East is much less dominant. Not surprisingly, East Anglia (i.e. Cambridge) is a more substantive competitor and other peripheral regions (e.g. Northern Ireland) also perform relatively well.

Because the number of annual projects is small, market share varies substantially from year to year. However, a comparison of 1997/99 with 2000/03 projects shows only minimal changes. Scotland achieved a 16% market share in both periods. However, 30% of Scotland's projects arrived in just one year (1999). Over the last two years, there has been a

substantial reduction in both the number of projects (seven) and Scotland's market share. This may be a cause for some concern.

## **4.3 Scottish Investments**

### **4.3.1 Headquarters**

Scotland is recorded as attracting 18 HQ projects. As in the rest of the UK, 80% of these are new locations (rather than expansion or co-locations). The majority of projects plan to employ fewer than 50 people. Nevertheless, with 22% planning to employ over 100 staff, the average size is somewhat above average. (However, one of the large projects did not proceed). These larger projects are HQs linked to other activity (e.g. an assembly plant, a call centre).

Accounting for 33% of HQs, electronics is substantially over-represented. This illustrates the continuing role of this sector in the Scottish economy. With three investments each, the other significant sectors are software (substantially under-represented compared to the UK average), manufacturing (but with no pharmaceutical HQs) and business services. While spread throughout the SIC codes, several of the businesses are involved in the oil and gas industry (e.g. Haliburton, Read Well Services, Weildinger Associates, Daniel Management and Control).

### **4.3.2 Sales and Marketing**

Scotland attracted 46 Sales/Marketing projects. Of these 12 planned to employ over 100 people. This is 26% of projects compared to just 7% in the UK. In other words, Scottish projects are few in number but larger in terms of employment.

Sales/Marketing projects are dominated by business services (30%), software (26%), finance (22%) and electronics (13%). Compared to the UK, business services and finance are substantially over-represented while software is under-represented. There are surprisingly few projects in other manufacturing (2% compared to 21% nationally). This sectoral description under-estimates the influence of both electronics and, more importantly, oil and gas. For example, several of the business service firms serve the oil and gas industry.

The majority of projects (67%) are new locations. However, compared to elsewhere in the UK (with 90% as new locations), this is a relatively low proportion.

### **4.3.3 Research and Development**

Scotland attracted 53 R&D projects. As already illustrated, over the period 1997 – 2003, Scotland was one of Europe's top destinations ranking 5<sup>th</sup> in the list of NUTS I regions. However, its market share fell from 6% (with a ranking of 3<sup>rd</sup>) in the first half of the period to 3% (with a ranking of 6<sup>th</sup>) in the second half of the period.

On average, each employs more people than either HQs or Sales/Marketing projects. Almost 40% planned to employ over 100 with 4 announcing an intention to employ over 500. Again, the average size of Scottish projects is larger than the UK average. For example, in Scotland 75% planned to employ over 20 compared to 55% of all UK R&D projects.

The sectoral breakdown of R&D projects compared to the Rest of the UK is shown in Figure 4.11. Electronics closely followed by software are the two main sectors in Scotland. Both are over-represented relative to the Rest of the UK. Pharmaceuticals is also important. However, R&D in Other Manufacturing is more or less absent from Scotland. Its strength elsewhere in the UK is largely in the automotive and chemical industries.

**Figure 4.11: R&D by Sector: Scotland and the Rest of the UK 1997/03 % of Total**

	Scotland	UK
Electronics Related	32.1	26.8
Pharmaceuticals	18.9	18.7
Other Manufacturing	5.7	23.2
Software	30.2	26.1
Business Services	3.8	4.0
Finance	5.7	0.4
Other	3.6	0.8
<b>Total</b>	<b>100.0</b>	<b>100.0</b>

Compared to HQs and Sales/Marketing, R&D projects are more likely to be expansions (26%) or co-locations (21%). Just over 50% are new locations. This is a substantially lower proportion than elsewhere in the UK or Europe.

#### 4.4 The Role of Policy

Grants and incentives are not high on the list of location priorities for most MNEs HQ investment decisions. Nevertheless, as illustrated in Figure 4.2, an attractive fiscal regime (and stable exchange rates) are an important issue at least for some companies. Furthermore, many of the capital cities which attract more HQ projects per capita than London have tax regimes which offer incentives for HQ (and sometimes R&D) investments.

**The Netherlands.** From the late 1980's, the Netherlands has used its tax system to target 'high value' inward investment. The main features of its system are:

- A 'cost plus' tax ruling for qualifying activities i.e. headquarters, distribution centres and supporting services (such as R&D) which are cost rather than profit centres within the corporation. These are 'negotiated' on a case-by-case basis and fixed for a 10-year period. While it is claimed that this is not an incentive (but simply provides certainty), it is generally believed negotiated tax rates are below the standard rate.
- To make the Netherlands an attractive location for ex-patriots of the investing firms, income tax relief is available on the time spent travelling outwith the Netherlands.
- Corporate income from dividends (and some other ownership sources) is exempt from corporation tax. This makes the Netherlands a tax efficient location for international HQs.
- More relevant to R&D, expenditure on certain types of employees (e.g. scientists and technologists) can be offset against a variety of taxes (e.g. the UK equivalent to National Insurance).

In addition, a large scale redevelopment project (Amsterdam South) in close proximity to Schipol Airport is being used to target mobile HQ and related activities.

**Belgium** has a similar range of incentives to the Netherlands. The tax ruling system targets 'co-ordination centres'. These are facilities with at least 10 employees providing support and financial services for the international activities of MNEs. A negotiated annual lump sum tax is negotiated and fixed for a 10-year period regardless of actual income.

**Ireland.** Historically, Ireland attracted inward investment with the introduction of a 10% corporation tax rate for qualifying activities (compared to the standard rate of just over 30%). Initially, manufacturing was the main qualifying activity. However, this has been gradually extended to include call centres, software and activities such as information processing. In the late 1980's, it was further extended to cover companies locating in the International Financial Service Centre – a prestigious £640m development in central Dublin including 1.2m sq. ft. of high quality offices. As in Amsterdam, a major physical development has been used to attract HQs (and other office-based tradeable services).

The 10% rate of corporate tax makes Ireland a tax efficient location in which to declare corporate profits. Companies do this via various forms of transfer pricing which 'move' profits from higher to lower cost tax regimes. This boosts Ireland's GDP but may have less impact on Ireland's National Income. It may also make Ireland a more attractive location for EHQs. Our Scottish interviews found one overseas-controlled company which has moved its HQ from Scotland to Eire to take advantage of lower corporate taxes.

However, we have found no systematic research on the influence of Ireland's low corporate tax rate on HQ locations. In particular, it is not clear whether it attracts substantive and real management functions and jobs or whether it attracts 'name plates' which enable companies to declare profits in Eire. Further research on the role of tax regimes may be required. Here we simply note that despite these tax advantages, even on a per capita basis, Dublin attracts fewer HQs than London (but many more than Scotland).

**Geneva.** The Swiss Government has offset the country's high cost base with an aggressive tax policy to attract investment. This consists of low corporation tax rates and allowing headquarters to act as the 'principal company' which receives favourable tax treatment. By using contract manufacturers and 'commissionaire' arrangements with sales/distribution companies, this transfers income to the principal company (in a form of transfer pricing). This delivers company-wide tax minimisation for firms locating their HQ in Switzerland. Geneva itself is one of the few cities to have an explicit programme attracting mobile HQs<sup>43</sup>.

Measured as HQ projects per capita, Geneva is Europe's most successful city. However, a relatively small city, it attracts only a small number of projects. Indeed, its size limits the number (and size) of HQ projects it can support. Large projects, for example, place considerable strain on its infrastructure and labour supply.

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<sup>43</sup> See for example Geneva Department of Economy, Labour and Foreign Affairs (2003). International Comparisons: Company Costs, Human Resources, Infrastructures, Productivity, Social Changes and Taxes.

**Singapore.** From the early 1980's onwards, a central objective of the government's economic development strategy has been to develop Singapore as a global (or, more realistically, regional) business hub. To achieve this, it offers discretionary reduced corporate tax rates on incremental qualifying income earned outwith Singapore. This is a tax efficient location for Regional HQs.

In addition, the Pioneer Incentive Scheme offers corporate tax exemption for between 5 – 10 years on incremental profits from 'pioneer activity' which includes the development and production of products and services new to Singapore and which 'take forward' the Economic Development Board's strategy. To encourage existing investors to upgrade their activities, the Development and Expansion Incentive offers reduced corporation tax on approved activities. The actual tax rate and its duration are subject to negotiation.

In combination, the various tax incentives offer a substantial inducement to firms investing in HQs and R&D. Not surprisingly, Singapore is now a major business and commercial centre and one of the main locations for Asian Regional HQs. The incentives encourage the upgrading of the entire subsidiary (rather than focusing simply on one function).

**Scotland and RSA.** The UK has no specific tax incentives. Linked to regional policy, the main incentive remains Regional Selective Assistance. This offsets capital investment costs. While beneficial to manufacturing, it offers limited (if any) assistance to HQ investments. The majority of 'stand alone' HQ investments require little capital expenditure. Consequently, unless linked to other activities (and especially production), the UK (and Scotland) has no incentives which attract Headquarter investments.

## Strategic Implications

The nature of internationally mobile investment has changed and continues to change. There are more mobile HQ and R&D projects. These are generally seen as 'higher value' fdi. This has created new economic development opportunities for those regions able to attract such investment.

As a starting point, this chapter has taken 'high value' fdi as HQs, Sales/Marketing projects and R&D. From a Scottish perspective, the following conclusions and strategic implications emerge from the analysis:

- While the number of HQ and R&D projects is probably higher than during the 1980's, the pool of 'high value' fdi remains relatively small. Nor is there any strong evidence that the number of projects locating in Europe (or the UK) has increased in recent years.
- Individual projects generally employ few people. They are unlikely to create large numbers of new jobs. Furthermore, more or less by definition, ultimate management control remains with the parent company. They remain subsidiary HQs.
- Such investments generally reflect the upgrading of an existing subsidiary company. A UK (or European) subsidiary may have several locations. Consequently, companies with facilities in Scotland need not choose to upgrade their Scottish plant.
- Different policies and marketing strategies are required to attract HQs and R&D. The factors determining their location are very different. For example, R&D is

influenced by a region's academic, scientific and technological infrastructure. In contrast, HQs are influenced by, inter alia, proximity to customers, business and financial services and air services.

- The UK attracts a large (but perhaps declining) proportion of Europe's mobile HQs and, to a lesser extent, R&D and Sales/Marketing projects. However, especially for R&D, serious competition from lower cost locations in both Eastern Europe and the developing world (e.g. India) can be expected in the future.
- Electronics related manufacturing industries continue to account for a substantial proportion of HQs, Sales/Marketing and R&D investments in both Europe and the UK. However, the software industry is now the largest source of such projects.
- Over the past few years, Scotland has done well in the R&D market. Its strengths are in electronics software and North Sea Oil related investments. However, the number of projects is small and its market share has declined over the past two or three years.
- In contrast, Scotland attracted under 5% of UK HQ and Sales/Marketing projects. Again, its strengths emerge as electronics related manufacturing, the offshore sector and finance. It is seriously under-represented in the fastest growing sectors of software and business services.
- Compared to the UK average, Scotland tends to attract larger projects. It attracts relatively few small projects which are a growing proportion of mobile projects. If it is to attract more 'high value' fdi (HQs, Sales/Marketing, R&D), means need to be found to increase success in the small project market segment.

