

# Firm Foundations

*Levelling Up Inward Investment*



Will Holloway

ONWARD >



# About Onward

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# Contents

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<i>Summary of the argument</i>	1
<i>Recommendations</i>	7
<i>Are we as good as we say we are?</i>	8
<i>What do other countries do to boost FDI?</i>	19
<i>Solutions</i>	43
<i>Conclusion</i>	55
<i>Annex</i>	57
<i>Endnotes</i>	59

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# Summary of the argument



Foreign Direct Investment can have a transformative role on a country's long-term growth. Through a ruthless focus on attracting certain types of FDI in some sectors, together with trade liberalisation and modernisation, economies like Ireland, Singapore, and the former East Germany have transformed some of their least productive places and industries over the last half century. Is it time for the UK Government to do the same to support its mission of levelling up?

Overall, the UK has long been an attractive destination for foreign direct investment, The UK has a larger FDI stock than any of the remaining 27 EU countries and a recent survey placed the UK second only to the United States in terms of investment attractiveness. Analysing the growth of the UK's FDI stock since 2010, we find that 775,000 new jobs have been created through inward investment in the last decade, as well as almost £600 million in R&D expenditure.

But while foreign investment in the UK has risen by volume, it has simultaneously become highly concentrated by geography. Based on a sample of FDI project level data in the United Kingdom between 1997 and 2016, we find that the number of foreign investments made in London has more than tripled while the number of projects in the rest of the UK fell by 15% in the two decades to 2016.<sup>1</sup>

As a result, the capital's share of FDI projects rose from a fifth in 1997 to more than 50% in 2016. Even though the UK's core cities all more than doubled the number of projects between 1997 and 2016, no other location gets close to London's share.

Meanwhile, the proliferation of investment attraction mechanisms like special economic zones and investment tax credits in other jurisdictions, matched with the growing number of opportunity markets through globalisation, means that competition in the future will be more intense. Since the turn of the millennium, the number of bodies registered with the World Association of Investment Promotion Agencies has increased by over half.

This paper summarises some of the regional and sectoral mechanisms and incentives competitor countries are using, including:

### **South Korea**

- *Foreign Investment Zones:* Foreign companies investing in specially designated investment zones are offered full discount on corporate tax and income tax for seven years and then 50% for another three years.
- *Income tax support:* For eligible investors, following approval from the Foreign Investment Committee, corporate tax and income tax are reduced by 100% for the first five years and by 50% for the next two years.

- *Cash grants*: If the level of foreign investment is 30% (or 40% for research centres), and criteria are met, the Korean government can provide subsidies for the establishment or expansion of certain plants, research facilities, or headquarters of global companies.

### **Singapore**

- *Double Tax Deduction for Internationalization*: Companies can benefit from tax deductions of up to 200% for certain expenses related to “market expansion and investment development activities”.

### **Japan**

- In April 2020 Japan announced a \$2.2 billion fund to support the reshoring of production to Japan - the first round of the fund in June 2020 saw 57 firms including Sharp relocating production to Japan.

### **Canada**

- *Strategic Innovation Fund*: A \$1.26 billion fund, profiled over five years, dealing with funding requests over \$10 million. Projects are assessed based on the potential benefits to Canada, including: the creation and commercialization of new intellectual property in Canada; development of new and improved products, services or processes; and significant R&D creating technology with the potential for market disruption.

### **Ireland**

- *Corporation tax*: Ireland’s corporate tax rate is 12.5%. However, various bilateral treaties and interactions with the US tax system may well reduce the effective rate to a much lower level. For example, in 2016 the European Commission stated that “selective treatment allowed Apple to pay an effective corporate tax rate of 1% on its European profits in 2003 down to 0.005% in 2014.”

### **Germany**

- *Special Economic Zones*: There are five free trade zones in Eastern Germany.
- *Cash Incentives Programme*: The cash incentive programme is a national scheme that helps to reduce the cost of setting up factories and other units. Individual states have their own incentive programmes with the same conditions for foreign and domestic investors. Regions with the highest incentives rates offer grants of up to 30% of eligible expenditures for small enterprises. Small enterprises situated in the regions bordering Poland can receive up to 40% funding.

## Israel

- *Targeted Grants Programme:* Priority development areas have been defined as Development Areas A and B. Approved Enterprises in development area A may receive fixed asset grants of 24%, with development area B's rate at 10%.
- *Tax Exemptions:* A total exemption from corporate tax on undistributed profits is available for ten years in development area A and for six years in development area B.

## Netherlands

- *Innovation Box:* The Innovation Box has been introduced with the aim to encourage successful innovations in The Netherlands. The box offers an effective 80% tax advantage on profit derived from innovation. Qualifying innovative profits are effectively taxed against 5% instead of the regular 25% corporate income tax.

## Sweden

- *Tax relief for key personnel:* Sweden offers a special 25% income tax relief to encourage highly skilled people, such as international executives, experts, researchers and others with special skills, to work in Sweden.

## USA

- *State level incentives:* There are approximately 250 foreign trade zones and over 500 foreign trade subzones across the United States. Across all states and territories, there are currently over 2,000 mechanisms – including tax credits (603), grants (537) and loans (436)– to attract investors.
- *Federal incentives:* Three federal agencies are aimed at attracting foreign investors. The Economic Development Administration offers long term loans, with preferential rates for projects that create or lead to jobs. The Small Business Administration offers guarantees for loans contracted by SME and can finance plants construction or material purchase by mid- and long-term loans. The Rural Development Office can guarantee up to 90% of the loans granted to commercial companies that create jobs in rural zones.
- *Sector specific incentives:* The Federal Government has also created mechanisms to attract specific industries to the US. For example, the Creating Helpful Incentives to Produce Semiconductors for America Act (CHIPS), which would give manufacturers a 40% refundable investment tax credit for facilities and equipment, aims to attract semiconductor manufacturers to the United States.

These twin challenges - concentration of FDI in London and rising global competition - demand a new approach.

In recent years, the consensus view among economists and policymakers in the UK was that maintaining a predictable taxation regime with a low rate (in reality only a low *headline* rate) was sufficient for a country like the UK to attract internationally mobile investment. However, other countries are competing much more aggressively on tax. Ireland has attracted far more inward investment proportionally than the UK and other similarly sized countries, and its wages and living standards have overtaken the UK. Over time, the UK risks being outclassed as our competitors around the world become more activist in their pitch to attract inward investment.

