

## **EU Membership and FDI**

### **Summary:-**

**The UK has seen substantial growth in both inward and outward FDI since accession to the EU, although determining how far the EU was responsible for this is complicated by other factors – in particular the global surge in FDI at the same time. However, the stylised facts support the theory that membership of the EU is a key factor in attracting investment to the UK, and demonstrates the importance of this investment for the UK.**

**EU membership has contributed to FDI growth in the UK by reducing access costs to a larger market, enabling greater economies of scale and returns on investment, increasing competition and facilitating agglomeration.**

**The UK has been a major beneficiary of FDI flows in the EU, but integration has also enabled growth in outward FDI to EU countries, and increasing returns on this investment.**

**Important potential future FDI gains are possible from further integration, particularly following successful liberalisation of services industries. The long-term FDI cost of withdrawal would be significant.**

The UK has seen a substantial increase in both inward and outward investment since joining the EU. Investment is a key determinant of economic growth, and while Foreign Direct Investment (FDI) may crowd out a small element of domestic investment, the net result should be to increase the capital stock of an economy, with benefits for growth and jobs – in 2004, new investment created 39,592 jobs in the UK.<sup>1</sup> Flows of investment between Member States should also enable restructuring and the reallocation of resources to create more efficient pan-European market structures.

Moreover, FDI can be a useful vehicle for the transfer of new and innovative technologies and processes, and through linkages with domestic firms it can have spillover effects that work to boost the productivity both of the industry and of the wider economy.

This note sets out the theoretical impact of regional integration within the EU on investment by foreign firms (both intra and extra-EU) in the UK, and in this context examines the stylised facts on FDI over the period of integration. There is then a short discussion of potential future gains from further integration – particularly important here are the services sectors – and consequently the costs of withdrawal. The dynamic effects of FDI on productivity are discussed elsewhere.

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<sup>1</sup> UKTI: UK Inward Investment 2004/05

## **1. The Theory of Regional Integration and FDI**

Foreign investment into an economy can be either *horizontal* – where firms set up a subsidiary or affiliate in another country to gain access to a market – or *vertical* – where firms locate different stages of the production process in other countries according to comparative advantage. Horizontal investment is often considered to be a substitute for trade because FDI replaces exports, while vertical investment is complementary to trade as Multinational Enterprises (MNEs) will export components to foreign affiliates and then re-export the goods produced. FDI can be undertaken as either ‘greenfield’ investment, where a new enterprise or plant is established in the host country, or through mergers and acquisitions, where the ownership of existing firms is transferred.

### **Determinants of FDI**

Although the relative importance of each will vary between different sectors, the main theoretical determinants of FDI in recent literature can be summarised as:

- **Market access / transport costs** – firms will choose to undertake horizontal investment and locate in a market if the costs of exporting to a market are high. However, this will discourage vertical investment designed to source intermediate production more cheaply.
- **Size of the host market** – access to a larger market will offer firms choosing to locate there greater returns from economies of scale and scope, thereby reducing marginal production costs. This will have a particular effect on horizontal FDI.
- **Agglomeration effects** – horizontal and vertical FDI can provide firms with access to economic clusters with pools of valued resources, leading to reduced costs, enhanced knowledge spillovers, and increased returns.
- **Factor costs** – lower factor costs encourage vertical FDI, and depending on the size of the market, horizontal FDI. Skill levels in the economy may also be an important determinant – a higher skilled workforce will be more attractive to investors.
- **Trade barriers / openness** – horizontal FDI will be less attracted to a market if trade barriers are lower, as the relative cost of exporting goods and services decreases. This includes both tariffs and non-tariff barriers to trade. However, the more open the economy the more incentives there will be for vertical FDI.
- **Fiscal incentives** – fiscal incentives can render a country more attractive for both vertical and horizontal investment. However, it is not always clear that the benefits from investment justify the level of incentive provided.
- **Imperfect competition** – a situation of imperfect competition can stimulate horizontal FDI as firms with informational advantages seek to protect their assets by establishing their own operations rather than exporting.
- **Business / investment climate** – reduced costs of doing business will help attract FDI. Of particular importance are regulation and bureaucracy, property rights, the judicial environment, contract enforceability, labour regulations, and political and macroeconomic stability.

- Exchange rate – reduced volatility that reduces exchange rate transaction costs can stimulate vertical investment, but can discourage horizontal investment as trading incurs fewer transaction costs.

Regional integration will impact on many of these drivers, but to different degrees – explained in more detail below.

Economic literature suggests that market size is the strongest driver of FDI – third country investors will have greater incentives to invest in the region if their investment provides access to a much larger market; and the increased competitive pressures should stimulate investment by all firms in an effort to maintain a competitive edge. However, intra-EU investment will face conflicting incentives, as the necessity for EU firms to undertake investment, particularly greenfield, to locate in another Member State to avoid tariffs will no longer apply, but there will be increased incentives for intra-regional mergers and takeovers as EU firms try to consolidate market position. Moreover, there are significant intangible benefits available to an investing firm from market knowledge and benefits from locating near clusters. These agglomeration economies can be important in a firm's location decision, and countries can often develop a 'first-mover advantage' in emerging competitive industries.

By reducing the cost of access to other Member States' markets, regional integration should increase intra-EU vertical FDI and specialisation, allowing EU firms to locate different parts of the production process in different Member States to maximise efficiency. However, it could have the opposite effect on intra-regional horizontal investment, as locating in another Member States is no longer necessary to access markets. Firms can benefit from economies of scale on their investment in a larger number of Member States.

The literature is more ambiguous about the effect of trade openness on FDI. The reduction of barriers within the region, as discussed above, should stimulate FDI flows from outside investors wishing to access the market and, to some extent, intra-regional flows. Flows from outside the region are also likely to be affected by the degree of external openness of the region – if there is a high external tariff, there will be greater incentives to invest in a subsidiary within the region. However, if the reduction of external barriers results in a more competitive and dynamic economy this should also attract more investment through offering higher returns.

If regional integration succeeds in reducing the factor costs of production by increasing competition and specialisation, this should also indirectly have a positive impact on FDI, as firms outside the region are attracted by more competitive production conditions. The level of product market regulation will also have an impact on FDI through its effect on relative production costs.