Finally, for HQs and Sales/Marketing investments, London and South East England are the dominant UK destinations for overseas companies. To increase its market share (and the number) of HQs substantially, Scotland needs to compete more effectively with South East England. This raises the question, examined in the next chapter, of why so many projects choose to locate in South East England?

## 5. London and the South East FDI

As illustrated in Chapter Four, the majority of the UK's HQ related inward investment locates in South East England. This raises the question of whether at least some of these projects could be attracted to Scotland. To answer this question, a better understanding of the nature of the South East's projects and why they locate in the South East is required. This chapter examines these questions. While it includes R&D investments, the main focus is on HQs and Sales/Marketing projects.

### 5.1 Introduction

The analysis presented in this chapter is exploratory rather than definitive. It is based on an analysis of the Ernst and Young Investment Monitor and telephone conversations with 20 companies shown as having invested in a HQ, R&D or Sales/Marketing project in either 1997 or 2003 in London and the South East.

Investment projects for 2003 were selected because it is more likely interviewees remember and know about the actual location decision. The 1997 projects were selected to explore the experience of companies post the initial investment. In particular, we sought to explore the extent of growth and the location of any follow-up investment.

Throughout we have used the old Standard South East Region (which includes London) rather than the new government regions. Within the South East we have separated out London from the rest of the South East Region. For convenience, we refer to the South East Region when discussing the entire Standard Region and to the Outer South East when referring to the South East excluding London.

Having selected a sample of 2003 projects from the Ernst & Young database for interview, it proved impossible to find any trace of 20% of the businesses via a search on both the Internet and telephone directories. The vast majority of these are recorded on the EY database as small and either HQs or Sales/Marketing investments. From the interviews with the 1997 projects, it is likely that some of these planned investments 'fell through' and did not proceed while others will not yet be up and running. The interviews with the 1997 projects found that there can be a significant delay between the project being announced and becoming operational. In addition, a few were almost certainly planned as no more than a 'name plate' presence in the UK.

It proved impossible to trace a somewhat larger proportion (almost 50%) of the 1997 projects. In addition to projects which were never completed, the interviews suggest that this higher figure is because some have closed, moved location or changed their name often via mergers and acquisitions. There is a substantial amount of turbulence in the small HQ and Sales/Marketing sector. This is much less the case for R&D investments.

## 5.2 Project Characteristics

### 5.2.1 Headquarters

Over the period 1997/03, there were almost 320 HQ investments in the South East (i.e. just 46 per year). This is 64% of UK HQ investments and 30% of all European investment. This reflects the region's attraction as a location not only for UK but also European HQs. Within the region, London is the main destination accounting for over 60% of the region's HQ investments.

Changes in HQ investments between 1997/8 and 2002/03 are shown in Figure 5.1. The number of both European and UK investments was somewhat lower in 200/03 than in 1997/98. However, HQ investments in the South East remained more or less unchanged. Consequently, the Region's share of the European market increased marginally while its share of UK investments rose substantially (from 48% to 68%).

**Figure 5.1: HQ Projects in London and the South East 1997/98 and 2002/03**

		London	South East	Total
No. of Projects	1997/98	46	31	77
	2002/03	59	19	78
Market Share: % of Europe				
	1997/98	14.7	9.9	24.6
	2002/03	21.0	7.0	28.0
Market Share: % of UK				
	1997/98	28.9	19.5	48.4
	2002/03	51.3	16.5	67.8

Within the Region, the number of HQs locating in the Outer South East declined. In contrast, the number locating in London increased. Consequently, London has become a much more dominant HQ centre for mobile investment obtaining 50% of all UK HQ projects in 2002/03.

A sectoral comparison of HQ investments in the South East and the Rest of the UK is shown in Figure 5.2. The main contrasts are:

- The software industry is by far the largest sector in the South East and, in turn, the South East dominates the software industry. Software accounts for 48% of the Region's HQ investments. Elsewhere the industry represents just 17% of investments. The Region won 80% of all UK software HQ investments.
- While the absolute numbers are much smaller (accounting for 5% of investments compared to 2.6% elsewhere in the UK), the Region also has a large share of pharmaceutical HQ investment in the UK (76%).



- In contrast, the South East is under-represented in the rest of the manufacturing sector. Manufacturing companies account for 20% of its HQ investment compared to 52% elsewhere in the UK.
- Nevertheless, the Region still attracts 38% of all non-pharmaceutical manufacturing HQs. It remains strong in electronics related industries with almost 50% of HQ investments.

Accounting for 21% of the Region's HQ projects, finance and business services are less significant than might have been anticipated. Its market share in these two sectors combined is 63%. This is more or less the same as its market share (64%) of all HQ investments.

**Figure 5.2: Sectoral Distribution of South East HQ Investments 1997/03 (%)**

	<b>South East</b>	<b>Rest of UK</b>
Primary Industries	0.3	1.5
Electronics and Related Industries	11.6	19.8
Pharmaceuticals	5.2	2.6
Other Manufacturing	8.4	32.3
Software	48.2	16.7
Business Services/Telecoms	14.9	14.1
Finance	6.5	6.2
Distribution/Logistics	1.6	2.1
Other	3.2	4.7
<b>Total Number</b>		

Within the Region, there are substantial differences between HQs locating in London and the Outer South East.

- London dominates finance with 90% of regional projects and almost 60% of all UK finance HQs.
- Manufacturing companies are more likely to locate their HQs outwith London in the Outer South East. Manufacturing accounts for 35% of its HQs compared to 20% in London.

The largest sector, software, is spread throughout the region and is the dominant source of investment in both London and the Outer South East.

A large majority of HQ projects employ (at least initially) few people (Figure 5.3). An estimated 65% plan to employ less than 20 staff. Only 18 projects were planned with over 200 employees over the entire period. With very few exceptions, the Region's larger HQ investments choose to locate outwith the capital.

**Figure 5.3: Employment Size of HQ: % of Projects**

	Outer South East	London	South East	Rest of UK
1 – 19	68.5	65.0	65.7	38.8
20 – 49	11.9	21.3	18.1	17.4
50 – 199	5.6	11.0	9.1	22.4
200 – 499	8.2	2.0	4.2	10.4
500+	3.7	0.5	1.6	6.0

Note: Investments in the EY database giving no employment figure have been allocated to the smallest size category. This may over-estimate somewhat the proportion in the 1 – 19 employment category.

The South East's projects are, on average, smaller than HQs locating elsewhere in the UK. Compared to 39% outwith the South East, 66% of its investments plan to employ less than 20. Looking at the picture slightly differently, the South East obtained 70% of HQs planning to employ less than 50 compared with just 35% of projects planning to employ over 200.

A comparison of the 1997 and 2003 projects shows that there were no large HQs announced in the South East in 2003. Consequently, there are few large mobile HQ investments currently locating in the South East which could be targeted as possible investors in Scotland.

### 5.2.2 Sales and Marketing

Over the 1997/03 period, the Region attracted almost 830 sales and marketing projects. This is 73% of UK projects and 21% of all European projects. The majority locate in London which itself accounts for over 50% of all UK projects (and 75% of the region's projects). From the interviews, it is likely that a few of these quickly relocate to the Outer South East.

**Figure 5.4: Sales and Marketing Projects: Sectoral Breakdown (%) in London, South East and Rest of UK**

	London	Outer South East	South East	Rest of UK
Primary Industries	0.5	0.5	0.5	0.3
Electronics Retailled	7.8	18.9	10.8	12.6
Pharmaceuticals	2.6	1.9	2.4	2.6
Other Manufacturing	6.5	6.8	6.5	20.5
Software	32.8	54.9	38.3	30.8
Business Services/Telecoms	25.7	13.6	22.7	18.2
Finance	18.6	2.9	14.7	10.6
Distributions/Logistics	1.8	-	1.3	2.6
Other	3.9	0.5	3.0	2.6
<b>Total (Absolute Number)</b>	<b>619</b>	<b>206</b>	<b>825</b>	<b>302</b>

A sectoral analysis is shown in Figure 5.4. For the region as a whole, software is the largest industry accounting for 38% of projects. This is followed by Business Services/Telecoms (23%), Finance (15%) and Electronics related manufacturing (11%). The electronics projects have a strong consumer electronics orientation.

Compared with the Rest of the UK, the South East has a greater share of its projects in Software, Finance and Business Services. It has a lower proportion in manufacturing (19.7% compared to 35.7%). This arises because Other Manufacturing (i.e. outwith Pharmaceuticals and Electronics) is much more likely to locate sales/marketing offices outwith the South East.

However, it should be stressed that this is a relative phenomena. The South East still takes just over 45% of all UK Other Manufacturing Sales/Marketing offices. With over 70% of all UK projects, it is even more dominant in Primary Industries, Pharmaceuticals, Electronics, Software, Business Services and Other Industries. It took over 80% of sales/marketing investments made by the financial sector.

The majority (75%) of the Region's sales/marketing investments were in London. The main sectoral contrasts between London and the Outer South East are:

- A larger proportion of the South East's projects (55%) are in Software (compared to 33% in London). Nevertheless, it remains the case that more software projects go to London than elsewhere in the Outer South East (i.e. it takes 65% of the Region's projects).
- London dominates financial services. Very few finance Sales/Marketing projects locate in the Outer South East.
- London also dominates Business Services with 85% of the region's sales/marketing projects.
- Measured as a share of the Region's investments, the Outer South East's strongest position is in electronics related manufacturing with 45% of projects.

London attracts the vast majority of sales/marketing offices in all sectors. Only in software and electronics are there substantial numbers locating in the Outer South East.

The region's sales/marketing projects are dominated by small projects to an even greater extent than for HQs. Almost 80% of projects are in the 1 – 19 employee category. Our interviews suggest that many are towards the bottom end of this size range. The region attracted only 37 projects which planned to have over 100 employees. Sales and marketing projects are dominated by small projects throughout most of the UK. Nevertheless, those in the South East (including the Outer South East) are smaller than those which locate elsewhere.

The average annual number of projects locating in the South East for 1997/98 was 131. This had fallen to 95 for the two years 2002/03. Nevertheless, the Region has maintained its share of the UK market. There is no evidence that sales/marketing projects are shifting their location away from the South East.

While Scottish Enterprise has devoted considerable attention to HQ and R&D projects, there has been much less focus on mobile Sales/Marketing projects. This may reflect a perception that such projects involve a limited range of functions staffed by 'lower level' sales people. However, from our interviews, this is, at best, a poor caricature. These projects often incorporate important technical support and aftercare services, play an important strategic role in the company's market entry and require substantial technical and language skills. These observations apply particularly to the software industry.

### **5.2.3 Research and Development**

With 31% of the UK's R&D projects over the period 1997/03, the South East is a less dominant location than for either HQs or sales/marketing projects. It attracted just over 100 projects. Within the region, the Outer South East is the main location attracting 62 projects compared to 39 in London.

As in the UK, the number of R&D projects locating in the region has fallen substantially. Over the two years 1997/98, the average annual number of projects was 19. For the two years 2002/03, the equivalent figure was just 7. Nevertheless, the region's market share has remained more or less constant.

The sectoral structure is not dramatically different to that of the Rest of the UK except:

- The South East is somewhat over-represented in Pharmaceuticals and under-represented in Other Manufacturing (outwith electronics).
- Perhaps surprisingly, it is somewhat under-represented in the software industry. However, from the interviews, it is clear that some R&D is undertaken in its many HQs and sales/marketing facilities.