Evidence from other countries suggests that there is much more that the UK could be doing to attract FDI to boost lagging areas. The eight Freeports the UK government is to create are welcome, but only affect eight relatively small areas.

The UK is now an outlier amongst the G20 grouping of economies in its approach to attracting FDI. Not only is it one of the few countries not to offer a bespoke investment incentive tax regime for foreign investors, almost every other G20 country has also developed the ability to incentivise FDI attraction to specific places through discretionary funding. In particular, the experiences of places as diverse as South Korea, Ireland, Germany, Singapore, and the US suggest that the UK lacks these two critical components for attracting FDI to regions which would benefit most from FDI.

The economic rationale for incentives to attract mobile investment is similar to that for R&D tax credits. Academic research suggests FDI has positive externalities, bringing new ideas and techniques to a country, as well as increasing competition and increasing rates of innovation and investment. For example, a 2007 paper by Haskel et al argues that the value of these spillover benefits are large enough to potentially justify substantial subsidies to inward investors:<sup>2</sup>

“Typical estimates suggest that a 10-percentage-point increase in foreign presence in a U.K. industry raises the TFP of that industry’s domestic plants by about 0.5%. We also use these estimates to calculate the per-job value of these spillovers at about £2,400 in 2000 prices (\$4,300). These calculated values appear to be less than per-job incentives governments have granted in recent high-profile cases.”

Going all out to attract productive mobile investment is one of the best ways we could revive the economy after the effects of the coronavirus pandemic and attract firms and investment from overseas after Brexit. Membership of the European Union previously strongly limited the discretion of the government over where the UK could offer local inward investments, particularly through detailed rules on “assisted areas”.<sup>3</sup> Of the 48 enterprise zones created 2010-2017 only eight were allowed to offer enhanced capital allowances. Outside of the EU far more choice is open to ministers once again.

A number of industries, most notably electric vehicles, are at a point of transition where having an internal-combustion car industry is no guarantee that a nation will attract the new industry that is replacing it.

The UK has taken a more active approach before. In 1984, when Margaret Thatcher's government offered Nissan the 799-acre site of the former Sunderland Airfield at a discounted price plus a special tax deal modelled on Regional Development Grants to encourage the Japanese manufacturer to locate its new factory in the North East. The choice made by the Thatcher administration, representing a short-term for the government, led to the creation of 1,100 jobs in 1987, rising to 6,700 in 2019, and a supply chain that has created tens of thousands of additional jobs across the region. The plant is one of the most productive car plants in Europe, producing more than half a million cars a year. That decision paid dividends.

The UK did previously have a number of schemes to encourage investment into poorer areas, and academic evidence suggests that these did encourage FDI projects into poorer areas and were additional, rather than simply redistributing activity.<sup>4</sup> There are, of course, risks and downsides to FDI attraction. For example: the risk of asset stripping; fears of leverage over a host economy by a foreign country; a firm with strong growth potential may be bought up and its technologies transferred elsewhere within a large multinational, meaning potential growth is lost to other countries; or the risk of profit repatriation from the host country to the home country, becoming akin to a 'branch plant' economy.<sup>5</sup>

To an extent, these risks can be mitigated, and the UK is now putting in place the same kind of legislation most other countries have to scrutinise and set conditions on overseas takeovers where they have national security implications.<sup>6</sup>

It is clear that in an increasingly competitive globalised economy, mobile investment is crucial. Given FDI projects can take different forms – from buying up football clubs, to investing in high-growth innovative companies, to building up new foreign-owned companies in host countries – how can the government attract productivity-enhancing FDI inflows?

For a government committed to levelling up, inward investment can play a significant role in boosting regional growth. The question the government faces is how to upgrade the country's toolkit to maximise the volume and quality to FDI projects, and, importantly, how to ensure that lagging areas benefit.

As well as options to reform the incentives available to inward investment, the Government should review the uneven patchwork of responsibilities at the moment. The UK currently has stronger inward investment agencies in London and the devolved administrations, but a confusing patchwork of LA, LEP and city region bodies in the rest of England. This report recommends that the government reviews and rationalises the landscape of agencies.

## Summary of Recommendations

### Challenge

### Solution

The UK risks becoming less competitive internationally over time, as it is one of the only countries in the G20 not to have a bespoke investment incentive regime for foreign investors.

Introduce formal tax and regulatory incentives for inward investment, which could be:

1. A nationwide tax relief to encourage foreign direct investment into greenfield projects. This could be achieved by maintaining enhanced capital allowances, which would disproportionately benefit greenfield investments, for a fixed period.
2. A regionally specific tax relief to encourage FDI to lagging areas. This could be achieved by maintaining the Super Deduction capital allowance enhancement for foreign investment into Britain's least productive regions.
3. An industry specific tax relief designed to boost FDI into specific sectors. This could follow the examples in Ireland with the Manufacturing Companies Relief or more recently the United States' tax relief for Semiconductor manufacturers locating to certain states. It could target sectors like electric vehicles, aerospace or life sciences.
4. Introduce an individual tax relief targeted at executives who take decisions about FDI. This should replace the Tier 1 Investor Visa with a fast track Foreign Investment Visa linked to FDI projects over a certain value.

Historically UK inward investment agencies were fragmented and underpowered compared to rivals.

5. Overhaul the inward investment attraction architecture in the UK. Build on the creation of DIT and grow the new Office for Investment into a UK-wide body, with at least the same strength as international peers like the Irish Development Agency.
6. Review the role that LEPs, local authorities and Elected Mayors in England outside London play in inward investment attraction, with a view to rationalising the landscape, joining up policy locally.

# Inward Attraction

*Are we as good as we say we are?*



A country's ability to attract foreign direct investment (FDI) is influenced by many factors: innovation, skills, infrastructure, the rule of law, finance, taxation - as well as operating and labour costs - and regulation as well as social factors (like prevalence of crime and corruption). These factors are evaluated over the course of an investment cycle by multinational, and often highly mobile, companies and investors, and as such long-term stability in the host economy is also a significant factor.<sup>7</sup>

The UK ranks second only to the US in terms of inward investment projects. Before the onset of the pandemic, the UK's FDI stock (the level of direct investment in a host country) was the highest in Europe, worth more than France and Germany combined and generating more than 56,000 new jobs in 2019. The Department for International Trade estimated that for every £1 million increase in the value of FDI stock in the UK: the value created in the economy would increase around £69,000, 1.3 net jobs would be created, average annual wages per employee would increase by £0.001 and R&D expenditure by existing firms increases by around £1,700 on average.<sup>8</sup>

In absolute terms, the value of FDI to the UK has grown considerably over the past forty years. In 1980, the stock of inward investment in the UK was at \$63,014 million. This rose to \$1,124,650 million in 2007, before the 2008 global financial crisis led to a sustained drop in global FDI. Inward flows (the value of cross border transactions) recovered to their previous peak in 2011 and rose again before falling again around the time of the EU referendum. They have since recovered and now stand at more than twice their 2009 level, valued at \$2,075,271 million.

