Institution: University of Reading

Unit of Assessment: 19 Business and Management

Title of case study: Improved targeting of subsidies for inward direct investments into the UK

1. Summary of the impact

Research by Professor Mark Casson and colleagues at the University of Reading demonstrated that the net benefits of inward investment to the UK economy had been systematically overstated by HM Treasury (HMT) up until 2007. The research findings overturned the Treasury's view that all foreign direct investment (FDI) by multinational enterprises (MNEs) was equally beneficial to the UK economy, and so equally merited special efforts to attract it. Instead the University of Reading research was able to show that UK-located SMEs would provide a bigger return to any subsidy either by increasing export sales, or by building stronger links within the supply chains of overseas MNEs. The research team's report led to a change in Government policy after 2007, with measures to attract FDI since that date being targeted only towards those types of investment which are most likely to unambiguously benefit the UK economy.

2. Underpinning research

In a series of publications in the 1990s and 2000s Mark Casson (first appointed to Reading in 1969) developed his earlier research on the economics of FDI (Casson 1999, Buckley and Casson 1998a, 1998b, 2003). Much of this work builds on the seminal publication by Casson and Buckley (appointed to Reading from 1973 to 1975, now at the University of Leeds) on *The Future of Multinational Enterprise* (1976). Previous to this publication FDI was largely understood to be a form of transferring capital investment. But Buckley and Casson introduced and subsequently developed the concept of FDI as a response to market failure in the market for knowledge. This research underpins the modern view that inward foreign direct investment should be encouraged because it brings with it knowledge of technology and management practice which might not otherwise find its way to the host economy. This research has been published in 3* and 4* journals and is among the most highly cited research in the subject area of international business worldwide. Casson's original work also highlighted the fact that different types of FDI bring different benefits – an important point that was subsequently lost sight of as different nations began to compete as to which could attract the most inward investment.

By developing the idea that FDI was a response to market failure, Casson (and subsequently many others) was able to represent the activities of MNEs as knowledge-intensive, and hence FDI as a value-adding activity in the economies in question. This became a foundational assumption of economic policy in the 1980s and 1990s, when much inward direct investment was encouraged into the UK in order to overcome some of the prevailing unemployment arising from the decline of many older industries. In this initial phase of attracting inward FDI, however, there was little discrimination between the different kinds of inward direct investment that were promoted by governments. By the mid-1990s Casson questioned whether many of these investments were as valuable to the economy as policy-makers believed. He suggested that for many investments, the private profit to parent companies overseas was capturing all the net gains arising from the FDI. Special subsidy measures to attract new FDI into the UK were therefore increasingly unnecessary unless justified by some additional evidence of genuine spill-over gains to the UK economy.

This proposition was in stark contrast to the prevailing HMT view of that time, which held that all FDI was a net benefit to the UK economy. But Casson's research argued that inward FDI has costs as well as benefits for the host economy and suggested that different kinds of inward direct investment had different net benefits to the UK economy. The net benefit from a greenfield investment, for example, was far greater than from a foreign firm simply acquiring an existing indigenous firm, because the new knowledge introduced into the economy by the foreign investors in the former activity was considerably greater than with the latter. Equally the net benefit to the host economy from an inward direct investment in a manufacturing or research facility was far greater than an equivalent investment in a sales subsidiary, again because the addition to the stock of knowledge from the former kinds of FDI is likely to be far greater than with the latter. The research went on to show that efforts to attract investment ought correspondingly to be targeted at those kinds of inward direct investments that had the greatest net benefits, and withdrawn from those that had the least.

3. References to the research

Buckley, Peter J. and Mark C. Casson (2003) The Future of the Multinational Enterprise in retrospect and prospect, Journal of International Business Studies, 34 (2), 219-222. (ABS 4*)

Casson, Mark C. (1999) The organization and evolution of multinational enterprise, Management International Review, 39(1), 77-121 (ABS 3*)

Peter J. Buckley and Mark C. Casson (1998) Analyzing foreign market entry strategies: Extending the internalization approach, Journal of International Business Studies, 29 (3), 539-562. (ABS 4*)

Peter J. Buckley and Mark C. Casson (1998) Models of the multinational enterprise, Journal of International Business Studies, 29 (1), 21-44. (ABS 4*)

Mark C Casson, et al, *Evaluation of Industry Support provided by UKTI Sectors Group*. Report for UKTI, Department of Trade and Industry, 2006.

Grants:
1] *Design and Analysis of a Survey of UKTI's Trade Development and Inward Investment Activities and Compilation of Case Studies*, DTI/FCO/UKTI, HM Treasury. 2005. Project number J30384.
[2] *Evaluation Methodology for UKTI based on Case Studies*. 2006. Project number J31086.

4. Details of the impact

Mark Casson's research has made, in the words of the UKTI Director of Economics and Evaluation, 'an outstanding contribution' to the analysis of the economic rationale for Government support for exporting and inward investment [1].

In the 1990s and early 2000s Government policy was to encourage all forms of inward FDI through the UK Trade and Investment (UKTI) arm of the then Department for Trade and Industry (DTI, now the Department of Business, Innovation and Skills, BIS). The prevailing view among policy makers was that the net benefit of inward FDI on the productivity growth of the indigenous firms (mostly in the supply chain) was very significant, indeed more significant than the impact of assisting SMEs to begin exporting. The 2004 Spending Review proposed that resources to increase efforts to attract inward investors be doubled from 2005 to 2008, but trade support services for exporters receive an increase of only 30% [see section 4.10, p. 44 in source 2]. The DTI, Foreign and Commonwealth Office and HMT commissioned research from the University of Reading because of the international reputation of several economists there in the field of international business. Led by Casson, this grouping was called the Reading Business Group [see Annex 1 'Reading Business Group', in source 3].