Within the Region, the vast majority of R&D related to ICT manufacturing locates in the Outer South East. Pharmaceuticals is split more or less evenly between the Outer South East and London.

As already illustrated in Chapter Four, R&D investments are, on average, somewhat larger than HQ and Sales/Marketing projects. Nevertheless, as with HQs and Sales/Marketing, those locating in the South East are smaller than those locating elsewhere in the UK. This is particularly true of projects locating in London.

An estimated 55% of the Region's R&D projects employ less than 20 (compared to 38% in the Rest of the UK). Over the entire period, the Region attracted just 20 R&D projects planning to employ over 100. At the beginning of the period, two or three well known major multinationals (in ICT-related industries) invested in large R&D facilities with planned employment of over 500. There were no similar projects in 2002 and 2003.

## **5.3 The Location Decision**

### **5.3.1 HQs and Sales/Marketing**

The factors influencing the location of projects vary between industries, functions and, within both of these, between individual projects. While there are differences between the factors influencing the location of HQs and Sales/Marketing, there are also many commonalities (especially in the software industry). In the software industry and for those companies without substantial production facilities in the UK, HQs often incorporate the sales/marketing function.

In contrast, the factors affecting R&D decisions are clearly differentiated from those affecting HQs and sales/marketing. Consequently, the reasons for HQs and Sales/Marketing projects locating in the South East are discussed together. The R&D projects are examined subsequently. Five major factors attracting HQs/Sales and Marketing to the South East were identified.

**i) Access to Markets.** Not surprisingly, access to customers (and potential customers) is the critical issue determining the location of sales/marketing projects and, because this is a key function of many HQ investments, it is also a major factor determining their location.

The specific customers which matter obviously vary from company to company. Nevertheless, the following emerged as important:

- Several software companies noted the importance of access to corporate HQs which are concentrated in London and the South East. This is because IT systems are frequently purchased centrally (and some of our interviewees 'like to sell' via corporate HQs even if the final customer is a Business Unit).
- Several consumer electronics companies mentioned the need for proximity to the large retailers (e.g. the various parts of the Dixon Group) while others mentioned the major telecom operators most of whom have their HQ in the South.
- London's financial sector is a major draw for the business service and software companies. Several of the software firms noted that finance is their largest market segment.
- Those businesses with clients in mainland Europe believe they can be cost effectively served from a location in the South East. Businesses which located in the UK to serve only UK clients believe they can be accessed most effectively from the South East. This is particularly the case when their clients are either concentrated in the South East or spread throughout the UK (rather than being concentrated in a specific region away from South East England).
- For businesses locating in the South East without mainland Europe clients, a strategic aim is often to (at least try to) establish a presence in the European market. Again, they felt this could be done most effectively from South East England.

Given that some HQs have a company co-ordinating role, it was expected HQs would give greater weight to proximity to other company facilities. However, all our HQ interviews emphasised the importance of access to customers rather than access to existing operating units.

**ii) Communications and Air Services.** The most frequent reasons for not being able to reach a senior staff member on the telephone during this study was 's/he is out of the office' (rather s/he is in a meeting). In most of the companies surveyed, senior staff travel extensively. This remains true despite attempts by some of the larger companies to make greater use of IT to cut down the amount of air travel post 9/11.

Access to air services is the critical issue. The full range of services (e.g. within the UK, to/from Europe and inter-continental) were mentioned. Travel to both customers and corporate HQ are important. The South East offers by far and away the widest range of services both within and to/from the UK.

The specific comments were numerous. For example, one company chose a location near Gatwick in part because of a direct flight to its US home town. Japanese companies noted that having flown from Japan, changing planes to fly to Scotland would not be acceptable to directors. A US company said its HQ staff need to fly to London, have a meeting and then fly the same day for meetings in Geneva. This made even an Outer South East location (away from the M4 corridor) problematic.

**iii) Existing Contacts and Investments.** Sales/Marketing projects (and HQs in software) were often the firm's first UK investment. Nevertheless, their location was influenced by established contacts. In some cases, these were existing customers while others mentioned their agents.

Outwith the software industry, the majority of businesses locating an HQ in the South East already had other facilities in the Region. Large MNEs investing in a Sales/Marketing project also generally had other facilities in the Region. These have built up over time as different subsidiaries and Business Units made (often unco-ordinated) investments in the South East. Sometimes the projects are a market entry mechanism for a specific subsidiary or business unit while others were designed to 'pull together' and integrate several existing facilities.

Over time, the company gets to know the area. Consequently, even when not co-locating with existing facilities, reasonably close proximity is common. As the number of Business Units with a South East presence increases, eventually some sort of HQ function may be required. Consequently, some of the HQs interviewed brought together the management of several Business Units. In part to retain staff, the new HQ's location is somewhere reasonably near pre-existing Business Units.

**iv) The City of London.** As already illustrated, the vast majority of the Region's financial service projects locate in London. Even when our interviewees in financial firms have few day-to-day contacts with the City, it was simply seen as 'the place to be'. This reflects, inter alia, image and the availability of skills. While not having to be in London, both software and business service firms noted the importance of the City.

**v) Skills and Labour Market Depth.** The companies generally believed that the South East is the best location for recruiting specialist skills including the attraction of talent from outwith the Region. A surprisingly high number of our interviewees were of non-UK origin including staff from the company's parent country. These staff saw the South East as a good place to live.

The software firms, in particular, saw the area as the 'home' of the UK software industry with large numbers of people having spent over 20 years in the industry. It is not seen as a new industry in the South East. Consequently, it has a well established labour market with appropriate sales, technical and business skills. The Region was also seen as the best location for attracting skilled individuals with languages. For example, one business was influenced by its ability to recruit a Japanese speaking PA/secretary.

### **5.3.2 Research and Development**

Our interviews included only 3 R&D projects. (Making contact with R&D laboratories was more difficult than contacting HQs and Sales/Marketing offices). They stressed access to a range of universities (rather than a specific university), customers, skills and international airports.

It was also clear that proximity to existing corporate facilities influenced decisions. In one case, for example, a very large facility was built in the same town as an existing administrative/management office block. The company knew the area and stressed its

residential attractiveness and commuting accessibility to recruit staff. It could also 'tap into' its existing infrastructure at minimal cost including a regular company bus service linking its different plant to the town centre (e.g. for lunchtime shopping) and the train station.

## 5.4 Post Set Up Growth

Based on data from D&B, Figure 5.5 shows the employment size of FDI projects in South East England. It compares the 1999 employment of projects which located in the region as new firms between 1995 and 1999 with the employment size distribution of the entire overseas-owned corporate stock in 1999. The vast majority of new projects (91%) are small with less than 50 employees. In comparison, the size distribution of the total 1999 stock of overseas companies has a greater proportion of large businesses. The data is consistent with the hypotheses that at least some of the South East's projects start small but subsequently achieve substantial growth<sup>44</sup>.

**Figure 5.5: Employment Size Structure (%) of South East FDI**

	<b>New Firms 1995 - 99</b>	<b>1999 Stock</b>
1 – 9	67.9	50.5
10 – 49	21.3	25.3
50 – 249	7.2	15.3
250 – 999	2.8	6.0
1,000+	0.8	2.9

Our interviewees confirm that some of the investments start small and subsequently grow substantially with the success of the business in the UK/European market. For example, three of the businesses interviewed were recorded on the Ernst & Young database as planning a project in the 1 – 19 employment category but now employ substantially more. The most substantial growth was a small Sales/Marketing office opened in 1997 which now employs around 250. Growth (or otherwise) of HQs and, to an even greater extent, Sales/Marketing projects is, in part, dependent upon the performance of management. Probably to a much greater extent than the management of a production branch plant, management in these projects has more influence over the survival and growth of the business in the UK.

At least some of the sales/marketing projects were set up almost like small independent companies with a strong entrepreneurial dimension. Included in our small sample are:

- A business set up as an independent agent/distributor for a US company which the US business later purchased.
- A sales/marketing company which was initiated by a UK resident who put the idea to the US parent company. Not surprisingly, in this case, its location was very much influenced by the residential location of the UK initiator (entrepreneur)?

<sup>44</sup> Botham, R. (2002). The Job Creation Process: Components of Change 1995 – 99 in Scotland and South East England. Report for Scottish Enterprise. There are, of course, other possible explanations. For example, it is possible that historically the Region attracted more large projects which still exist. In contrast, during the 1995 – 99 period, it attracted many more small projects and far fewer large ones. Similarly, it is possible that the smaller projects are more likely to close leaving large businesses as a greater proportion of the stock.

- A business incorporated by a US company which was later bought out by its local management forming a new independent UK software company.
- A successful Sales/Marketing project which subsequently resulted in a substantial distribution centre investment in a nearby town with direct access to the motorway network.
- Two US software firms which started small sales, marketing and technical support facilities which gradually expanded as they established a presence in the UK market. Both then identified UK acquisition targets which 'bought in' an R&D and product development function complementing their US parents' capacity.

The growth of these businesses depends upon their ability to increase UK/European sales. Many do not achieve successful market entry (and close) while others appear to achieve growth very much along the lines of SMEs more generally (but with the advantage of support from their established overseas parent).

Based on our interviews, it can perhaps be hypothesised that this type of FDI contributes to the South East's entrepreneurial potential. In contrast to the management running a production unit, the senior staff are in constant touch with customers and the market and have responsibility for the growth of the business (and, therefore, their own future). They are more likely to see market opportunities and obtain the skills and experience necessary to set up and their own business than those given responsibility for setting up and managing a large manufacturing plant.

By 2004, while a substantial number of HQ and Sales/Marketing projects had grown, many others had disappeared. Some had failed to make a successful entry and had closed. Others were difficult to trace because they had been acquired or grown via acquisition and changed its name. One business had gone through a series of mergers and acquisitions. In the process, the company's activities had moved away from those of the original project (electronic publishing) into IT-related medical research.

## **5.5. Perceptions of Scotland**

Of the 20 companies interviewed, just two had given some consideration to Scotland as a possible location. Both have Scottish clients. In addition, two finance companies already had a small marketing presence in Edinburgh.

The business which considered Scotland most seriously is in software for the oil and gas industry. It had some Aberdeen clients. However, the benefits of close proximity to these was outweighed by ease of access to both European and other UK clients from the South East. To have selected Aberdeen, its client base in Aberdeen would have had to be much larger or one of them would have had to apply pressure for its supplier to open an Aberdeen office. It was argued that Aberdeen can easily be served from a location near Heathrow. Europe and the UK cannot be readily served from Aberdeen. At least two other companies had Scottish customers (e.g. the utilities). However, they are not sufficiently important to draw the company to Scotland.

With the exception of the larger R&D projects, the majority of our interviewees had limited knowledge of Scotland as a potential location. The large R&D projects knew about Scotland,



but had not considered a location outwith the South East mainly because of existing corporate facilities. The smaller HQ and Sales/Marketing projects had little, if any, contact with the public sector or agencies making them aware of the potential benefits of a non-South East (e.g. Scottish) location. The one exception was a small Sales/Marketing project which had been encouraged by an (unnamed) development agency to locate outwith the South East. Since a non-South East location was seen as completely inappropriate, this pressure was greatly resented.

To the extent that our interviewees had knowledge of Scotland, it came either from clients or their Scottish employees living in the South East. Their general impression of Scotland as a place from which to do business was not highly favourable. In response to questions about potential advantages and disadvantages of locating in Scotland, the two negative perceptions which stand out are (lack of) accessibility to customers and difficulties with recruitment.