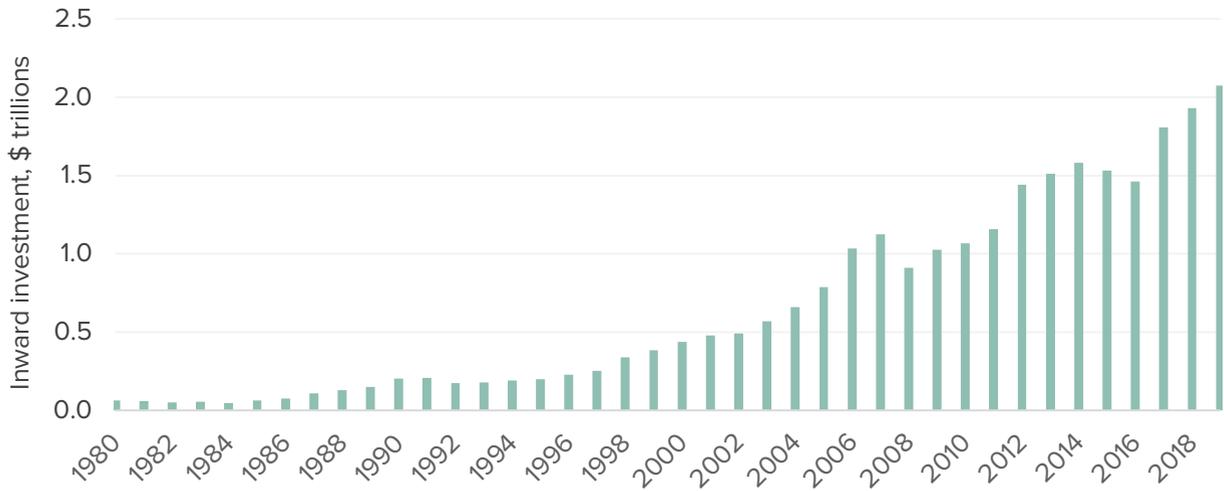
Extrapolating growth in FDI stock, using DIT's ready reckoner, at an aggregate level, finds that almost 775,000 new jobs created through FDI attraction with almost £600 million in R&D expenditure since 2010.<sup>9</sup> This suggests that of the over four million new jobs created since 2010, almost a fifth of new jobs created have been supported by inward investment into the UK.

The UK's FDI attractiveness regime is also competitive when it comes to FDI per capita or as a share of GDP. As shown below, the UK consistently outperforms the EU, G7 and OECD on both a per capita and share of GDP basis.

Recent studies have confirmed the UK's attractiveness to invest and do business. A 2021 CEO survey conducted by PWC recently found that the UK has overtaken India as the world's fourth most promising growth opportunity for multinational companies – behind America, China and Germany. Similarly, the UK ranked second in the G7 in the 2020 World Bank's Ease of Doing Business survey, based on 41 indicators of regulatory best practice including aspects such as ease of starting a business, paying taxes, and the availability of credit.

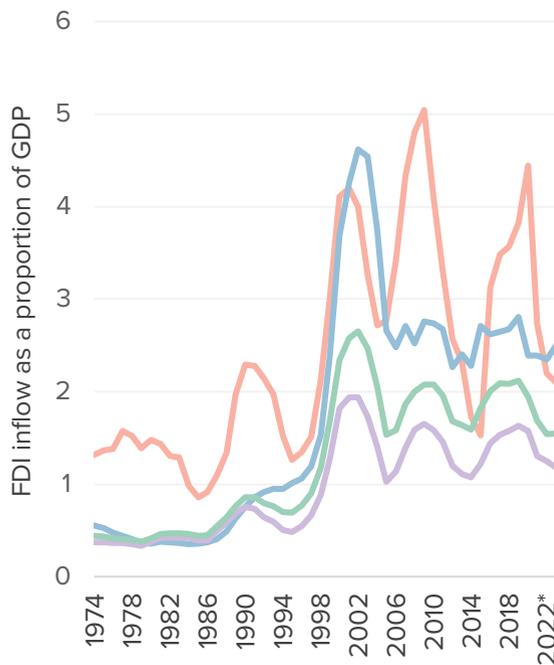
**Figure 1: Inward investment stock in the UK since 1980, \$ current prices in trillions**

Source: UNCTAD



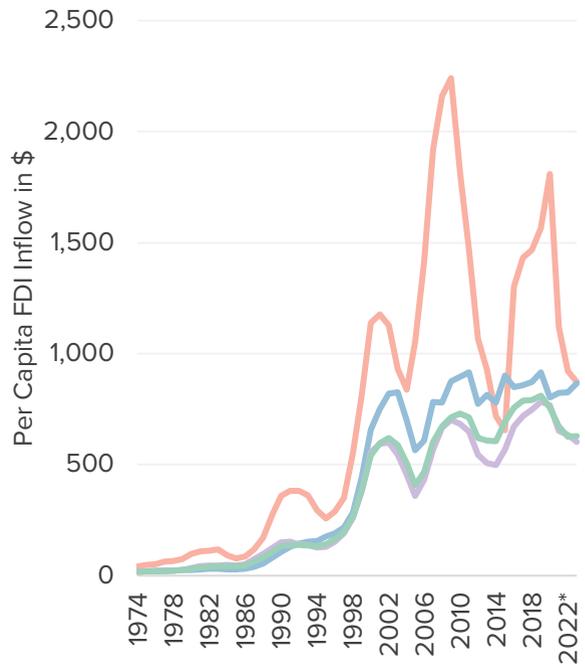
**Figure 2: FDI inflows as a proportion of GDP**

Source: Onward analysis \* = prediction



**Figure 3: Per capita FDI inflows, G7, EU, OECD**

Source: Onward analysis \* = prediction



— United Kingdom      — European Union (2020)  
— G7      — OECD

However, below the surface, what does the UK's FDI stock and inward flows consist of – how much grassroots economic activity is being attracted to the country? What is the sub-national spread of FDI flows into the country? On a fundamental basis, do we want to base future growth on FDI?