The effect of agglomeration on FDI has also been found to be positive and highly significant as firms try to benefit from network advantages and agglomeration economies. The Single Market should have a positive effect on the strength of this driver as it should offer greater opportunities for

agglomeration due to greater returns offered by a larger market – increasing returns will encourage investment in high-technology clusters. However, regional clustering could lead to widening regional disparities in the Union.

### Distribution of FDI

FDI into the region will not be evenly spread – Blomström and Kokko (1997)<sup>2</sup> suggest that FDI surges following regional integration are likely to be concentrated in the areas with the strongest locational advantages. This is not necessarily limited to those areas with low labour and production costs; the new economic geography theories give evidence of strong clustering effects, in particular for high technology investments, often regardless of direct factor costs. By choosing not to participate in the eurozone, it was feared that the UK could in theory begin to lose out on investment. However, the UK has many inherent benefits that have enabled it to maintain FDI share, such as macroeconomic stability, flexible labour markets, a light regulatory regime, and, importantly, its already strong integration into global FDI. Moreover, the structural problems of many eurozone countries are also likely to deter investors. The UK's tradition of openness to FDI has already produced certain self-perpetuating clusters, e.g. the City in London, around Cambridge, and 'Silicon Glen', where firms benefit from agglomeration economies.

However, although the UK has been successful in attracting FDI and developing clusters, leaving the EU and the Single Market would incur additional trade costs. This would reduce the attractiveness of the UK for foreign investors, although sunk costs make actual disinvestments unlikely – see Pain & Young study discussed later.

Looking forward, if regional integration – in the EU's case the Single Market programme – and reform – through the Lisbon Agenda – succeeds in creating a more dynamic, productive economy, this should stimulate further investment into the region, although these links are hard to analyse exactly. Moreover, FDI is thought to have additional dynamic spillover effects (discussed elsewhere). Blömstrom and Kokko conclude that 'regional integration should enhance the attractiveness of investing in the region as a whole by creating a larger common market and contributing to improved overall efficiency and higher income levels in that market. The magnitude of the changes in investment liberalisation initiatives embodied in the RIA (*regional integration agreement*)<sup>1</sup>.

### Outward Investment

While inflows of capital contribute to economic growth by increasing the capital stock in an economy and through productivity spillovers, outward investment could be considered to have negative impact through compositional effects – if there is considered to be a finite 'lump of capital' and outward investment is thought to remove this from the economy. However,

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<sup>2</sup> Magnus Blömstrom & Ari Kokko: Regional Integration and Foreign Direct Investment. Working Paper Series in Economics and Finance no 172, May 1997.

this ignores evidence which shows that direct investment abroad can also bring important benefits to the home economy.

Investment in fast-growing and emerging economies and industries abroad can bring significant returns, and provides a good route for technology transfer – some studies suggest that technology diffusion is higher with outward investment than with inward FDI<sup>3</sup>. In particular, if activities where the comparative advantage lies elsewhere are outsourced to more efficient locations, this can free up resources in the home country to undertake more productive activities. By freeing up barriers to other EU markets, European integration can facilitate such vertical restructuring within the Union. In addition, if the EU becomes more outward-looking, and does not try to prevent outsourcing and '*delocalisations*' this effect will be further strengthened.

Although outward investment may lead to some lower-skilled activities being carried out abroad, Lipsey<sup>4</sup> shows how this can lead to a more capital and skill intensive production. This facilitates restructuring towards a higher value-added economy, and will further attract investment from high technology multinationals. Concerns arise over the impact on employment, particularly for lower-skilled workers. However, most empirical work has shown a marginally positive to neutral effect, particularly in the longer term.

Investment abroad will also bring important returns to the home economy, and these should be higher than had the investment been undertaken at home, improving the balance of payments. These returns can then be reinvested in higher skilled activities in the home economy, as firms often maintain head office and R&D activities in the home country, while exporting lower skilled activities.

The UK has a strong tradition of investing abroad, and has benefited from this in the past. EU Member States are an important destination – at the end of 2003 the book value level of UK direct investment in the EU was £388.9 billion, 56% of total investment abroad, and equivalent to over 35% of UK nominal GDP<sup>5</sup>. The Netherlands has been the UK's most important destination for outward investment since 2000, accounting for 25% of UK-owned assets at the end of 003, and delivering 22% of total earnings (£12.1 billion) from foreign investment in 2003, (second behind the US at 23%)<sup>6</sup>.

## **1. FDI – Stylised Facts**

Accurately calculating the effect of EU integration on FDI is complicated for a number of reasons, and literature on this is limited. Reliable data, in particular over long periods, is hard to come by, and what data exists is mostly on the aggregate level and often does not show the extent to which integration has impacted on different sectors. Moreover, the long and gradual process of integration makes it hard to accurately determine a specific 'EU effect',

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<sup>3</sup> Source?

<sup>4</sup> R E Lipsey: Home and Host Effects of FDI. NBER Working Paper 9293, 2002

<sup>5</sup> Office for National Statistics (2004): Foreign Direct Investment 2003. December 2004

<sup>6</sup> Much of the investment in the Netherlands is oil-related.

complicated further by the coincidence of FDI growth in the EU with other factors which have boosted flows, in particular the global surge in FDI over the period of EU integration, the removal of capital restrictions, the rapid development of EU and other capital intensive technologies, and wider liberalisation measures. Disentangling these effects is fraught with problems.

These data constraints mean that detailed econometric analysis, particularly of developments at the level of individual Member States, is complicated. This note will therefore instead discuss some stylised facts in the context of the theory of regional integration outlined above.

Theory would suggest, and most literature supports, that European integration, and particularly the Single Market, increases intra and extra-regional FDI, although the effect varies between industries.

Although they can be substitutes, in the long-run trade and FDI are generally complementary, and Blömstrom and Kokko cite some early studies that found that the early years of the Common Market had attracted investment from the US that might otherwise have gone to other European countries, demonstrating a locational impact of integration on US FDI. Inflows of FDI into the EU-15 rose sharply from the mid 1980's as barriers between markets were removed – by over 350% between 1985 and 1992 alone, and, given that this is almost double the increase of global FDI over the same period, part of this FDI boost should be attributable to EU market integration.