Most were not aware of any available assistance to locate in Scotland and believed assistance was not available to their type of project. Furthermore, most believed that the location decision would not have been affected by the availability of assistance.

## **Strategic Implications**

The HQ and Sales/Marketing projects currently locating in London and the South East will not be easily attracted to Scotland. Even if successfully achieved, the number of projects and their employment will be relatively small. Nevertheless, the longer term impact of such projects could be significant. In this context, Sales/Marketing investments appear at least, if not more, important than mobile HQs. However, they are probably the most difficult to attract.

As a starting point, mechanisms are required to 'get to' a large number of small projects. Historically, the inward investment system has been geared up for the attraction of relatively large projects. A better understanding is required of how to attract small, non-manufacturing projects.

It is likely that only a small minority of projects locating in the South East could be persuaded to consider a Scottish location. The projects which are most likely to be attracted are:

- Companies with existing or potential customers in Scotland. These could be in, for example, financial services, the offshore sector, utilities and the public sector. This implies the need to include specific information on major purchasers in marketing material.
- Companies with existing facilities in Scotland. The attraction of HQs and Sales/Marketing functions should be an integral part of reinvestment and aftercare activity.
- Companies with their parent HQ located in areas with direct air services to/from Scotland.

More generally, HQs, Sales/Marketing and R&D are more likely to be attracted in sectors (or clusters) in which Scotland has competitive strengths. Throughout this study, oil/gas, electronics (defined broadly) and financial services emerge as the sectors in which such activity is most likely to be attracted.

Finally, reinforcing the conclusion from Chapter Four, further consideration should be given to the software industry. To a greater or lesser extent, Scotland has maintained a long term interest in developing an IT cluster. Software could be an integral part of such a cluster. Furthermore, Scotland has important niche markets (e.g. oil/gas, utilities) for software and a presence in perhaps the major software market (i.e. financial services). Despite this, relatively few software projects are being attracted to Scotland. Those currently locating in South East England often integrate HQ, Sales/Marketing, Technical Support and R&D. In this respect, software fdi may differ from traditional fdi in important respects with potential longer term developmental benefits.

## 6. Developmental Impacts

Having looked at the changing nature and location of HQ functions, this chapter examines their longer term developmental effects. It is based largely on a review of the literature plus the interviews with companies with a Scottish HQ. The analysis differentiates between inward investment HQ functions (including R&D projects) and indigenous businesses. It also highlights the relationship between clusters and developmental spillover effects.

### 6.1 The Inward Investment Dimension

There is a well established view that certain types of inward investment become more embedded in the local economy and have greater long term, indirect economic development effects. This argument is well summarised by the UN World Investment Report.

*“The prospects for technological upgrading through assembly type activity is limited. Such activity is more geographically mobile and less connected to the local economy. The affiliate makes no contribution to transforming the pattern of comparative advantage....*

*In contrast, technologically dynamic, research related FDI is attracted to countries having some locational asset of interest to TNCs... They can become part of a local inter-firm network and evolve into centres of excellence. The competitive advantage of TNCs interacts positively with the locational advantage of the country so that both the competitiveness of the companies and local economic development are increased. As a result the comparative advantage of the host country in the relevant industry is progressively enhanced and is more firmly grounded in a coherent local innovation system (e.g. Singapore.”<sup>45</sup>*

This essentially contrasts the limited impacts of branch plants with the developmental effects of technology based inward investment via technology and knowledge transfer.

There is an extensive literature on the characteristics of inward investors with potential developmental effects. There is widespread agreement that R&D projects or subsidiary companies with substantial R&D ‘fit the bill’. Other characteristics expected to generate developmental effects are Centres of Excellence (which may, or may not, derive their status from R&D), companies with product design responsibility or global product mandates and subsidiaries with purchasing autonomy<sup>46</sup>. For example, such subsidiaries may establish long term developmental relationships with key suppliers. These suppliers may, or may not, be local<sup>47</sup>.

At this point, three points should be stressed. First these arguments refer to the entire subsidiary and not individual plant within the subsidiary. A Centre of Excellence or subsidiary

<sup>45</sup> United Nations (1996). World Investment Report 1996.

<sup>46</sup> Young, S. et. al. (1994). Multinational Enterprise and Regional Development, Regional Studies, Vol. 28, No. 7, pp. 657 – 678.

<sup>47</sup> Turok, I. (1993). Inward Investment and Local Linkages: How Deeply Embedded is Silicon Glen, Regional Studies, Vol. 27, No. 5, pp. 401 – 18.

with a global product mandate could have several locations including, for example, its HQ in London, R&D in Cambridge and production in Scotland. Under these circumstances, the developmental effects may not be felt in Scotland. Second, none of the literature suggests that stand alone HQs (e.g. a EHQ) have developmental effects per se. The literature says nothing about the potential effects of such facilities. Indeed, this is not a question which has even been considered in the literature.

The third point is that these are expected or hypothesised developmental effects. They are based on logical deduction rather than empirical evidence. Despite the substantial literature on inward investment with developmental characteristics, there is little research on actual developmental effects. The literature remains largely concerned with describing the characteristics of inward investment. Its main finding is that while the nature of inward investment is changing, the majority of overseas subsidiaries are branch plant implementers with limited business autonomy or control over their own future<sup>48</sup>.

For example, a recent study of fdi in Wales and North East England concludes that few overseas subsidiaries are embedded in the local economy or have developmental characteristics. This is despite the fact that there are relatively few pure 'branch plant' which do nothing other than manufacturing. Around 75% are co-located with some upstream or downstream business functions. For example, 50% have some on-site RD&D. Nevertheless, this is mainly concerned with adapting products and processes to local circumstances. Very few, if any, contribute to the creation of an effective innovation system<sup>49</sup>.

It is perhaps not surprising that a study of the overseas corporate stock finds that the old 'branch plant' model still dominates. However, a more relevant question is whether recent investments have more developmental characteristics and whether plant with specific characteristics (e.g. R&D) have more developmental impacts (e.g. follow-up investment, local purchasing) than plant without these characteristics. The data could be analysed to answer these questions. Unfortunately, such an analysis has not been undertaken.

One of the few studies which examines the indirect effects of UK inward investment concludes that there has been positive developmental effects mainly via technology and knowledge transfer to suppliers<sup>50</sup>. This implies that HQs with purchasing autonomy have greater spillover and developmental effects than businesses without such autonomy.

Building on this finding, a recent study examined whether the beneficial spillovers to suppliers (e.g. resulting in improved competitiveness of suppliers) varied with the characteristics of the inward investor<sup>51</sup>. This found that businesses with a regional or global product mandate, *ceteris paribus*, have greater spillovers than other businesses. However, this is just one of several factors which determine such spillovers. Other influential factors include the longevity of the subsidiary in the UK, the size of the inward investor and the characteristics of the

<sup>48</sup> Holm, U. and Pedersen, T. (2000). *The Emergence and Impact of MNE Centres of Excellence: A Subsidiary Perspective*, Macmillan Press.

<sup>49</sup> Phelps, N.A., MacKinnon, D., Stone, I. and Braidford, P. (2003). *Embedding the Multinationals? Institutions and the Development of Overseas Manufacturing Affiliates in Wales and North East England*, *Regional Studies*, Vol. 37, No. 1, pp. 27 – 40.

<sup>50</sup> PACEC (1995). *Wider Effects of Foreign Direct Investment*. Report for DTI, Scottish Office, Northern Ireland Office and Cabinet Office.

<sup>51</sup> Potter, J., Moore, B. and Spires, R. (2003). *Foreign Manufacturing Investment in the United Kingdom and the Upgrading of Supplier Practices*, *Regional Studies*, Vol. 37, No. 1, pp. 41 – 60.

suppliers. Nor does the study give any indication of the magnitude of spillover effects. It is, however, self-evident that if the plant/subsidiary has few local suppliers (which is generally the case in Scotland), the spillover effects must be small (regardless of the characteristics of the inward investor).

This observation is confirmed by a study of mainly manufacturing inward investment in Scotland undertaken for Scottish Enterprise<sup>52</sup>. Apart from demand side multiplier effects and some spillovers via workforce training, this found little evidence of longer term developmental effects. This was true even for manufacturing plant with at least some developmental characteristics (e.g. management authority over non-manufacturing functions). However, the study did not explicitly examine spillovers from R&D and HQ projects per se.

To identify a wider range of spillover effects, the perceptions of the MD of Centres of Excellence (COE) and other inward investment subsidiaries have been compared<sup>53</sup>. For example, 25% of Centres of Excellence MD's believe their subsidiary has a significant impact via technology transfer to the local economy. Just over 10% believe their business has attracted other inward investors into the region and 7% say it has stimulated the creation of new firms. Such spillovers arise from all types of Centre of Excellence and not just those which derive their status from R&D. Such impacts were perceived to a lesser extent by the MDs of other inward investors. The COE MDs are also more likely to participate in local business networks and they believe their subsidiary is more embedded in the local economy than are branch plants.

At least some MDs of Centre of Excellence believe their subsidiary has beneficial longer term developmental effects. However, whether these perceptions reflect reality is unknown. It is, however, clear that it is only a minority of Managing Directors who believe their 'Centre of Excellence' has significant economic development spillovers. This means that the majority believe their Centre of Excellence has no substantial spillover or developmental effects.

As with other forms of inward investment, spillover effects from R&D are 'deduced' rather than empirically observed. For example, a recent study of foreign-owned R&D in Europe shows that such R&D is geographically concentrated into relatively few regions and that it is attracted to areas with pre-existing R&D facilities. It is argued (but not empirically shown) that this is because of spillovers and externalities arising from proximity to other R&D facilities<sup>54</sup>. While this does not demonstrate the existence of developmental effects such as spin off companies, it does demonstrate that a critical mass of R&D attracts further R&D investments

<sup>52</sup> Firm Crichton Roberts *et al.* (2000). Op cit.

<sup>53</sup> Holm, U. and Pedersen, T. (2000). *The Emergence and Impact of MNC Centres of Excellence: A Subsidiary Perspective*, Macmillan Press, Basingstoke.

<sup>54</sup> Cantwell, J. and Piscitello, L. (2005). *Recent Location of Foreign-Owned Research and Development Activities by Large Multinational Corporations in European Regions: The Role of Spillovers and Externalities*, *Regional Studies*, Vol. 39, No. 1, pp. 1 – 16.

One study which has attempted to empirically identify R&D spillovers is based on a limited number of R&D projects in India and Singapore. This found:

- They attract highly qualified people into the two countries. Most of these were expatriots who had either been educated overseas (generally in the US) or were working overseas (again, generally in the US).
- Some developed links with universities via sponsoring research, professorships, student placements and recruitment. Especially in India, these links have introduced more commercial, application-orientated research into the academic system in contrast to its traditional theoretical and scientific focus. This has begun to breed a pool of potential 'high tech' entrepreneurs.
- While the majority of laboratories have minimal links with local industry, anecdotal evidence suggests that knowledge transfer to local firms is occurring via recruitment and the movement of employees into local industry.

However, these spillovers often take several years to materialise and are not extensive.

Perhaps the main conclusion from this review is that there is little empirical evidence on the developmental effects of 'high value' inward investment. It is also likely that any such effects depend upon local circumstances<sup>55</sup>. For example, with a well established academic system funded and driven by non-commercial criteria, it is unlikely corporate R&D investments would have a similar impact on the culture and orientation of Scottish universities. This raises the question of how the local environment affects the extent and nature of spillover and developmental effects.