Given the impact that FDI projects can have, a more granular understanding of the state of play in the UK is needed. Albeit not uniformly, and not always, FDI projects can create new jobs, lead to new and more efficient management practices, and import skills and technology as well as funding.

Not all types of FDI projects are equal, nor as sought after. FDI can involve “greenfield” investment where inward investors create new firms or facilities in a country, or “brownfield” investments where investors buy up existing companies and facilities. Brownfield investment can take two forms: mergers and acquisitions, and expansions.

Expansion FDI is where an investor provides additional capital funding to grow the business, whereas merger investment is regarded as foreign investors gaining control of part or the whole of an existing company.

In many cases international competition for investment might be better described as a competition for “mobile investment” rather than FDI, as it takes the form of a competition for further rounds of investment into facilities and businesses that are already present - for example the production of a new car in an existing plant.

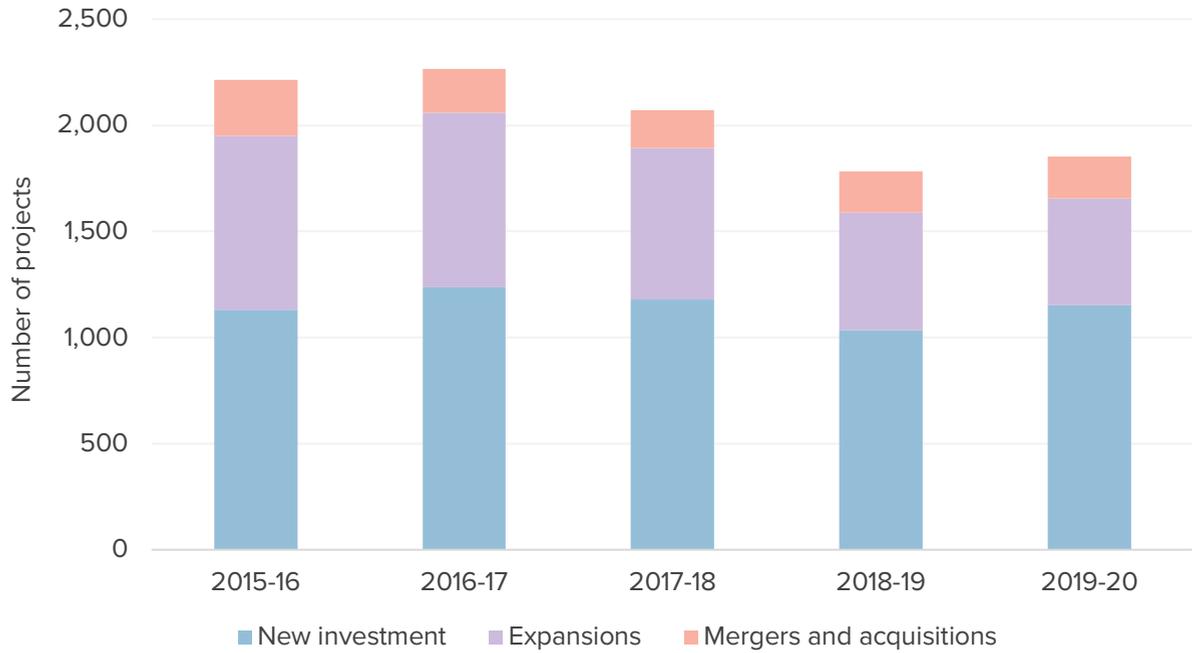
The UK's share of worldwide FDI is structurally smaller than it was in the 1990s. But it is also changing in terms of composition. Data from the Department for International Trade below demonstrates that even in the last few years there has been a decline in corporate expansion-led FDI and a small drop off in the number of cross-border M&A led schemes.

This reflects a longer run trend. Looking at a three-year moving average to reduce volatility, cross-border M&A activity has declined from a peak in 2007 of \$150 billion to around £58 billion today. This 61% decline compares to a sharp 79% increase for the USA and a fourfold increase for Japan over the same period. Within the G7, France has also seen a small increase in cross border M&A activity over the period, while Canada, Germany and Italy have all experienced a decline.

A similar trend is visible among announced greenfield FDI investments. Between 2003 and 2019, China dropped from the most popular destination in the world for greenfield FDI projects to second most popular. Meanwhile, even though Europe became increasingly attractive to greenfield investors, rising from 17% of the global total to 24% over the period, the UK outperformed nearby competitors France and Germany and ranked alongside emerging economies Brazil and India for value of greenfield FDI investment in 2019.

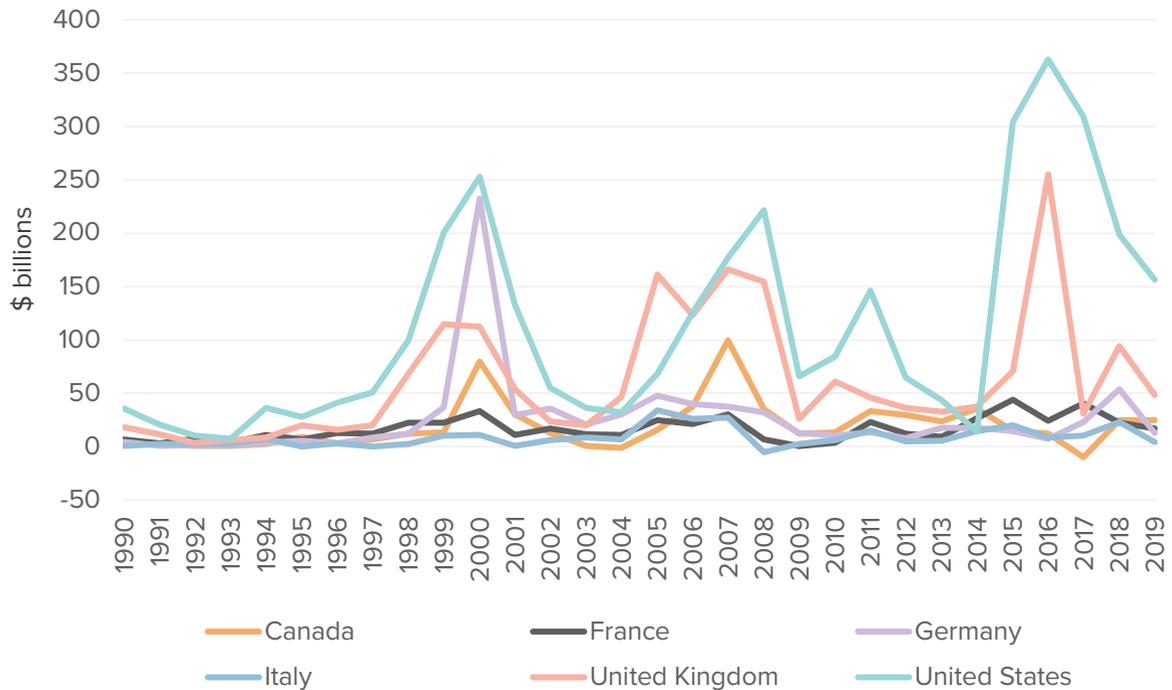
**Figure 4: Breakdown of FDI projects, UK, 2015-2019**