There is evidence of a positive impact of integration on FDI flows from both within and without the EU. An econometric study by Zu Kweon Kim<sup>7</sup> examined the effect of European integration on US and Japanese manufacturing FDI over two periods (1975-84 and 1985-96). The study found that European economic integration was significant on investment decisions in the latter period, when integration intensified. Looking at intra-EU investment using data on German investment in the EEA since 1980, Hubert and Pain<sup>8</sup> found evidence of significant structural change since 1990, with nearly all locations and industries seeing a higher level of cross-border investment than might have been expected. They also found that the growth in the share of manufacturing investment located in the UK since 1981 can be seen to have been driven largely by developments in transport and other manufacturing, with considerable gains also in financial services.

### Impact of Accession

The literature does not give unambiguous evidence of an EU investment effect at Member State level. Blomström and Kokko cite studies that found no investment effects for the UK, while other studies found that Ireland had benefited significantly – this disparity was attributed to the UK's relative openness to FDI prior to accession during the 1950's and 1960's. However, a

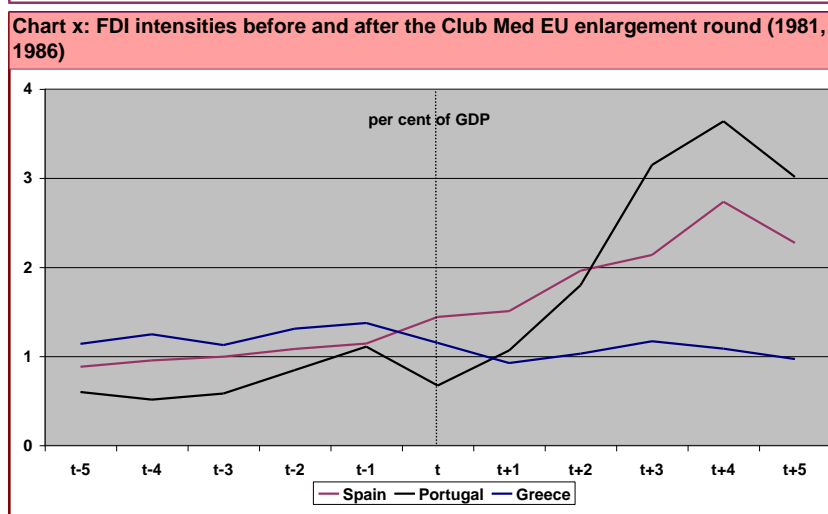
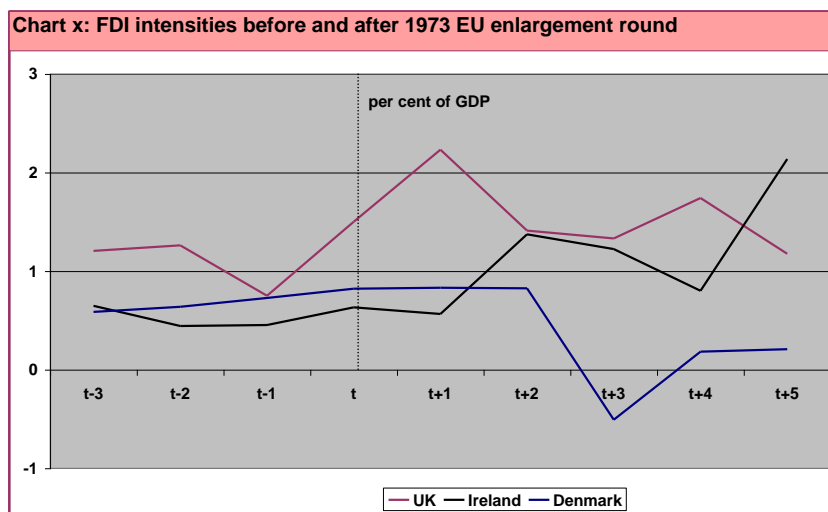
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<sup>7</sup> Zu Kweon Kim: The Effects of International Economic Integration on FDI Determinants: Japanese and US FDI in Europe.

<sup>8</sup> Hubert, F; Pain, N: Fiscal Incentives, European Integration and the Location of Foreign Direct Investment. NIESR, March 2002

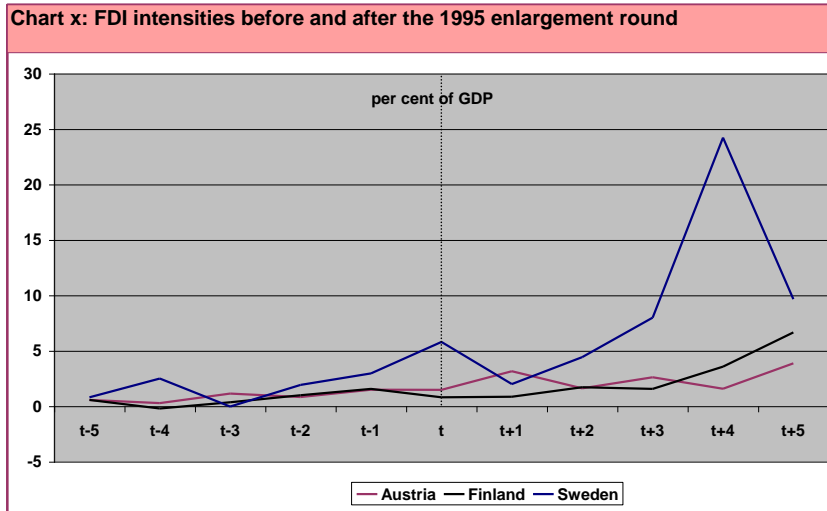
study by Barrell and Pain<sup>9</sup> (1998) found that entry into the EU had a significant effect on the stock of US FDI in the UK, Ireland, Spain and Sweden.

Looking at the experience of individual Member States (see following charts<sup>10</sup>), accession to the EU had a clear initial impact on FDI inflows, although this does then tend to tail off slightly. In the UK's case, the boost in FDI inflows appears to tail off and return to the level prior to accession, but this may be due to domestic economic issues at the time, and, as we see later, UK FDI inflows later more than recovered.