## 6.2 Individual Companies and Cluster Development

### 6.2.1 *Developmental Effects and the Local Environment*

While there is limited 'hard' evidence, as argued in Chapters Two and Four, successful industrial clusters attract HQs and R&D mobile investment. They also enable the upgrading of existing inward investment. For example, relationships with customers play an important role in this process. Simultaneously, the extent and nature of spillovers and developmental effects are influenced by the local environment. Many spillovers are to suppliers. Self-evidently, without local suppliers such spillovers cannot occur. More generally, case studies of successful clusters provide some of the most obvious evidence of spillovers and developmental effects from R&D and indigenous businesses with a local HQ.

### 6.2.2 *ICT: Austin, Texas*

This is one of the fastest growing ICT clusters in the United States initially based on computers, semiconductors, telecoms and a related software industry. Many factors contributed to its growth. Nevertheless, several specific companies had a distinctive and widespread developmental impact.

- **Tracor.** Set up in 1955 as a spin off from the University of Texas, the company was the source of much of the cluster's initial indigenous business development. By

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<sup>55</sup> Reddy, P. (2000). *Globalisation of Corporate R&D: Implications for Innovation Systems in Host Countries*, Routledge.

1985, the company employed 2,200. However, a further 3,050 were employed in 16 IT businesses which had directly spun out of Tracor with the explicit support of Tracor's founder<sup>56</sup>.

- **Micro-Electronic Technology Computer Corporation (MCC).** This was set up in 1983 as a large collaborative research centre sponsored by major US ICT companies and the US Government. It is credited with introducing knowledge of, and a commitment to, commercialising science and technology, support for spin outs and 'putting Austin on the R&D map'. In addition to helping transform the University of Texas at Austin into a major research university, a specific indirect impact was its contribution to attracting Sematech to Austin.
- **Sematech.** Like MCC, this is a collaborative research centre specialising in the design of semiconductors. This has had less effect than MCC on, for example, the entrepreneurial environment. However, it attracted a large number of semiconductor related companies (e.g. equipment manufacturers) to Austin (at least in some cases to participate in Sematech research projects).
- **IBM.** The company developed a large software centre in Austin which is now a major source of IBM patents. As with MCC and Sematech, this attracted talent from around the US (but especially Silicon Valley and Route 128). Subsequently, IBM spawned a large number of software start-ups during an industry recession which saw the company lay off large numbers of software engineers. These businesses contributed much to Austin's strength in the software sector.

The growth of Austin's ICT cluster reflects many factors. In addition to these projects, much else was going on. It may (or may not) have been equally successful without these four companies. There are many other large R&D facilities, substantial indigenous businesses with a local HQ (e.g. Dell) and inward investors with HQ functions in Austin. However, while obviously important, few of these are credited with the same level of indirect developmental effects.

It is also clear that these developmental impacts reflect local conditions. For example, without the entrepreneurial environment which already existed, redundancies at IBM may not have generated new software businesses. Ex-employees may simply have moved back to a job in Silicon Valley or Massachusetts. Nevertheless, the Austin story suggests that a minority of indigenous businesses and R&D facilities have extensive spillover effects given the right local conditions.

### 6.2.3 Silicon Valley

Many thousands of start-ups, individuals and organisations have contributed to the growth of Silicon Valley. Nevertheless, out of the many businesses and R&D centres located in Silicon Valley, all histories of the region's IT cluster identify a few indigenous companies and research centres with disproportionately large developmental impacts<sup>57</sup>. These include:

- **Hewlett Packard (HP).** Set up in 1938, this was the Valley's first electronics company to grow into a global business retaining its independence and HQ in Silicon Valley. It became 'the' role model pioneering a new management style and culture

<sup>56</sup> Gibson, D.V. and Smilor, R.S. (1991). The Role of the Research University in Creating and Sustaining the US Technopole. In Brett, A. et. al. (eds), University Spin Off Companies, Savage, Maryland.

<sup>57</sup> Koeppe, R. (2002). Clusters of Creativity, John Wiley and Son Ltd, Chichester.

(The HP Way) creating the distinctive business model which (along with its technology) underpins the growth of Silicon Valley. For example, HP began life with a philosophy of informality, flat structures, share options, an empowered workforce and a willingness to collaborate with local firms and competitors. Packard was responsible for the creation of the IT cluster's early governance structures, getting industry involved in the development process and the Valley's tradition of academic-industry collaboration. By the mid-1990's, the two founders had donated over \$300m to Stanford and Hewlett's foundation donated a further \$400 following his death in 1999. With its ongoing process of restructuring, HP spun off its instrumentation division in 1999 creating a new Silicon Valley company (Agilent Technologies) which, itself, has 47,000 employees.

- **Shockley Semiconductor Laboratories and Fairchild Semiconductor.** As a leading scientist/technologist, William Shockley set up his business in 1956. As a commercial failure, it closed in 1968. However, during its short life, Shockley's appalling management style drove away the 'Traacherous Eight.' They set up Fairchild Semiconductors. Within 10 years, they had all left to set up further businesses with the last two (Noyce and Moore) leaving to create Intel. This is now the Valley's leading semiconductor business. During the process, Arthur Rock moved from New York to Silicon Valley to become Chairman of Intel and set up Davis Rock which represents the birth of Silicon Valley's 'classic' venture capital industry.
- **Xerox PARC<sup>58</sup>.** To keep an eye on the emergence of networked computing, Xerox opened its R&D centre in Palo Alto (just down the road from HP) in 1970. This became the catalyst for the commercial development of networked computing. While Xerox has systematically failed to exploit its many inventions, its technology has been extensively utilised by companies such as Apple, 3Com (a direct spin out), Sun and Adobe. Spillovers from PARC explain, to a considerable extent, Silicon Valley's dominant position in internet-related technology.

It is such examples which support the argument that indigenous businesses with local HQs (HP, Shockley, Fairchild, Intel) and R&D centres (Xerox PARC) have significant developmental impacts.

Similar examples are found in other successful clusters. For example, the National Research Centre (a public sector research institute) and Nortel's research laboratories played a key role in the development of Ottawa's telecommunications cluster (Silicon Valley North)<sup>59</sup>. Both generated substantial numbers of spin offs and helped establish a technological paradigm upon which the cluster is based. Similarly, Newbridge Networks pioneered a high profile corporate venturing model. In the case of San Diego, spin offs from Hybretch contributed greatly to the growth of the city's biotech cluster while Cambridge Instruments was a source of many new starts in Cambridge, England.

The development of successful clusters demonstrates four important conclusions. First, companies with a local HQ and R&D centres can have substantial developmental impacts on the local economy. Second, the nature and extent of such spillovers depend upon the 'fit'

<sup>58</sup> See Brown, J.S. and Duguid, P. (2000). *The Social Life of Information*, Harvard Business School, Boston, USA.

<sup>59</sup> Shavinina, L.V. (2004). *Silicon Valley North: A High-Tech Cluster of Innovation and Entrepreneurship*, Elsevier Ltd., Oxford.



between the company and the local environment. It can at least be hypothesised that spillovers are more likely to occur within the context of a reasonably well developed cluster. Third, substantial spillovers appear to come from a minority of businesses. Many HQs and R&D centres have few spillovers and developmental effects. Fourth, the cluster case studies suggest that spillovers mainly come from R&D centres and indigenous businesses born locally rather than subsidiary inward investment HQs.

## 6.3 Indigenous Business

### 6.3.1 Demand for Business, IT and Financial Services

For many businesses, the purchase of business, financial and IT services is a headquarter function. As previously illustrated, purchasing appears more centralised in US Corporate HQs. Presumably in the UK, somewhat more purchasing responsibility is in Subsidiary HQs. Nevertheless, HQs are an important source of demand.

However, there are no systematic data on demand generated by HQs in Scotland or the UK. The input-output tables show demand generated by each industry. They do not differentiate between companies with a HQ in Scotland and those without a Scottish HQ. While there is no direct evidence, HQ purchasing is likely to be considerable. A study of 30 Swedish HQs (with the companies having around 4,000 employees) found they purchased services valued at around £600m (i.e. approximately £150k per employee)<sup>60</sup>. A breakdown by product is shown in Figure 6.1. While spread throughout several industries (finance, legal, R&D), the demand for IT services dominates. This expenditure supports an estimated 7,500 jobs. This is a substantial multiplier effect.

**Figure 6.1: HQ Purchasing by Service (% of Total)**

Finance	5.1
Accounts	2.3
Legal	8.2
Marketing	13.5
R&D	7.9
Consulting	1.4
Training	4.9
IT	44.7
Local Services (e.g. hotels, transport)	11.9
Total	100.0

Source: Calculated from UK Trade International, p.19

The existence of HQ purchasing offers an important opportunity for local suppliers. However, not all is, or could be, spent locally. For example, Scotland's financial sector is increasingly purchasing globally, perhaps with less going to Scottish suppliers. Indeed, the customer (in this case, Scotland's financial sector) may perceive little advantage in having local suppliers<sup>61</sup>.

<sup>60</sup> From an unpublished internal report by UK Trade International (2003) on European HQs.

<sup>61</sup> Cap Gemini and Ernst & Young (2001). Scottish Enterprise Financial Services Supply Chain Research, Report to Scottish Enterprise and Scottish Financial Enterprise.

On the other hand, suppliers often want to be reasonably close to customers. The evidence from South East England shows that customers attract higher value inward investment. A good illustration of the drawing power of HQs with major purchasing power is the clustering of suppliers around Walmart's US HQ. The purchasing power of HQs is an important factor determining the growth and development of business services and, as illustrated throughout this study, the software industry. Given that IT accounts for such a substantial proportion of HQ purchasing, this is perhaps not surprising.

Looking at the issue from the perspective of Scottish companies, the existence of local HQ customers is important. For example, one of our interviewees (a business service firm) stressed the importance of customer proximity noting the loss of trade following either an external acquisition or when HQ functions drift south. Similarly, concerns continue to be expressed over the adverse impacts of the loss of financial service HQs. A specific question is whether the loss of life insurance HQs will have adverse effects on demand for the services of Scotland's independent fund managers<sup>62</sup>.

### **6.3.2 New Business Formation**

It seems reasonable to argue that HQs provide the experience, training, networks and knowledge which enable employees (either individually or in teams) to set up their own business. It may also be reasonable to argue that such individuals are more likely to set up high growth new starts. The HQ might be seen as a 'high class business school'. For example, the Macdonald Hotels was set up by staff from Stakis.

To an unknown extent, HQs are also believed to employ a disproportionately large number of graduates. Graduates are more likely to set up their own business than non-graduates. Consequently, an economy with a large number of HQs may have, *ceteris paribus*, a higher business birth rate. On the other hand, there is no direct evidence of a link between large company HQs and the business birth rate. Nor is there any explicit evidence that inward investor HQs (e.g. EHQs) generate new firm formation.

While there is little hard evidence showing that large company HQ staff are an important source of new businesses, there is evidence showing that corporate R&D staff are an important source of 'high tech' new starts. Such businesses are generally set up by science and technologists (not professional managers and accountants) with experience in small high tech firms and corporate laboratories. One of the reasons for Scotland's relatively low high tech business birth rate is the under-representation of corporate R&D in Scotland. Nevertheless, some of the earliest IT start-ups (e.g. OWL, Spider) were set up by teams from ICL's Scottish R&D laboratory.

While there is no direct evidence on the extent to which HQ staff leave to set up their own business, HQs do generate new firms via corporate venturing, joint ventures and corporate restructuring (i.e. spin offs). A few examples illustrate the point:

- **Royal Bank of Scotland** is responsible for Direct Line and, in a joint venture with another local company, set up Kwik Fit Assurance. It also set up Tesco Bank in a joint venture with Tesco.