Building on Buckley and Casson's 1998 analysis of foreign market entry strategies (see section 3 above), the Reading Business Group (James Pemberton, appointed to Reading in 1984, retired 2011, Simon Burke, appointed to Reading 1989 to the present, Andrew Godley, appointed 1991 to present, and Nigel Wadeson, appointed 1997 to present) then produced the 2005 report on the *Design and Analysis of a Survey of UKTIs Trade Development and Inward Investment Activities* [see Section 3 above]. This report then formed the basis of the DTI report, *Study of the Relative Economic Benefits of the UK Trade and Investment Support for Trade and Inward Investment: Final Synthesis Report*, which became known as the 'Relative Net Benefits Study' [3].

This study showed that the previous consensus among policy makers had both over-estimated the benefits of inward investment to the UK economy (through failing to acknowledge both that subsidiary profit is repatriated and that inward investment might undermine indigenous intellectual property rather than add to it) and underestimated the benefits of trade development (by failing to acknowledge the impact on SME profitability from increased exports and underestimating SMEs' export potential). This work was followed up by the *Evaluation of Industry Support provided by UKTI Sectors Group*, 2006 [4], which showed that Government support for trade development was being targeted on a limited range of sectors, many of which (e.g. banking) did not need support.

HMT was initially proposing a radical change in UKTI policy that would sharply reduce the proportion of support for SMEs and divert those resources in favour of a doubling of support for inward investors. But the University of Reading research team demonstrated that in fact this was based on flawed assumptions. Instead the University of Reading research demonstrated that the net benefits of supporting UK-based SMEs to export and to become embedded within UK supply chains were significantly higher than previously believed [3, 4].

These findings were initially seen as controversial. The initial DTI report, which drew on the Reading research, *International Trade and Investment – The Economic Rationale for Government Support* [5] required additional data gathering by an independent source. This source corroborated the Reading Business Group's findings. The Reading findings were then subsequently accepted and incorporated into UK policy, and the shift of resource to supporting inward investment was reversed back in favour of export support.

This can be illustrated from successive UKTI Annual Reports. In 2005-06 UKTI spending on inward investment support totaled £27.3m and on trade support £57.1m. Then, in UKTI's first significant response to the 2004 Spending Review target of doubling resources for inward investment support, resources for inward investment then increased by almost one-fifth to £32.1m in 2006-07, while trade support spending was cut to £51.7m [pp. 10-11 in source 7]. But once the Reading findings were accepted, the funding of inward investment support fell from £32.6m in 2007-08 to £26.2m in 2010-11, whereas the funding for trade support increased from £51.7m in 2006-07 to £57.6m in 2007-08, and increased further to £62.1m in 2010-11 [Fig 17, p. 31 in 8].

A clearer illustration of the impact of the research is when the amounts of funding are depicted in relative shares of the total UKTI funding for trade and inward investment support. In 2005-06 the relative shares of trade support and inward investment support were 68% and 32%. In 2006-07, when the 2004 Spending Review targets first significantly influenced spending decisions, those shares changed to a fall to 62% in the share of UKTI funding for trade support and a rise to 38% for inward investment support. After the Reading Business Group's findings had been accepted and policy was reversed back to favour trade support, the relative shares changed. First a slight change in 2007-08, when trade support received 64% and inward investment 36%, then more clearly by 2010-11, with trade support receiving 70% and inward investment support 30% of the total. The latest *UKTI Annual Report* confirms that this continues, with 75% of funding going to trade support and only 25% to inward investment support activities [see p.8 in source 9].

The UKTI Director of Economics and Evaluation confirms that the 'analytical work did indeed play a crucial role in shifting the policy attitude in Government towards greater recognition of the validity of the economic rationale for this [trade] support'. As a result of this work by Mark Casson and the team at the University of Reading, UKTI practice was changed in 2007 and measures to attract FDI became far more selective, notably focusing on the potential to benefit UK-based firms in the supply chains of the proposed inward investments. In addition, successive adaptations since 2008 have reversed the earlier UKTI (and HMT) prioritisation of supporting inward FDI and instead UKTI now devotes a greater share of its resources to supporting SME exporters than was envisaged in 2007 [5, 6, 7, 8, 9].

In sum, this research has had a major impact on UK Government policy since 2007. Its direct beneficiaries include UKTI, BIS, and HMT. Its indirect beneficiaries include UK-based SMEs that benefited from UKTI support to become part of inward investors' supply chains.

5. Sources to corroborate the impact

[1] UKTI Director of Economics and Evaluation, Department of Business, Innovation and Skills. (Contact details provided separately)

[2] *2004 Comprehensive Spending Review*, HM Treasury, chapter 4. http://webarchive.nationalarchives.gov.uk/20071204130111/http:/hm-treasury.gov.uk/media/B/6/sr2004_ch4.pdf

[3] *Study of the Relative Economic Benefits of the UK Trade and Investment Support for Trade and Inward Investment: Final Synthesis Report*, DTI Evaluation Report Series, No. 9. 2006 (06/ 1055).

[4] *Evaluation of Industry Support provided by UKTI Sectors Group*. 2006. Reading Business Group Report for UKTI.

[5] *International Trade and Investment – The Economic Rationale for Government Support* DTI Economics Paper No. 18, 2006. http://www.bis.gov.uk/files/file32297.pdf

[6] *International Trade and Investment – The Economic Rationale for Government Support* BIS Economics Paper No. 19, May 2011. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32106/11-805-international-trade-investment-rationale-for-support.pdf

[7] *UKTI Annual Report and Accounts 2006-07* (London Stationery Office).

[8] *UKTI Annual Report and Accounts 2010-11* (London Stationery Office).

[9] *UKTI Annual Report and Accounts 2012-13* (London Stationery Office).

(all available on request)