<sup>9</sup> Barrell, R & Pain, N: Real Exchange Rates, Agglomerations, and Irreversibilities: Macroeconomic Policy and FDI in EMU; Oxford Review of Economic Policy, 1998

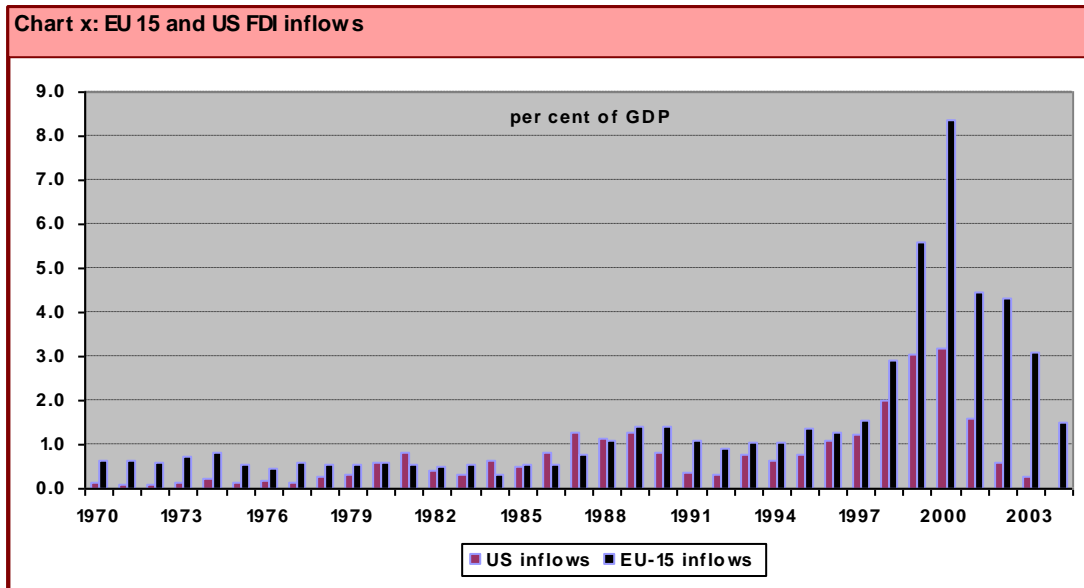
<sup>10</sup> The charts show changes in the intensities of FDI flows in the years preceding and following accession to the Union.



Market Integration and FDI

In addition to the increase in FDI flows in the immediate aftermath of membership, FDI also further increased as integration among European member countries was deepening – although this also must be seen in the context of global FDI growth. Instrumental in this drive for integration has been the Single Market programme, which aimed to create a unified market within the EU through the dismantling of trade barriers, including the harmonisation of standards among countries, and the removal of barriers to FDI. Although the Single Market programme is associated with the year 1992, it has been an ongoing process over much of the last twenty years<sup>11</sup>.

**Chart A: FDI inflows into EU-15 and US 1973-2004**



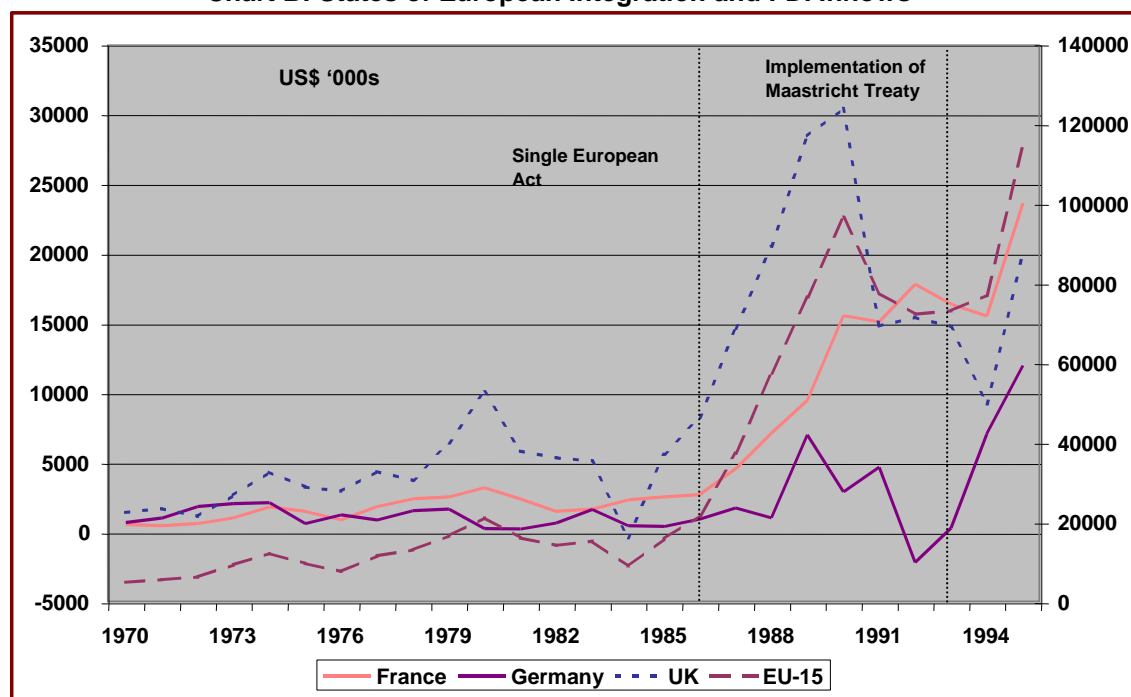
<sup>11</sup> The announcement of the Single Market project in 1986 will have impacted on firms’ investment behaviour, and this will have continued to adapt as further reforms are implemented, and will be continuing to adapt now.



Although the increase in FDI flows is to some extent mirrored globally, particular in the earlier stages of integration, Chart A shows clearly that from 1989 onwards, as market integration through the Internal Market programme intensified, inflows of FDI into the EU surpassed those into the US. Within Europe it is reasonable to expect the Single Market also to have had an added impact on FDI flows. Shatz and Venables (2002) also found that integration particularly intensified the investment relationship between EU Member States – intra-EU investment accounted for 30% of all FDI involving EU countries from 1985 to 1988, but rose to 62% over the next five years, over the period of implementation of the Internal Market.