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<sup>62</sup> Deloitte (2004). Scottish Financial Services Industry: PEST/SWOT Analysis.

- **Halifax Bank of Scotland** is responsible for Esure, Intelligent Finance and Sainsbury Bank (as a joint venture with Sainsburys).
- **Standard Life**. Again reflecting, the freedom of action available to Corporate HQs, Standard Life set up a telephone banking arm (Standard Life Bank).
- **Scottish Power** was responsible for spinning off Thus, one of Scotland's few new starts in the telecom services sector.

Without the Scottish HQ, it is unlikely these new businesses would have been established in Scotland.

### **6.3.3 Corporate Linkages**

At least early in a company's life, there is a close link between its HQ and production/operating facilities. As the company grows, the HQ becomes increasingly separate from production and even functions such as R&D. Indeed, it is sometimes claimed that there is now little locational link between HQs and other corporate functions such as production<sup>63</sup>.

However, this is to overstate the argument. For example, Silicon Valley's IT firms continue to undertake a substantial amount of both R&D and production in Silicon Valley. Ford modernised its Detroit production plant next to its HQ rather than seek lower wage costs elsewhere in the US. The direct employment impact of Scotland's major financial firms is not their HQ employment but, rather, the large number of 'production' staff in Scotland. Within banking, for example, 70% of employees are in customer service related jobs (e.g. service centres and call centres).

Indigenous business HQs are important because of their influence over local production facilities. The main direct impact of the company is through these facilities rather than the HQ itself. Production and other activities are more likely to remain in the company's place of birth and in close proximity to its HQ.

Similarly, a long standing concern relating to branch plants' is that with no HQ influence, they are vulnerable to closure. In making decisions on plant closure, proximity to head office is rarely given as a major influence. Other factors dominate. Nevertheless, it often emerges as a secondary influence. It also appears that in the case of MNE closure decisions, overseas rather than domestic plants are more likely to be closed<sup>64</sup>.

### **6.3.4 Corporate Sponsorship**

The HQ of large corporations may benefit the local area through sponsorship of charities, cultural facilities, events and economic development activities such as enterprise agencies and industry associations. Countering this view, at least in the US, the majority of companies say they spread sponsorship around the country and do not confine it to their HQ locality. Nevertheless, companies cannot spread their sponsorship to all parts of the country and they are unlikely to ignore their local area. Furthermore, a substantial minority of companies

<sup>63</sup> UK Trade International, op. cit., para 70.

<sup>64</sup> UK Trade International paras 79 – 82, op. cit.

concentrate their sponsorship in the vicinity of their HQ. Consequently, 40% of US sponsorship is for projects in the vicinity of the corporate HQ<sup>65</sup>.

There are no UK studies of corporate sponsorship and no systematic data on sponsorship in Scotland. However, as an illustration of its possible significance, Figure 6.2 (next page) shows the companies which sponsor the Edinburgh Festival. The majority of sponsors are Scottish including some of Scotland's largest businesses. Of the non-Scottish companies, most were either originally Scottish (e.g. Scottish Widows) or have a long established presence in Scotland (e.g. IBM). While companies such as Scottish & Newcastle and Caledonian Breweries have vested self-interest in sponsoring the Festival, it cannot be assumed that in their absence non-local breweries would step in and fill the gap.

The Festival is now perhaps Scotland's main tourist event. Once well established, it becomes easier for events to attract non-local sponsorship. However, this is much less true when something new is being 'got off the ground'. It is, therefore, no surprise that Scottish & Newcastle was a key sponsor in the Festival's early years. This illustrates how indigenous company HQs can play a decisive role in launching economic development initiatives. It is often in their own interest to do so.

**Figure 6.2: Companies Sponsoring the Edinburgh Festival**

Scottish	Non-Scottish
<b>Bank of Scotland</b>	IBM
Caledonian Brewing Co.	<b>Lloyds TSB</b>
Hire-a-Phone	Renault
The List	<b>Scottish Widows</b>
Macdonald Orr	<b>Total E&amp;P</b>
<b>MacTaggart &amp; Michael</b>	
<b>Royal bank of Scotland</b>	
<b>Scottish &amp; Newcastle</b>	
<b>Scottish Power</b>	
<b>Standard Life</b>	

Note: Bold italics indicates companies in the Business Insider Top 500

## 6.4 Effects of Acquisition

The acquisition of a company leads to a loss of autonomy and functions in the acquired company's HQ or even its complete closure. For example, following the Royal Bank's acquisition of NatWest, the London HQ of NatWest was closed. One of our Scottish interviewees noted that following the acquisition of an English company, its HQ functions were transferred to Scotland and the subsidiary subsequently used its Scottish parent's service providers. However, as already illustrated, more generally the acquisition of Scottish companies has led to the loss of Scottish HQs.

<sup>65</sup> National Commission on Philanthropy and Civic Renewal (1998). Washington, DC.

It is widely argued that the acquisition of Scottish companies (i.e. the loss of independent HQs) has negative developmental impacts on the Scottish economy. Consequently, studies of the effects of acquisition could, indirectly, provide evidence relating to the impact of HQs.

Studies of the impact of the acquisition of Scottish companies show that the effects vary greatly from case to case. Some improve performance and increase employment, others shed jobs and even close. However, for the acquisitions during the period 1965 – 1986, it has been argued that, on average, the performance of acquired companies in terms of employment, productivity and profits were marginally better than they would have been without the merger<sup>66</sup>. On balance, the performance of smaller independent companies improved while that of the acquired PLCs declined. The smaller acquired companies benefited because the new parent brought improved access to finance, distribution channels, management know-how and greater market muscle.

Nevertheless, the acquired companies lost autonomy and management jobs. More specifically, there was a loss of R&D and marketing functions. Furthermore, even if employment was marginally higher than it would otherwise have been, within about a decade of acquisition, employment in the acquired companies had more or less halved.

In addition, in the longer term, acquired companies probably become more vulnerable to closure<sup>67</sup>. They may lose the freedom of action to respond to changing circumstances (e.g. investment in new products, corporate diversification etc.). Management not only has less freedom of action, it may also have less vested interest in responding to change.

While there is room for debate over the short to medium-term impact on company performance, the external (or developmental) effects of acquisition are less ambiguous. Acquisition leads to a loss of such effects<sup>68</sup>. For example, of the companies acquired between 1965 and 1986, 72% reduced their purchase of locally produced services. The main losses were auditing and banking. Under today's circumstances, IT services would be an equally significant loss. None increased their purchase of services from Scotland. The 16 Scottish PLCs purchased in 1985 – 86 reduced auditing spend in Scotland by around 4% of total demand for auditing services.

It can be argued that loss of independent HQs has undermined demand for brokerage services and constrained the development of merchant banking and business services. Equally important, the loss of HQs means the loss of potentially 'demanding customers' who play a critical role in the innovation process<sup>69</sup>. While there is no direct evidence, the loss of key players in the innovation process can be hypothesised to be one of the most serious negative effects of the loss of HQs.

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<sup>66</sup> Ashcroft, B.K. *et al.* (1987). The Economic Effects of the Inward Acquisition of Scottish Companies 1965 to 1980, ESU Research Paper 11, Industry Department for Scotland. Henry, J.D. (1988). The North South Divide: Merger Mania and the Impact on the Regions: A Scottish Dimension, P.E. Inbucon Ltd.

<sup>67</sup> Mason, C.M. and Harrison, R.T. (2004). After the Exit: Acquisition, Entrepreneurial Recycling and Regional Economic Development, Hunter Centre for Entrepreneurship, Strathclyde University.

<sup>68</sup> The obvious caveat is acquisitions which save a business from closure, its external impacts after the acquisition are self-evidently greater than under the counterfactual (i.e. closure).

<sup>69</sup> Scottish Development Agency (1989). Submission on Public Interest Issues to the Monopolies & Mergers Commission on the bid by Elders IXL for Scottish & Newcastle Plc.

Almost all the evidence on the effects of acquisition is for the 1970's and 1980's. There is surprisingly little recent research. However, the impact of acquisition on five small Scottish 'high tech' companies is summarised in Figure 6.3. These stories are consistent with the results of previous research.

**Figure 6.3: The Impact of the Acquisition of Scotland's High-Tech Start-Ups**

**Award.** Set up in 1993, by the time it was acquired, it employed 100. Four years later, following a major investment by the new owners, it employed 1,000. Despite a pre-purchase agreement that would have seen it run as an autonomous business in competition with other business units in the parent, the parent integrated it into the wider business reducing Award to a manufacturing/supply unit.

**Atlantech.** Set up in 1992, it was sold to Cisco in 2000 when it had a workforce of 130 (mainly software engineers). Cisco was able to take its product worldwide leading to an increase in the Scottish workforce. However, it was integrated into Cisco with the loss of its separate identity and in 2003 it was announced that Cisco planned to downsize or even close the plant.

**OWL.** Set up in 1982, it was sold to Panasonic in 1989 when it employed 140. Its commercial activities were shut down but its R&D lab (with around 50 highly qualified staff) has prospered continuing to supply ideas to its parent. At the time of the sale, its technology was well ahead of the game but financing expansions had become very difficult (with its funders wanting an exit) and the company needing a major 'leap forward'.

**Spider Systems.** Sold in 1995 to Shiva (a US company of similar size but with a NASDAQ listing) when it employed 150 in Scotland. Shiva brought in its own management (so the original founders left) and in 1995 it was closed (due to Shiva's overall poor performance).

**Objective Software Technology.** Set up in 1991, it was sold to a NASDAQ listed US firm (Wind River Systems) in 1998 where it had 12 employees. It was closed in 2002 in a company-wide rationalisation programme.

Source: Mason, C.M and Harrison, R.T. (2003). Acquisitions, Entrepreneurial Recycling and Regional Economic Development.

In most cases, in the short term, the performance of the business improved. The entrepreneur generally sold out for good business reasons and the new parent provided resources (e.g. capital, distribution channels) which enabled the business to grow. However, in the longer term, the outcome has been fairly or completely negative for both the company and the Scottish economy. While all the founders recycled some of their assets resulting from the sale (e.g. as business angels, business advisors etc.), the possibility of growing a new independent company with its corporate HQ in Scotland was closed off by the acquisition<sup>70</sup>. They will not grow into major independent companies with the type of developmental impacts illustrated by companies such as Hewlett Packard or Scottish & Newcastle elsewhere in this chapter.

<sup>70</sup> Mason, C.M. and Harrison R.T. (2004). Op.cit. However it should be noted that without the acquisition there was no guarantee that the company would have achieved significant growth or even survived.

## 7. Conclusions and Implications

In this final chapter, the analysis is brought together to provide, as far as the available evidence allows, explicit answers to the questions posed in the introduction. It then draws out for discussion the strategic and operational implications.

### 7.1 The Changing Nature of HQs

All businesses, even the smallest, have HQ functions. However, discussion of HQs generally refers to large companies. Unfortunately, there is no obvious (or correct) size at which companies can be said to have an HQ. Consequently, defining the HQ concept is problematic and the results of empirical studies are highly sensitive to the size cut-off used in the research.