Source: Department for International Trade



**Figure 5: Value of net cross-border M&As by region or economy of seller**

Source: UNCTAD



Taking a three-year moving average, the value of UK greenfield FDI has risen by 30% since 2007, roughly the same as Germany and considerably more than France, although the trend since 2010 is generally in a downward direction, as Figure 6 below demonstrates.

Unfortunately, disaggregated FDI data is not available at the sub-national level in the UK – as noted by the ONS.<sup>10</sup> While the UK's absolute stock of FDI has been rising, there is evidence to suggest that this has not been felt evenly across all regions. So in this section, we have to use data on the number of projects attracted to the UK between 1997 and 2016 compiled by EY to extrapolate the distribution of FDI projects within the UK.

This is a crucial question for the Government's efforts to level up regional growth. FDI can have a positive and significant influence on regional growth. Evidence from Korea found that for every 1% increase in FDI stock, regional value added increased by 0.09 percent. Meanwhile, evidence from Spain between 1987 and 2000 showed a strong positive correlation between FDI and broader economic growth.<sup>11</sup>

In 1997, Greater London saw 20% of total FDI projects including 8% of all 'manufacturing' FDI and 49% of all 'finance and business services'. By 2010, Greater London's dominance had grown to 41% of total FDI projects, 20% of all 'manufacturing' and 62% of all 'finance and business services'. Figure 7 below shows that London punches above its weight in terms of attracting FDI projects, illustrating the uneven extent of FDI distribution across the country.

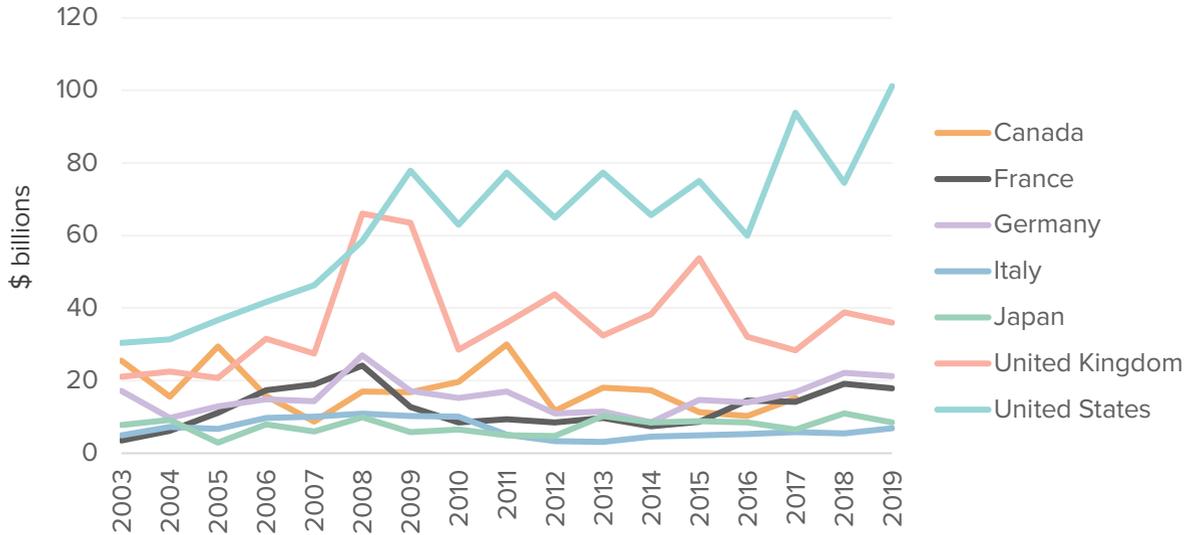
London significantly stands out, both for having the largest number of inward FDI projects, but also seeing the largest growth from 159 projects in 1997 to 539 projects in 2019. The South East saw fewer FDI projects in 2019 compared to 1997, having peaked in 2006 at 107 projects. The East Midlands, East of England and South West all have particularly low numbers of FDI projects. This indicates that investment is unlikely to be a North South issue, but rather a London versus rest of the country issue.

We find that even though Bristol, Leeds, Edinburgh, Manchester and Newcastle all more than doubled the number of projects between 1997 and 2017, no other location gets close to London's share. This correlates with more recent data, showing that London attracted 1 in 10 of all FDI projects into Europe in 2018 638 (34%) of the 1,852 new projects attracted to the UK in 2019 went to London. London has been and continues to be the location of choice for inward FDI projects in the UK.

Using more recent data from the Department of International Trade covering the period 2016-2020 shows that London's dominance in terms of FDI attraction continues. FDI has been falling as a share of all jobs created in London, but this may reflect a strong employment performance more generally.