Observing the various stages of integration on individual Member States, there is also a clear positive effect. However, it is also clear that other factors, such as domestic reforms, affect the extent of the positive impact. For instance, Chart B shows a significant upswing in FDI inflows following the Single European Act and the inception of the Single Market programme. There is a further upswing around the time of the implementation of Maastricht – this may be linked to the announcement of further market integration, or it may merely be part of the cycle. The chart shows the UK benefiting more than France, Germany and the EU-15 average (but also more susceptible to downturns), which could be linked to earlier relaxation of capital controls and market liberalisation, or from the effects of the first wave of M&A deals. Germany in particular benefits relatively little from the intense period of integration from 1987-1993 – the shock of reunification and the lack of flexibility in the German economy could be a factor here.

**Chart B: States of European Integration and FDI Inflows**



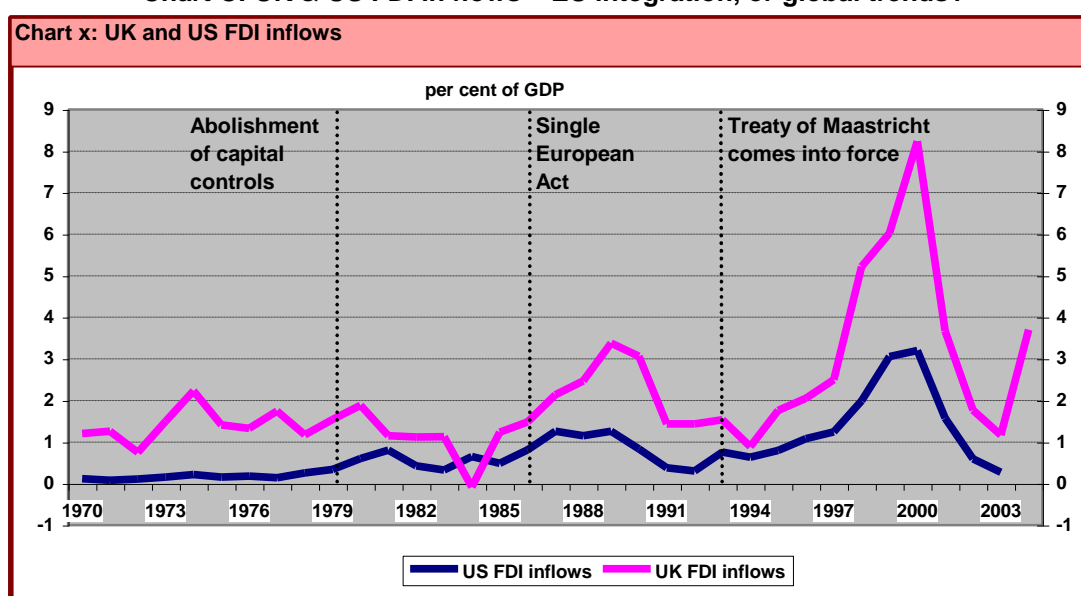
The UK has therefore been well placed to take advantages from market integration, and this first mover advantage is important, particularly in

developing clusters of high-technology, capital intensive industries, where there is potential for significant agglomeration economies, resulting in high productivity self-sustaining clusters – *benefits of clustering / agglomeration discussed further in productivity work.*

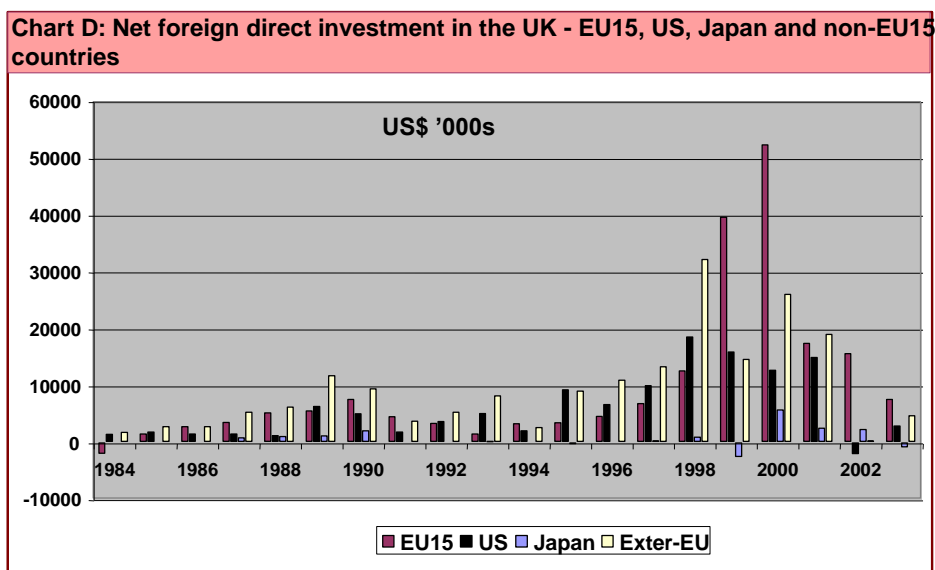
### EU Impact on UK FDI

As noted above, the UK has been able to attract relatively more FDI than some other European economies as a result of market integration. As a proportion of GDP the UK also attracts more FDI than the US. The chart below shows that although the UK's FDI inflows are to some extent in line with global trends, the various stages of European integration appear to have increased the UK's FDI performance relative to the US.