Here the focus is on the HQs of large companies (with, say 2,500 employees plus). The following characteristics of corporate HQs were identified:

- The role, nature and function of HQs varies greatly from company to company. Even within any given market segment such as specific sectors or Regional HQs, there is no standard HQ.
- The average size of HQs is now relatively small. Much employment once located in the corporate HQ is now located elsewhere in the company. This includes, for example, subsidiary company HQs and shared service centres.
- The majority of HQs (say, around 80%) are 'stand alone' identifiable HQs while the rest are 'embedded' HQs (i.e. linked to, and integrated with, operational management of the business.)
- The vast majority of HQs are responsible for corporate strategy and management, financial issues (e.g. tax, pensions, financial reporting and control), legal services and most aspects of human resources. Only a minority are responsible for R & D.
- US and Japanese HQs are larger than their UK counterparts. They have more functions and are more powerful within the wider corporation. For example, the majority of US HQs are responsible for purchasing compared to a minority of UK HQs.

While a substantial minority of corporate HQs remain at a given location for many years, geographic mobility is not uncommon. This is, in part, driven by the changing role of HQs.

Day-to-day management of large corporations is not undertaken by the Corporate HQ. Most large companies have a number of subsidiaries with their own HQs. With the exception of overseas subsidiaries of multinationals, there is little research on the changing role and nature of subsidiary HQs. However, they are more likely to be an embedded HQ (i.e. co-located with other functions) and they experience much more churn with the frequent opening of new, and closure of existing, HQs.

For legal reasons, all Scottish inward investors have a subsidiary HQ somewhere in the UK. Because many have multiple locations, this need not be (and often is not) in Scotland. It is widely believed that the range of management functions performed by overseas subsidiary HQs has increased in recent years.

However, the extent to which overseas subsidiaries have greater autonomy and management responsibility should not be overestimated. They remain subsidiaries with ultimate control resting with Corporate HQ. Beyond this, their main characteristics include:

- The majority employ relatively few people (i.e. below 50). While there are a growing number of 'stand alone' HQs, many are co-located with other corporate functions.
- There is great diversity in their nature and corporate role. For example, some are concerned with intra-company co-ordination, others with marketing or the provision of support services. There are also substantial differences between industries.

Even within a specific type of HQ, for example European Regional HQs, the best conclusion that can be reached is that there is no standard European HQ.

Over the past 20 or 30 year, the dominant trend has been the downsizing of Corporate HQs. This reflects;

- The drive to increase flexibility and responsiveness by moving from a centralised, hierarchical organisation to a more decentralised, flatter structure empowering a larger number of employees. By removing layers of middle management, this was also intended to reduce costs. This was the main driving force during the 1980s.
- The widespread application of IT during the 1990s to improve productivity and reduce the cost of HQ functions.
- The increased use of outsourcing. For companies not outsourcing HQ services, many decentralised the more routine services into subsidiary HQs in lower cost locations.
- Increased use of market mechanisms, rather than direct management control, to allocate corporate resources.

At the same time, the majority of companies have sought to increase the strategic influence and power of their corporate HQ.

These changes have themselves set in motion more recent drivers of change including:

- The creation of matrix structures to link and coordinate decentralised organisations. Such structures have proved problematic. The search is now on for more simple systems.
- Decentralisation often generated duplication of managerial and service functions. Consequently, services have been brought together in shared service centres generally in low cost locations to serve several subsidiaries.
- Decentralised structures make it difficult to offer an integrated service/product to customers. This is leading to the creation of Front End / Back End organisational structures.

These trends are changing the nature and location of subsidiary HQ functions. They do not create pressure for Corporate HQ growth.

In contrast to UK HQs, US Corporate HQs have increased their employment in recent years. This reflects the desire of many companies to create and exploit core competencies. Whether this trend will be replicated in the UK remains to be seen.



Multinationals are being driven by the same forces. However, the nature and role of overseas subsidiary HQs are also being determined by:

- The desire to augment their competitive advantage by 'tapping into' overseas assets such as technology, skills and sources of innovation. This is perhaps having the most impact on R & D.
- The need to reconcile economies of scale (e.g. the creation of global products) with local/regional responsiveness to differing market conditions. One, but far from the only, means of achieving this is via a regional (i.e. triad) organisational structure. This explains the growth in European HQs.

In some companies, these pressures are leading to new models with more Centres of Excellence and 'multi-home based' organisational structures.

## 7.2 Location of HQs

For most regions in the UK outwith London, the number of corporate HQs is determined by the start-up, growth and decline of local businesses. New HQs are created at the company's place of birth.

Corporate HQs generally remain at the company's place of birth for many years. However, with growth, the HQ often becomes a 'stand alone' function located away from day-to-day operations. In the UK, generally this means a re-location to London and the South East. This is more likely to occur when companies grow via product diversification and/or acquisition and merger.

Because of this process, the majority of large UK companies have their HQ in the South East (and more especially London). The South East also attracts the majority of overseas company HQ investments in the UK. Its strengths reflect the key location requirements of Corporate HQs:

- Access to customers within the South East, including other Corporate HQs, in industries such as finance, telecommunications and retailing.
- Access to a wide range of frequent national, European and inter-continental air services.
- Access to a wide range of specialist business services and the City of London (i.e. financial services).
- An extensive and deep managerial and professional labour market and specialist skills (e.g. software, languages), linked to the ability to attract talent from elsewhere. Perhaps paradoxically, given salary levels, it is seen as a low cost recruitment location.
- Substantial and internationally competitive industrial clusters in industries such as finance, media, business services, travel and tourism, ICT (e.g. software and computer services, telecommunications) and pharmaceuticals.
- Rapid economic growth which helps attract mobile HQs. Simultaneously, the region's high business birth rate creates a stream of new indigenous HQs

Finally, for some companies, proximity to the policy making process and a prestigious address are also important.

While many HQ functions continue to drift into London, there is also a counter flow from London into the South East. This provides cost advantages while retaining the benefits of proximity to London. Longer distance decentralisation adds considerable cost and is rare. As yet there is no evidence, even from the US, that CIT has reduced the locational pull of major cities and increased the attractiveness of more peripheral areas or smaller cities.

The small number of mobile HQ investments locating outwith major commercial centres are generally attracted by strong industrial clusters and/or by the benefits of proximity to the company's existing investments.

For the majority of HQ investment decisions, basic cost factors (e.g. wages or property costs) play little role. Similarly, government financial and fiscal incentives are not ranked towards the top of the list of location determinants. However, in part this is because within most countries (including the UK) costs do not vary dramatically between regions and substantial incentives affecting within country location are not available.

London and the South East attract internationally mobile HQ investments without the need for financial incentives or, relative to some other European countries, a 'generous' corporate tax regime. However, having allowed for differences in size, a few European capitals (and major commercial centres) attract more or less as many mobile HQs as London. To some extent, these cities achieve their success by offering a more favourable tax environment.

### **7.3 Scotland's HQs**

While Scotland has many fewer companies per capita than the national (GB) average, there are around 53,400 limited companies with their HQ in Scotland. The vast majority (89%) are independent, indigenous businesses. There are 2,200 externally controlled subsidiary HQs. Of these subsidiaries, 40% have an overseas parent and 60% an English parent company.

In contrast to these large numbers, few large companies have a Scottish HQ. Just 19 companies with over 5,000 employees have a Scottish HQ. Most of these (17) are Scottish businesses including three (Royal Bank of Scotland, HBOS and First Group Plc) with over 50,000 employees worldwide. Scotland has five companies in Business Week's list of the world's Top 1000 companies. Indeed, the two large banks are in the Top 75. On a per capita basis, this is somewhat below the UK average, but is substantially ahead of Germany and more or less on a par with countries such as Finland, Eire and Japan<sup>71</sup>.

Taking Scotland's Top 500, with 64%, the indigenous sector continues to dominate. However, while just 4% of all limited companies, the externally controlled sector accounts for 36% of the Top 500. They consist of 129 overseas controlled subsidiaries and 50 English subsidiaries.

Over the past decade, the number of companies with over 1,000 employees with a Scottish HQ declined by 11 (11%) from 102 to 91. However, the number with over 50,000 employees has increased from zero to four. The number of medium-sized companies increased.

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<sup>71</sup> Simpson, E. *et. al.* (2004). Measuring Scotland's Progress Towards A Smart Successful Scotland, Training and Employment Research Unit, University of Glasgow, Report for the Scottish Executive.

Within the Top 500, both the indigenous and overseas-owned sectors have increased their share. The number of overseas-owned Top 500 companies rose from 107 to 129 (17%) while indigenous Scottish businesses increased by 6% (304 to 321). This was offset by a 44% reduction in the number of English companies with subsidiary HQs in Scotland.

There are a number of well known and long established HQs in Scotland (e.g. the two banks: Standard Life; and Scottish & Newcastle). On the other hand, as elsewhere, there is much churn and turbulence in the stock of HQs. Over a 10-year period, approximately 50% of indigenous business HQs in the Top 500 disappeared. The proportion is even higher for externally controlled subsidiaries. It cannot be assumed that HQs (and especially inward investment HQs) provide long term stable employment.

Much of the turbulence is caused by corporate restructuring via mergers and acquisitions. Of the Scottish companies in the 1994 Top 500, 20% had been externally acquired by 2004. With Scottish companies purchasing other Scottish companies, there had also been considerable consolidation in the Scottish food industry and local transport services. Consolidation and the acquisition of non-local companies led to the creation of the First Group which now has over 50,000 employees and a Scottish HQ.

Scottish HQs (and especially indigenous HQs) are concentrated in the 'traditional' manufacturing sector, utilities, retail/wholesale/automotive dealerships and transport/distribution. The largest indigenous businesses, while few in number, are in the financial sector. Both electronics and the offshore sector are also important, but consist mainly of externally controlled businesses.

Over the past decade, the number of Top 500 HQs in the traditional manufacturing industries has declined by 40. Increases occurred in the offshore sector, electronics, business services and retail/car dealerships. While the largest financial sector firms have grown via acquisitions, there has been a fall in the number of financial service businesses with a Scottish HQ. This has occurred via the external acquisition of Scottish firms. New Scottish financial companies have not been set up and grown to replace those lost.

There is little evidence of HQs being created in the new or information economy sector or, indeed, in 'high tech', more generally. While a few subsidiary HQs in the software sector have been attracted, Scotland attracts a very small proportion of the (substantial number) of software HQs locating in the UK. The subsidiary HQs it has attracted, largely reflect its established strengths in electronics manufacturing and the offshore sector.

## **7.4 Economic Contribution**

At an estimated 6,000, the direct employment in the HQs of Scotland's Top 500 companies is relatively small. Around 30% of this employment is in the financial sector.

It is believed (although we have no empirical evidence) that these jobs are highly paid, generally filled by graduates and that HQs both retain and attract talent to Scotland. These jobs have consumer multiplier effects. However, regardless of the level of income such impacts on the Scottish economy are, at best, modest.

Turning to spillovers and longer term developmental effects, there is much discussion of these effects, but remarkably little hard evidence. Nevertheless, the following tentative conclusions can be drawn:

- Indigenous HQs generate the most substantial and significant developmental spillovers. There have been few spillovers from externally controlled manufacturing subsidiaries in Scotland. This includes subsidiaries with at least some 'developmental characteristics'.
- Many of these impacts arise from corporate purchasing which generates demand for business, professional and financial services and, importantly, the computer services and software industries. The development of these industries is influenced by the extent and nature of demand from corporate HQs.
- In addition, HQs may contribute by corporate sponsorship, influencing the location of 'production' facilities, attracting and retaining talent, and enhancing regional capacity for entrepreneurship. As potential 'demanding' customers, they can play a key role in the innovation process and can attract 'high value' fdi.
- When considering spillovers and developmental effects, it is more useful to think about the company (and all its functions) rather than the HQ per se. Spillovers vary greatly from company to company. A few appear to generate substantial developmental effects. The majority appear to generate few such effects.