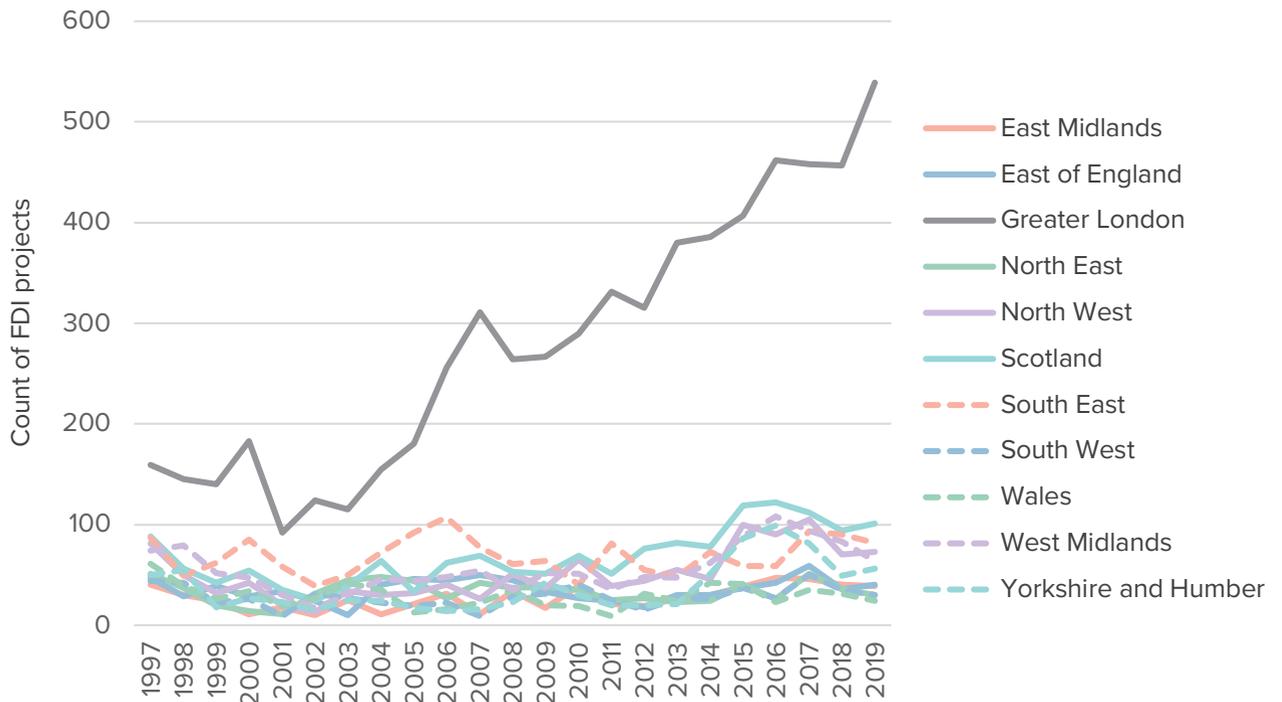
**Figure 6: Value of announced greenfield FDI projects, \$ billions, by destination, G7 countries**

Source: UNCTAD data, 3 year rolling average



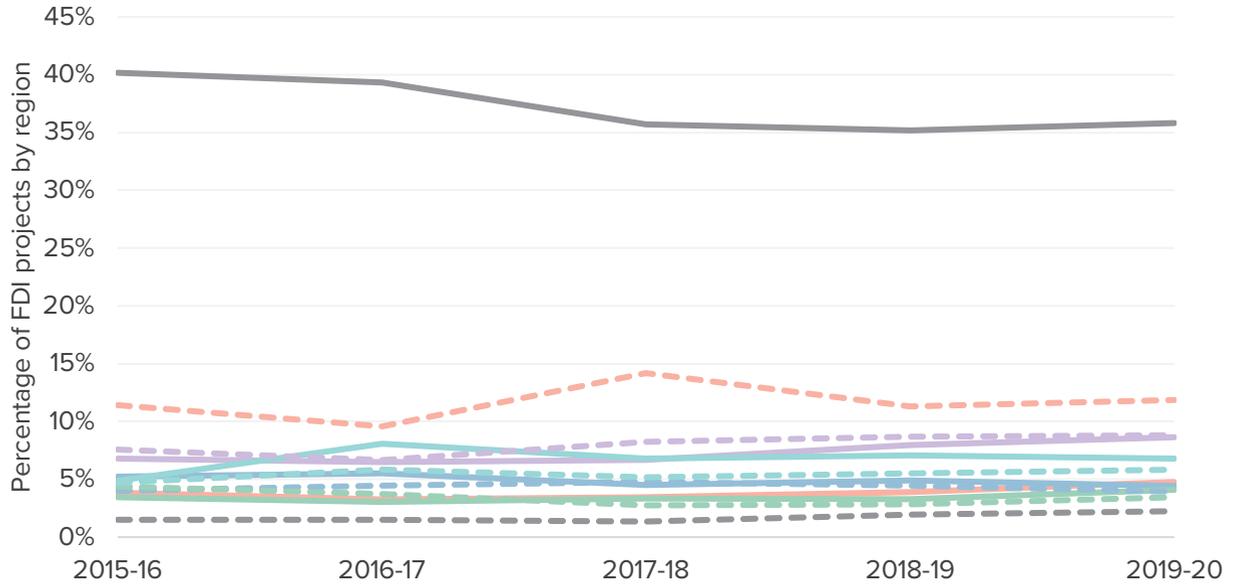
**Figure 7: Count of FDI projects by region, 1997-2016.**