**Chart C: UK & US FDI in flows – EU integration, or global trends?**



Since 1999, **the EU has been the UK's most important FDI relationship, for both inward and outward FDI.** At the end of 2003, the total stock at book value of direct investment into the UK stood at £341.2 billion. Europe accounted for 46% of this (with the Netherlands and France alone responsible for 13% and 11% respectively – or over 8% of nominal GDP). In comparison the US accounted for 39% of total stock. The following chart shows the increasing importance of the EU as a source of investment over the years:

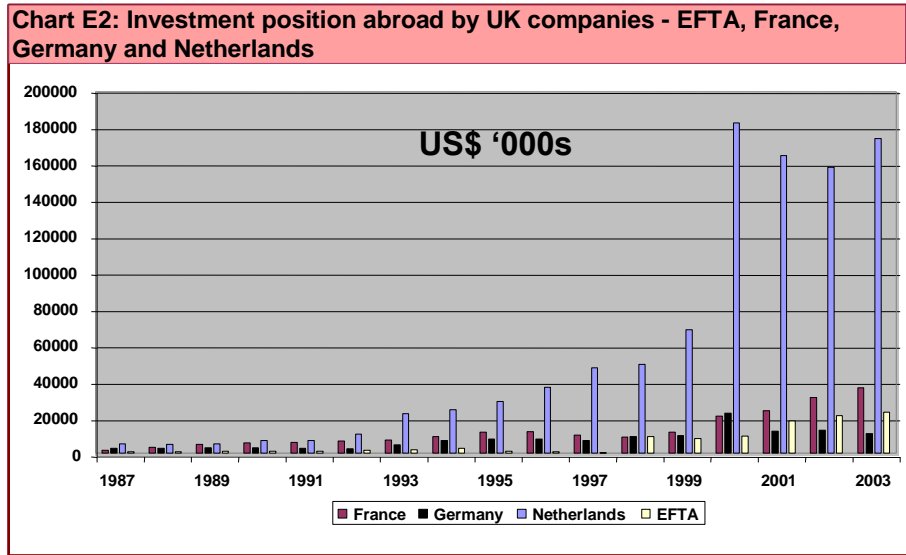
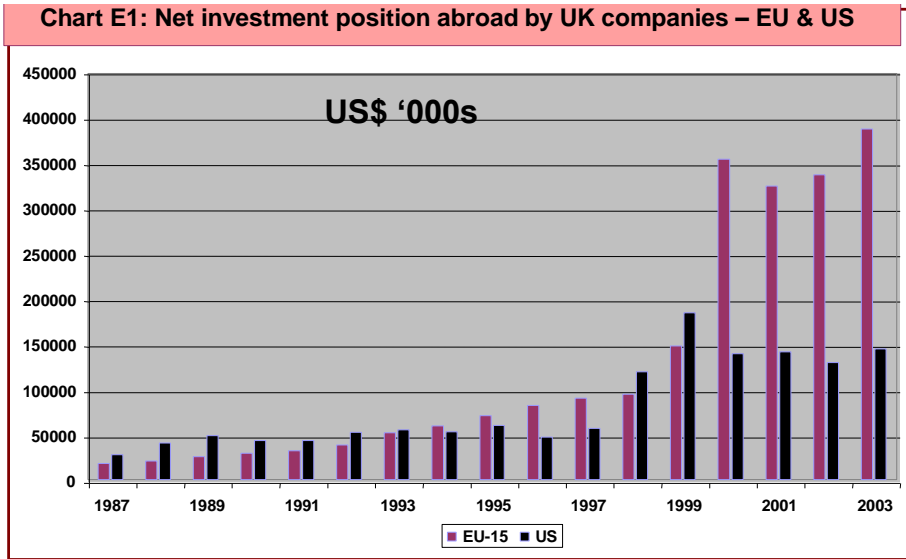


Despite a reduction in the UK's share of FDI since the launch of the Euro, the **UK remains a major beneficiary of global FDI flows, and is likely to remain so whether in or out of the Eurozone.** Survey evidence firmly points to the UK's continuing ability to attract FDI. In the AT Kearney FDI Confidence Index the UK was ranked the fourth most attractive FDI destination in the world in 2004, ahead of other major EU economies. US investors ranked the UK their second most attractive investment market in the world in 2004, and invested more in the UK than any other country, the UK accounting for 15% of total US outward FDI stock. However, while the UK remains highly integrated into global FDI flows, it has been claimed that the UK will suffer from the decision not to join the eurozone with the effect of exchange rate instability – EU FDI flows to the UK fell by an estimated 80% from 2002 to 2003, although the EU still accounts for about 47% of UK FDI stock. However, there has since been an upswing in FDI flows into the UK, showing that it is too early to determine what the 'euro effect' will be. The UK is likely to remain an attractive destination for FDI, and the fall in FDI from other Member States is unlikely to be caused solely by the euro effect – the slow recovery in eurozone countries would also have impacted on EU investment flows.

### Outward Investment

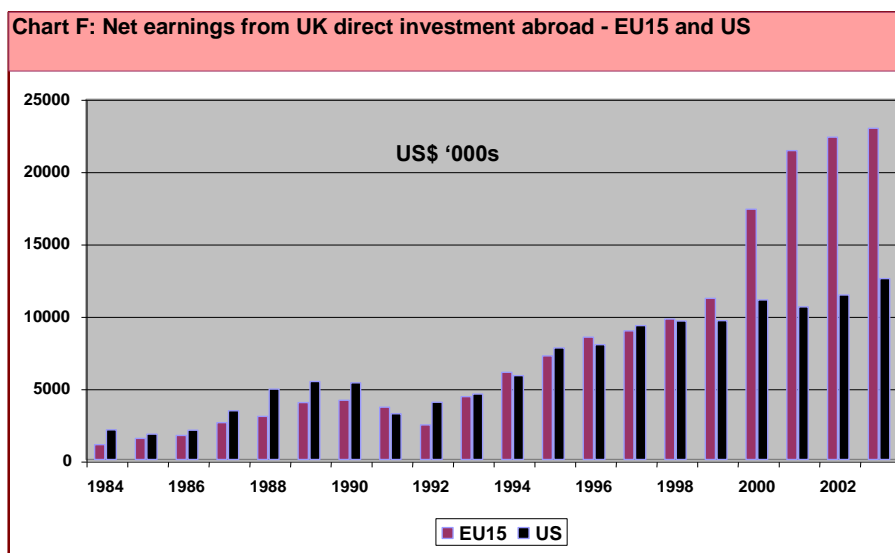
At the end of 2003 the book value level of direct investment abroad by UK companies stood at £692.5 billion. **The EU accounted for £388.9 billion, a share of 56% and equivalent to over 35% of UK nominal GDP<sup>12</sup>.** Since 2000 the Netherlands has been the most favoured location for UK direct investment abroad, with a 25% share of UK owned assets at the end of 2003. The growing importance of EU countries in relation to EFTA countries and the US in terms of FDI stocks can be clearly seen in the chart below:

<sup>12</sup> Office for National Statistics (2004) 'Foreign Direct Investment 2003'. Dec 2004.