Finally, spillovers depend upon the characteristics of the company, the nature of the local environment and the 'fit' between the company and its local environment. For example, companies (including inward investment projects) which are part of a successful industrial cluster are more likely to generate spillovers than those which are not part of a cluster.

For inward investment, the probability of substantive spillovers is higher for R&D projects, subsidiaries which are in some sense Centres of Excellence, businesses with purchasing autonomy and where management is responsible for relationships and networks external to the company (e.g. marketing) rather than when responsibility is restricted to plant management and intra-company relationships. With reference to purchasing, it is important to differentiate between purchasing autonomy and procurement. Many inward investors (especially in electronics) have substantial procurement but limited purchasing autonomy. They simply draw down procurement against purchases made by their parent HQ.

## **7.5 Strategic and Operational Implications for Scottish Enterprise**

### **7.5.1 A HQ Strategy?**

It is not possible to make recommendations on the basis of a single study. Recommendations are inevitably based on interpretation and judgement as well as the available evidence. A review of existing strategies and operations is also required. Such a review has not been undertaken. Consequently, the following are observations worthy of further discussion and consideration.

Based on the available evidence and our understanding of current Scottish Enterprise operations, an explicit HQ Strategy appears neither necessary nor justified. This is because:

- The concept of HQs is insufficiently precise and not adequately differentiated from other strategic issues and questions. For example, it can become little more than a strategy for indigenous business or big companies.
- The issues relating to indigenous HQs (i.e. Scottish businesses) and externally-owned HQs (i.e. inward investors) are very different. They are probably best treated separately.
- Most, but not all, of the strategic issues are already dealt with (or better dealt with) via existing priorities. To add another strategic priority adds little in practice and reduces strategic clarity and focus.
- The concern with HQs is often about wider questions rather than HQs per se. For example, some see financial services as important because Scotland has several large indigenous businesses with a Scottish HQ. However, this is to argue for a greater focus on financial services (rather than on HQs per se).

This is not to argue that HQs are unimportant. However, it is to suggest that they are best considered as part of other strategic themes.

### **7.5.2 *The Indigenous Dimension***

The concern with HQs is often little more than an argument that 'big companies' should be given greater strategic priority. The strategic question which needs to be considered is the balance between SME and large company support. Raising this question under the guise of HQs simply confuses the issue and muddies the water.

Similarly, much of the 'case for HQs' is little different from the case for indigenous development. All indigenous businesses, at least initially, have their HQ in Scotland. Consequently, increasing the number of Scottish HQs is already a strategic priority via, for example:

- The Business Birth Rate Strategy and, especially, programmes for high growth new starts. Those which achieve significant growth eventually create identifiable HQs. Some will remain embedded (i.e. linked to other operations) while others may eventually become 'stand alone' HQs.
- Support for existing businesses via Account Management and programmes such as Growing Global Companies. Business support services implicitly aim to develop larger companies with their HQ in Scotland.

Again, the question is not about HQs, but rather whether sufficient and appropriate support is provided for Scotland's indigenous businesses. In this context, large company HQs in more or less all sectors (and especially businesses with substantial purchases) may play a key role in economic development as 'demanding customers'. This element of Porter's diamond is often overlooked in economic and cluster development strategies.

The evidence presented in this report suggest two specific issues are worthy of further consideration. First, as indigenous companies grow, their HQ functions can (and sometimes do) drift away from Scotland. In some cases, it may be possible to work with individual companies to offer assistance which prevents such relocation. However, the wider question is whether Scotland's business environment can be improved to enable it retain its HQ functions. This might include, for example, the need to improve air services, the development

of stronger industrial clusters and mechanisms to enhance companies' ability to recruit internationally.

The second is the acquisition of Scottish businesses by non-Scottish companies. On balance, it is likely this has negative long term consequences for the Scottish economy. On the other hand, Scottish companies are growing via the acquisition of non-Scottish businesses and there are benefits from a reasonably free market in corporate control. This raises issues well beyond the scope of this study and, in practical terms, beyond the influence of Scottish Enterprise. However, the question which requires further consideration is whether Scottish companies are selling out to access resources (e.g. finance, skills, distribution systems) required for growth which they cannot access in Scotland as independent businesses.

### **7.5.3 Inward Investment**

Policy has increasingly focused on the attraction of 'high value' inward investment. This is currently defined as R&D and projects with wage rates at least 20% above the Scottish average. Consideration could be given to whether this is a satisfactory definition:

- While there is no direct evidence, R&D, HQ and S&M projects almost certainly have wage rates 20% or more above the Scottish average.
- However, such projects are generally small and their overall direct impact on Scotland's GVA is probably small. A large production plant may have a greater impact.
- On the other hand, the longer term developmental impacts of such projects is expected to be more significant.

It is suggested that the extent and nature of spillovers and developmental impacts should be given more explicit consideration in the definition of 'high value' fdi.

While work has been undertaken on the developmental effects of manufacturing fdi in Scotland, further research is required on the developmental effects of other functions such as R&D, HQ and S&M projects. Nevertheless, one important conclusion is that the issues involved in attracting, and the developmental consequences of, R&D and HQ/S&M projects are very different.

Taking first HQ functions, it is widely believed that MNEs are locating more management functions (and especially, Regional or European HQs) overseas. This raises the question of whether Scottish Enterprise should have a programme targeting RHQs? Such investments may be seen as 'high value' because they employ graduates and more highly skilled staff, are more embedded in the local economy and have developmental effects.

However, an explicit HQ or RHQ inward investment focus is probably inappropriate. This is because:

- While the UK has a significant market share, the annual number of HQ investments is small. Nor does the evidence suggest that the number is growing substantially (if at all).
- Such projects employ few people. While there is no direct evidence on their employment structure or developmental effects, there are few reasons to expect

substantial developmental impacts. The main exception is projects with corporate purchasing responsibility.

- There is no reason to believe that RHQs are more embedded in the local economy than other investments. Indeed 'stand alone' RHQ are likely to be highly mobile and can easily exit the local economy.
- For the vast majority of RHQ investments, Scotland would find it difficult to compete with London and South East England.

Under current circumstances, it is difficult to envisage any policies which would enable Scotland to compete effectively for HQs per se. Whether or not changes in the fiscal environment could be effective or represent value for money are questions beyond the scope of this study.

Sales and marketing functions have been given less attention by Scottish Enterprise. However, they are sometimes incorporated in HQs and, compared to HQs, there are many more inward investment projects. Furthermore, they may have at least, if not more, developmental effects than HQs. As with HQs, targeting S&M projects per se is probably inappropriate and unlikely to be successful.

This is not to argue that HQs and sales/marketing projects are unimportant and that SE should not seek to attract them. However, they can probably be most effectively targeted by ensuring HQ and marketing functions are explicitly incorporated in SE's activities to attract specific industry or cluster related investments (e.g. CIT, oil/gas/energy, financial services). Consequently, it could be worth reviewing existing marketing material to ensure appropriate HQ/marketing messages are included.

Within the UK context, costs and a well-educated, skilled workforce are not the issues. More important are the availability of air services and the ability to recruit senior staff internationally. Without improvements in both, marketing alone is unlikely to be sufficient. For many, access to customers is critical. Consequently, the sales message should include material on companies and organisations with purchasing authority ideally incorporating information on what, and how much they purchase.

Companies are most likely to locate HQ and S&M projects in Scotland under the following circumstances:

- They have actual or potential customers in Scotland.
- The company already has other investments in Scotland.
- Scotland has at least some cluster strengths.

Based on recent evidence, success appears most likely in electronics (defined broadly), the oil and gas/offshore cluster and financial services related investments.

The software industry is by far the largest source of HQ and marketing projects locating in the UK. In contrast to most other industries, the number of projects continues to grow. However, Scotland obtains less than 2% of both UK software HQ and marketing projects. With just 16,200 employees (5.7% of the UK total), the industry is under-developed in Scotland. Compared to 2.2% of all employment in South East England, it accounts for just 0.7% of Scottish employment. Given the strength of both the CIT industries and financial services (a major software customer), it would be worth reviewing whether more could or should be done

to attract the software industry to Scotland. Because HQ/marketing, 'production' and R&D are often integrated, this would inevitably involve attracting more HQ and marketing projects. Again, it is worth stressing that access to customers (e.g. finance and oil/gas) is critical.

Turning to R&D, compared to HQs and S&M, Scotland has a stronger competitive position. While varying from project to project, developmental effects appear to be more likely and, once attracted, R&D appears much less mobile (i.e. it is more likely to remain in Scotland for a reasonable period of time). Consequently, continuing the policy focus on attracting R&D is appropriate.

#### **7.5.4 Market Segmentation**

Based on the available evidence, the brief requests a HQ market segmentation. As an illustration, it suggests a global, functional, regional, back office and public sector HQ segmentation. For such a segmentation to be useful, each type of HQ must have distinctive characteristics and impacts on the economic development process. It would also be possible to develop such a segmentation further (e.g. stand-alone or embedded HQs, large/small, national/regional, actual/virtual etc.)

However, while conceptually attractive, we do not believe a detailed market segmentation is practical or, from an operational perspective, useful for two reasons. First, information and data on the nature and extent of economic development impacts from global, functional or regional HQs is not available. Nor is it likely to become available. Furthermore, impacts vary greatly between companies within each of the segments. For example, it is more than possible that a specific regional/national HQ has greater impacts than a global HQ (e.g. a subsidiary with a global mandate).

Second, we have argued that it makes little sense for Scottish Development International to target HQs explicitly. Consequently, if Scottish Development International is not targeting HQs, there is no sense in targeting global, functional or regional HQs per se.

A key conclusion is that for most purposes, consideration of HQs adds little to our strategic understanding or policy implementation. The issues relate to the characteristics of the company. Within this context, the following characteristics might underpin market segmentation:

- Independent indigenous companies versus externally controlled subsidiaries. This is to do no more than identify the fundamental distinction between indigenous growth and growth driven by inward investment.
- Within the externally controlled sector, the key differentiating characteristics which influence potential developmental effects are:
  - The nature and extent of managerial responsibility for, and power over, purchasing decisions.
  - The extent of management responsibility for commercial development (e.g. marketing, product development) over and above responsibility for day-to-day management of the plant (be it a factory, call centre, back office or shared service centre).



- Research and Development. Even without wider managerial responsibility, R&D projects have potentially greater spillovers than others business functions (such as shared service centre, processing centres, stand-alone HQs etc.).

Scottish Development International should continue to target R&D projects. Beyond this, greater consideration should be given to the range of management responsibilities attached to specific projects (or being developed within specific subsidiaries) and the nature and extent of management responsibility for purchasing within a specific project or subsidiary company.

## **7.6 Further Research**

From the perspective of further research, the main implication of the conclusions is that there is little need for further research on HQs per se. However, three specific questions are worthy of further research.

- What is the contribution and impact of indigenous company HQs in different sectors? Such research could usefully consider the actual and potential impact in all sectors including the services.
- Which organisations in Scotland have substantial purchasing autonomy and how can this information (and their autonomy) be used to further Scotland's economic development?
- What are the developmental and spillover effects of mobile R&D, HQ and S&M projects in both Scotland and elsewhere? While work has been undertaken by Scottish Enterprise on the manufacturing sector, similar work has not been undertaken on these 'higher value' functions.

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