Source: EY FDI database, Onward analysis



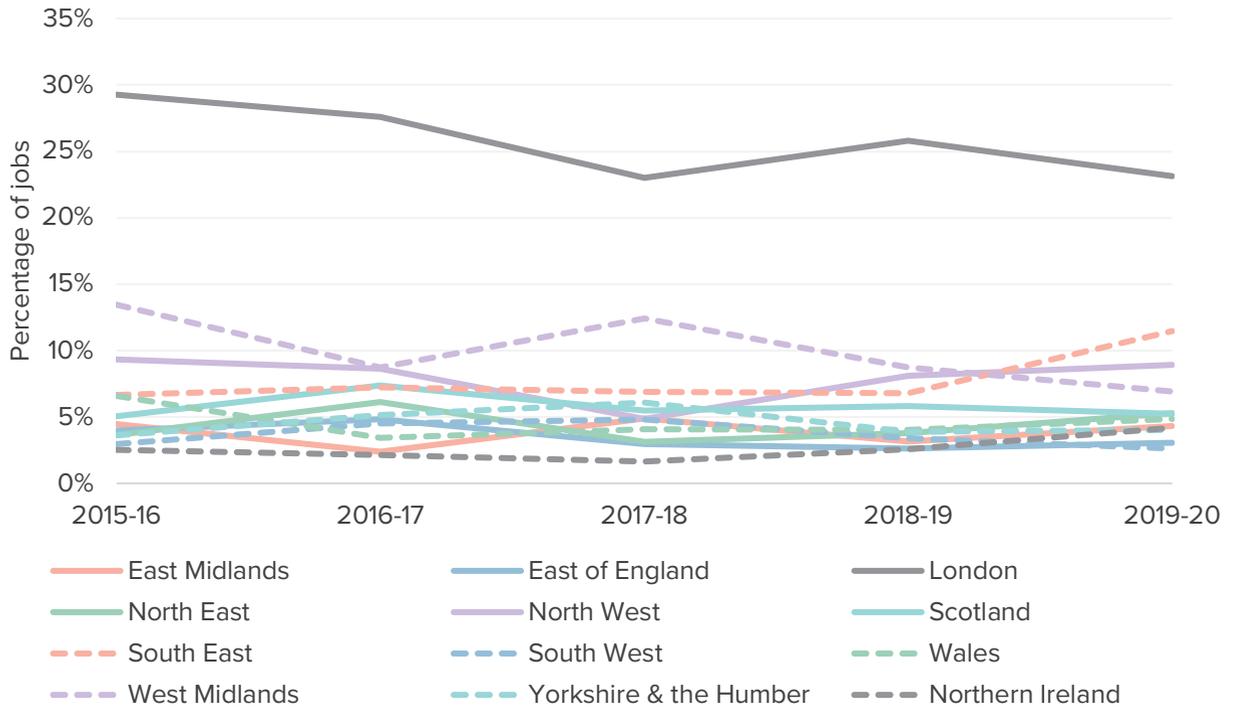
**Figure 8: FDI projects by region**

Source: Department for International Trade. See legend in Figure 9



**Figure 9: Percentage of jobs created by FDI projects by region, 2015-2020**

Source: Department for International Trade.



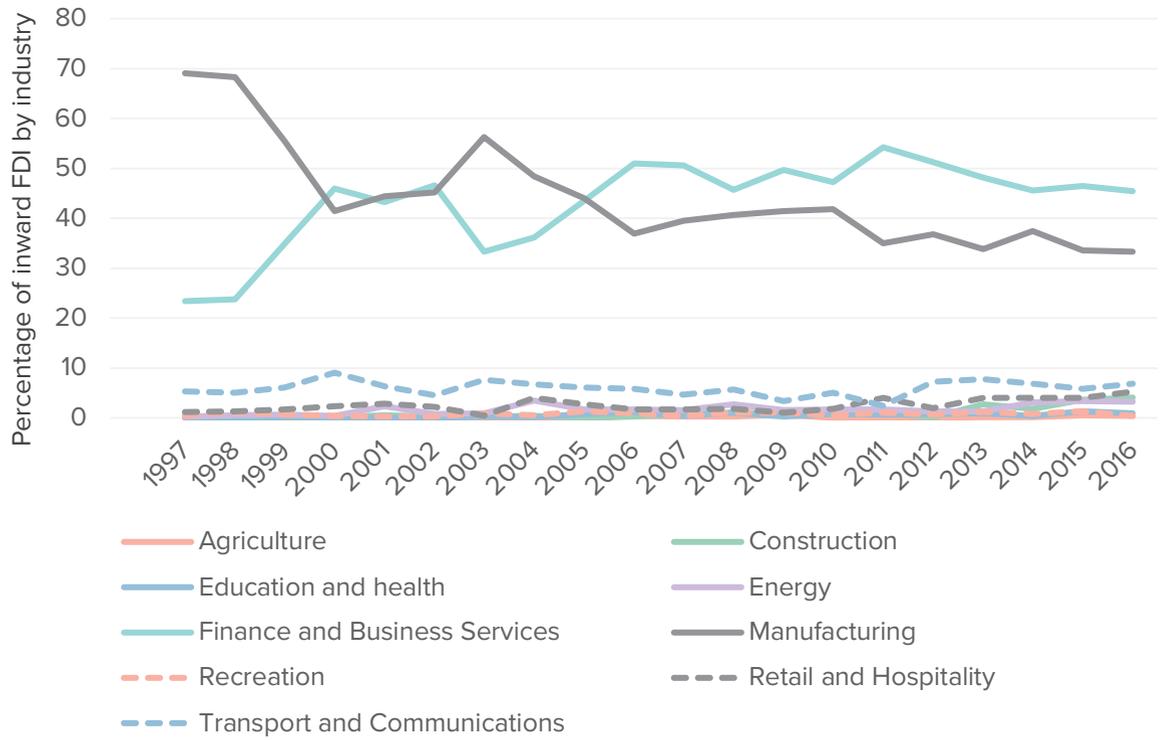
One reason for the popularity of London as a destination for foreign investment is because of the types of industry located there. In the UK foreign direct investment in finance and business services has grown significantly relative to other industries, while this is partly driven by the transformation of the UK economy, from a mainly manufacturing-based economy to a service-based economy (as illustrated below), efforts by the government to boost the profile of sectors within the UK may also have played a part. For example, combined efforts between the UK Government and sectoral trade bodies have successfully boosted the profile of sectors within the UK, specifically around London. For example, the combined efforts of TechCity and the UK Government through London Tech Week successfully put the capital at the centre of the tech world. Other examples include the Olympics, London Fashion Week and the redevelopment of the Excel centre into a venue for world-leading trade shows, all of which will enhance London's reputation as a global destination for investment, while doing little for wider UK-wide investment.

This has happened alongside a decline in the levels of FDI in manufacturing as Britain has deindustrialised more than any other G7 member over recent decades. In 1997, manufacturing made up the majority at 69% of all inward FDI investment projects. By 2016, this had fallen considerably to 33% of total FDI. Meanwhile, finance and business services attracted 23% of inward FDI investment in 1997 and has seen its share rise to 45% of all inward investment by 2016.

This transformation is reinforced in recent FDI projects data from DIT, which shows that the largest sector that attracted inward investment in 2019-2020 was software and IT services (21%), with business and consumer services (education, tourism and advisory) ranked the second largest single sector (9%). While the percentage of new jobs created through FDI projects in the last year shows a similar pattern (software and IT services, 18%; business and consumer services, 10%; Environment, infrastructure and transportation, 10%), the percentage of safeguarded jobs (existing jobs that otherwise may have been lost without intervention) through inward investment shows a different pattern. In 2016-17, more than half of safeguarded jobs were in advanced engineering, automotive or aerospace sectors. Unfortunately, data is not complete for further years given the publication would be disclosive to the identity of the companies.