In 2003, 52% of total UK earnings from foreign investment came from Europe and 32% from the Americas – the Netherlands alone accounted for £12.1 billion, being 22% of the total and 43% of European earnings.

**This strong investment relationship with other Member States reinforces the importance for the role of the UK in pushing for growth-oriented reforms in the EU.**



The Single Market programme appears to have had an impact on UK outward investment as well as inward FDI, although other factors may have been at work. Changing technology and increasing international competition in financial and product markets would also have impacted on FDI. However, a comparison with returns in the US suggests that there are extra factors at work in Europe, **indicating that the process of integration is improving the functioning of markets.**

### Sectoral Effects

Data is scarce on the sectoral impact of regional integration on FDI, but Dunning<sup>13</sup> makes some analysis looking at US Dept of Commerce data for a few countries, and over selected years. He looks at the growth in sales of US affiliates in Europe between 1982-89 and 1989-93 across various sectors, classified into their relative sensitivity to Internal Market reforms – i.e. the relative importance of barriers between markets prior to the reforms. Looking at the data, Dunning found that although sales of US affiliates grew faster in 'sensitive' sectors than non-sensitive sectors, this was less so in the later period. This indicates that the FDI effect of the Single Market programme was stronger in the earlier years of implementation, and that some of the increase in FDI may have been in anticipation of the benefits of integration. However, sales for all sectors in Europe, especially the most sensitive, outstripped the sales in the rest of the world.

The table below shows that there has been an increasing concentration of FDI, by both EU and non-EU investors in the tertiary sector, particularly finance, banking and insurance, telecommunications and business services. However, it is worth noting that these are sectors that are not yet fully liberalised, and similar patterns have been observed in other industrialised countries. This shows that other sector-specific trends are at work in addition to the 'EU effect'. It is interesting to see the high and increasing concentration

<sup>13</sup> Dunning J: 'The European Internal Market Programme and Inbound Foreign Direct Investment. Journal of Common Market Studies, Vol 35, No 1, March 1997

of both intra and extra FDI in services as compared to manufacturing, particularly given the remaining barriers to market integration in services.

#### Changing Sectoral Distribution of FDI in the European Community 1984-92 (%)<sup>14</sup>

	Intra-EC FDI			Extra-EC FDI		
	1984-86	1987-89	1990-92	1984-86	1987-89	1990-92
Manufacturing	22.9	32.1	28.8	28.7	38.2	28.6
- Agriculture & food products	2.2	7.3	7.9	6.2	6.8	1.3
- Chemicals & allied products	7.0	9.1	3.0	1.8	6.5	-0.2
- Primary & fabricated metals	0.2	2.0	1.2	-0.7	0.6	-0.6
- Machinery (exc. electrical)	3.6	1.0	3.0	4.8	0.6	2.3
- Electrical & electronic equip	4.2	4.3	4.3	8.5	7.7	4.1
- Transport equipment	1.9	0.7	4.4	7.0	4.4	9.6
- Other industries	3.8	7.7	5.1	1.8	11.5	12.1
Services	54.5	54.8	63.7	54.4	51.9	61.8
- Finance, banking, insurance	33.8	31.9	39.7	31.8	34.6	31.5
- Trade, hotels, catering	16.7	9.5	10.7	17.7	9.1	20.9
- Transport, communications	1.1	1.1	0.9	3.0	2.4	2.1
- Building, construction	2.5	2.5	0.6	1.8	-0.4	-0.6
- Other services*	0.4	9.8	11.8	0.7	6.3	8.0
Real estate	22.6	13.2	7.4	16.3	9.9	9.6
All sectors**	100.0	100.0	100.0	100.0	100.0	100.0

\* Including business services

\*\* Excluding energy

### **3. Looking Ahead**

Although there are issues complicating an accurate assessment of the size of the 'EU effect' on FDI, largely due to other global developments, the evidence that exists supports the theory that **regional integration boosts FDI, and that this is positive for the UK economy** – both through boosting the capital stock and through indirect, dynamic effects on productivity and competitiveness.

However, given that there remain significant barriers between markets, particularly in services but also in other sectors, **it is reasonable to expect that the further integration of EU markets and the removal of the remaining barriers to trade, combined with a deregulation agenda, should continue to have a positive impact on FDI for the UK.**

#### Potential Future Gains

The UK, with flexible labour markets and a tradition of strong integration into global FDI flows would be **well-placed to attract a significant share of future FDI flows**, particularly in high-productivity knowledge-intensive industries. The clusters of FDI the UK has already attracted, for instance in the City and around Cambridge, should also ensure continued FDI is channelled into these industries.

At the same time however, EU-wide liberalisation and deregulation should also make other Member States more attractive destinations for global FDI

<sup>14</sup> Dunning

flows, particularly those in the New Member States that may have lower labour costs. However, even though this may lessen the potential FDI gains for the UK, this will also have beneficial second-order effects on the UK through stronger economic relationships across Europe, particularly if successful liberalisation of network industries continues. Moreover, it would also offer the **potential of greater returns on UK outward FDI in other Member States.**

The greatest potential FDI gains are likely to materialise in those industries / sectors where significant barriers between markets remain. Some examples of these are **services**, including business services where the UK has a comparative advantage, communications, and **network industries**, such as transport, telecommunications, energy etc. Market integration could also stimulate greater cross-border investment within the EU on R&D and innovation, where the UK could also expect to benefit. A recent OECD Economic Study<sup>15</sup> suggests that liberalisation in services will bring an extra FDI boost, as establishing a commercial presence abroad generally brings stronger services trade in terms of transport, communications, etc.

