How Brexit will reduce foreign investment in the UK….and why it matters

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Foreign investors love Britain…

Foreign direct investment (FDI) comprises investments from outside a country to set up new establishments, expand existing establishments or purchase local companies.

According to UK Trade and Investment (UKTI, 2015), the UK has an estimated stock of over £1 trillion of FDI, about half of which is from the European Union (EU). Only the United States and China receive more FDI than this.

Countries generally welcome FDI as it tends to raise productivity, which increases output and wages (Bloom et al, 2013; Haskel et al, 2007). FDI brings *direct* benefits as foreign firms are typically more productive and pay higher wages than domestic firms. But FDI also brings *indirect* benefits as the new technological and managerial know-how introduced by foreign firms can be adopted by domestic firms, often through being part of multinationals' supply chains. FDI can also increase competitive pressure, which forces managers to improve their performance.

… but Brexit would kill the vibe

Why might FDI fall if the UK were to leave the EU? There are at least three reasons:

- First, being fully in the single market makes the UK an attractive export platform for multinationals as they do not face the potentially large costs from tariff and non-tariff barriers when exporting to the rest of the EU.
- Second, multinationals have complex supply chains and many co-ordination costs between their headquarters and local branches. These would become more difficult to manage if the UK left the EU. For example, component parts would be subject to different regulations and costs; and intra-firm staff transfers would become more difficult with tougher migration controls.

- Third, uncertainty over the shape of the future trade arrangements between the UK and EU would also tend to dampen FDI.

A number of factors determine where firms choose to locate and invest. Bigger and richer markets tend to attract more firms, which want to be close to their customers. The UK has strong rule of law, flexible labour markets and a highly educated workforce, all of which make it an attractive FDI location whether or not it is in the EU.

Supporters of Brexit claim the UK could attract more FDI outside the EU as it would be able to strike even better deals over trade and investment.

So what do the data say?

A new CEP Report on Brexit and FDI (Dhingra et al, 2016b,) looks at bilateral FDI flows across all 34 OECD countries over the last 30 years. We look at how FDI changes when countries join the EU after controlling for a large host of factors such as the size and wealth of the different countries.

The evidence is clear. Being in the EU increases FDI by around 28% (the exact magnitude ranges from a 14 per cent to 38 per cent increase in FDI depending on the statistical method used). These estimates are similar to those in Campos and Coricelli (2016), who find an impact of 25 per cent to 30 per cent using an alternative method that compares the evolution of UK FDI with a comparison group of similar countries.

Being a member of the European Free Trade Association (EFTA) like Switzerland would not restore the FDI benefits of being in the EU. In fact, we find no statistical difference between being in EFTA compared with being completely outside the EU like the United States or Japan. So striking a comprehensive free trade deal after Brexit is not a good substitute for full EU membership.

Foreign investment increases your income

To get at the nation-wide impact of FDI on output and income, we draw on the work of Alfaro et al (2004), who estimate the effect of changes in FDI on growth rates across 73 countries. We find that the impact of lower FDI following Brexit would be equivalent to a fall in real UK incomes of about 3.4 per cent. This represents a loss of GDP of around £2,200 per household.

Quantifying the relationship between FDI and growth is notoriously difficult so the exact number is subject to considerable uncertainty. But it suggests falls in FDI following Brexit would matter for living standards in the UK. An income decline of 3.4 per cent is larger than our static estimates of the losses from trade 2.6 per cent in our pessimistic case, but smaller than the long-run dynamic losses from trade of over 6.3 per cent (Dhingra et al, 2016a).

Of cars and cash – two UK success stories that stand to lose out

The macroeconomic estimates give a bird's eye look at the effects but it's useful to hone in on particular industries: cars and financial services.

Cars are a successful part of UK manufacturing. In 2014, the industry contributed around 5.1 per cent to UK exports, and about 40 per cent of its exports were to the EU.

Head and Mayer (2015) use information on assembly and sales locations (IHS Automotive data) on 1,775 models between 2000 and 2013. In their work, Brexit has two main disadvantages:

- First, as trade costs rise, locating production in the UK is less attractive because it becomes more costly to ship to the rest of Europe.
- Second, there is an increase in the co-ordination costs between headquarters and the local production plants

– for example, transfers of key staff within the firm may be harder if migration controls are put in place.

Putting both costs together, total UK car production is predicted to fall by 12 per cent – 180,000 cars per year. This is mainly because European car manufacturers such as BMW move some production away from the UK. Prices faced by UK consumers also rise by 2.5 per cent as the cost of imported cars and their components increase.

Financial services have the largest stock of inward FDI in the UK (45 per cent) and constitute 12 per cent of tax receipts (Tyler, 2015). The single market allows a bank based in one member of the EU to set up a branch in another, while being regulated by authorities in the home country. This 'single passport' to conduct activities in EU member states is important for UK exports of financial services. Passporting means that a UK bank can provide services across the EU from its UK home. It also means that a Swiss or an American bank can do the same from a branch or subsidiary established in the UK.

The UK might be able to negotiate some of these privileges after Brexit. Members of the European Economic Area outside the EU enjoy them, but they also have to contribute substantially to the EU budget, accept all EU regulations without a vote on the rules and must allow free labour mobility with the EU. And even for these countries, like Norway who must 'pay and obey with no say', there seem to be greater difficulties in doing business than a full EU member (Bank of England, 2015).

Staying in the EU also gives the UK the ability to challenge new regulations in the European Court of Justice, a right that was successfully exercised when the European Central Bank wanted to limit clearing-house activities to the euro area. If the UK leaves the EU, it would lose its leverage in negotiating and challenging future EU regulations.

Is it worth it?

Overall, Brexit would cut inward FDI – by close to a quarter according to our new estimates. This will damage UK productivity and could lower real incomes by 3.4%. Case studies of cars and finance also show that Brexit would lower EU-related output of goods and services, and erode the UK's ability to negotiate concessions from regulations on EU-related transactions.

Of course, these costs may be a price that many people are willing to pay to leave the EU. But they are not trivial costs. The UK received about £44 billion of new FDI inflows in 2014 according to UKTI (2015) – losing almost £10 billion of this after Brexit would be no laughing matter.

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Notes:

- *This article is based on the authors' paper The impact of Brexit on foreign investment in the UK, CEP Brexit Analysis No.3, LSE's Centre for Economic Performance.*
- *This post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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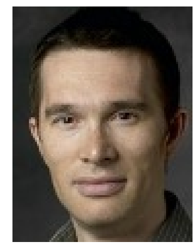

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