#### Potentially significant benefits in services

EU investment, and in particular intra-EU FDI is concentrated in service sectors – in general they receive three times more investment than manufacturing sectors. According to the OECD, FDI in services accounted for up to 65% of total FDI flows<sup>16</sup>. However, services is also a key area where significant barriers between EU markets remain, but where the need to be close to consumers means that there is a strong incentive to undertake investment and locate in another Member State – the sunk costs are also likely to be less than in manufacturing industries. There remain important barriers, largely resulting from national regulations for service providers. Barriers can often be in the form of national regulations, e.g. requirements for additional professional qualifications, local residence of management, additional professional insurance, and constraints on the use of inputs from the origin country. A study by CPB<sup>17</sup> that estimated the **potential benefits for the EU arising from the removal of barriers by the proposed (but controversial) Services Directive would stimulate an increase in intra-EU FDI stocks of between 20 and 25%**, mainly caused by less heterogeneity in barriers to competition and less FDI restrictions.

The CPB study also looked at the impact of the liberalisation of services trade on both inward and outward FDI by country:

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<sup>15</sup> Nicoletti, G; Golub, S; Hajkova, D & Yoo, K: The influence of policies on trade and foreign direct investment. OECD Economic Studies No. 36, 2003

<sup>16</sup> International Investment Perspectives; OECD 2002

<sup>17</sup> Kox, H; Lejour, A & Montizaan, R: The free movement of services within the EU. CPB Netherlands Bureau for Economic Policy Analysis; October 2004

Reporting country	Relative % increase		Absolute increase \$bn*		Net change in FDI position** - % of initial inward FDI stocks
	Outward FDI stocks	Inward FDI stocks	Outward FDI stocks	Inward FDI stocks	
Hungary	47.0	41.2	0.1	3.6	39.8
Austria	37.0	71.3	4.4	12.7	46.9
Czech Rep	32.9	39.8	0.1	6.3	39.4
Germany	32.2	24.3	69.6	41.7	-16.2
Poland	31.7	53.4	0.2	11.1	52.6
Italy	28.8	29.4	28.9	16.3	-22.6
Portugal	27.8	30.3	1.0	5.9	25.3
Spain	27.6	41.4	3.3	19.6	34.4
Finland	27.4	41.0	7.3	6.7	-3.7
Denmark	26.2	22.4	6.0	4.5	-7.6
<b>UK</b>	<b>24.2</b>	<b>20.6</b>	<b>58.5</b>	<b>37.6</b>	<b>-11.4</b>
Ireland	23.1	22.6	4.0	16.0	17.0
Greece	21.7	30.6	0.2	4.3	29.4
Belgium-Lux	21.6	19.6	22.6	31.8	5.7
Netherlands	21.4	19.1	56.5	51.0	-2.0
Sweden	21.1	27.7	12.7	12.9	0.5
France	19.5	23.0	30.9	23.9	-6.7
EU 17	24.7	24.7	306.1	306.1	0.0

\* the simulations only account for the effects of the EU measures on the level of FDI restrictions in destination countries, and for the decreased heterogeneity in product-market regulation within the EU.

\*\* change in inward FDI stocks less change in outward FDI stocks. A negative sign means that a country has a net increase in outward FDI stocks.

The table shows that liberalisation of services will lead to a growth in outward and inward FDI stocks. While the predicted proportionate increase in FDI for the UK is relatively less than for many Member States, this reflects the UK's current high level of integration into global FDI. **In absolute terms, the UK will be a major gainer.**

The UK is among the countries expected to have a net increase in the outward FDI position, but this should also bring benefits to the economy. Bitzer and Görg looked at the productivity impacts of inward and outward FDI for 17 OECD countries and 11 industries over 1973-2000. They found that, on average, inward FDI was associated with increased productivity at the domestic industry level, while outward FDI could have a negative impact. However, for France, Sweden, Poland, the USA, and, significantly, the UK, **outward FDI was found to have significantly positive productivity increase.**

A recent study for the Commission<sup>18</sup> has estimated that the productivity effect of elimination of barriers to trade in services would increase wages in the EU by 0.4% and employment by 0.3%.

### The Impact of Withdrawal from the EU on FDI and Growth

Pain and Young (2004) examined the effect of EU integration on the location and scale of investment by multinational companies in Europe, looking at panel data analysis of factors determining the level of fixed capital investments of US-owned manufacturing affiliates in Belgium, Ireland, Italy,

<sup>18</sup> Copenhagen economics



the Netherlands, Spain, Sweden and the UK. As well as the impact of European integration<sup>19</sup> the model considers the effect of factors such as market size and growth, relative factor prices and costs in the host country. The study concluded that **withdrawal from the EU would cost the UK 2¼ of GDP over time, largely from lost FDI flows.**

The model found that fixed capital investments by US multinational affiliates rose significantly following EU entry and the start of the Single Market – suggesting that, over time, the UK would suffer from withdrawal in terms of FDI flows, although actual disinvestment would be less likely given the sunk costs of investments already undertaken. Considering the effects on investments from Germany, the US and Japan, Pain and Young estimate that **the UK would lose approximately one third of inward FDI flows outside of the EU**, reducing output potential, and the spillover productivity effects assumed from foreign investment (these are discussed further elsewhere).

#### **4. Conclusion**

In summary, the theory of regional integration suggests that EU membership should have had a significant and positive impact on FDI flows into the EU, and into the UK from both EU Member States and outside the EU, the main driver being the reduced barriers to accessing a larger market. Although a detailed econometric study of the evidence is complicated, the evidence available supports this. This growth in FDI flows has direct benefits from increasing the stock of capital in the economy, but will also have further dynamic benefits. The UK has been particularly well-placed to attract FDI from regional integration due to its openness, flexible markets, and agglomeration economies from existing clusters.

However, the remaining barriers to market integration in the EU suggest that there is yet greater potential for FDI benefits from EU membership. Services is a key area for further gains, and in some areas, *e.g. logistics, distribution...*, the UK again stands to be a key beneficiary.

Although the UK's history of openness and integration into global FDI flows is strong, there is evidence to suggest that withdrawal from the Single Market would have a significant negative impact on FDI flows in the medium to long-term.

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<sup>19</sup> Captured using dummy variables for EU membership and for the inception of the Single Market.