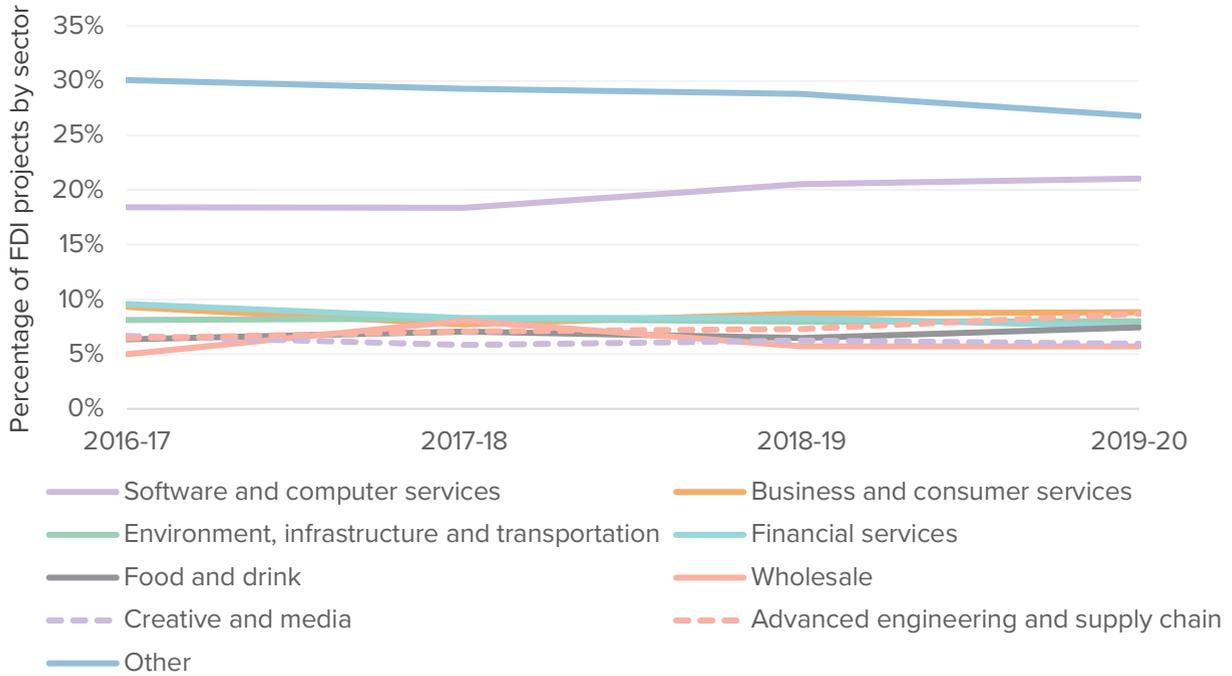
**Figure 10: Percentage of inward FDI by industry**

Source: EY FDI database, Onward analysis



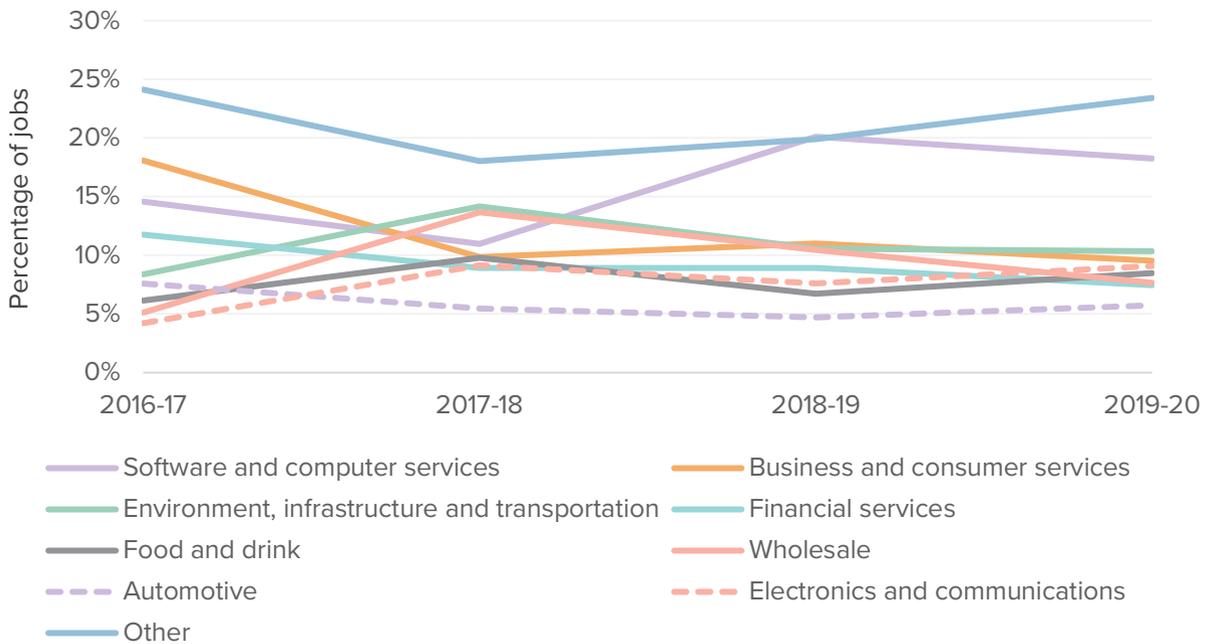
**Figure 11: FDI projects by sector**

Source: Department for International Trade



**Figure 12: Percentage of jobs created by FDI projects by sector, 2016-2020**

Source: Department for International Trade



# International Competition

*What do other countries do to boost FDI?*



With significant - albeit volatile - growth in FDI inflows worldwide in recent decades, alongside the potential transformative effects of inward investment in lagging regions and the growth in potential locations globally, competition over FDI projects has intensified. However, as shown by Figure 14, the growth in FDI stock has predominantly gone to advanced economies such as G20 and OECD member states.

Highlighting the effort that some countries make to attract FDI projects, in the United States, the combined value of federal, state and local attempts to attract investment have been estimated at \$95 billion a year.<sup>12</sup> At the US State level alone, there are around over 2,000 programmes aimed at incentivising investment.<sup>13</sup>

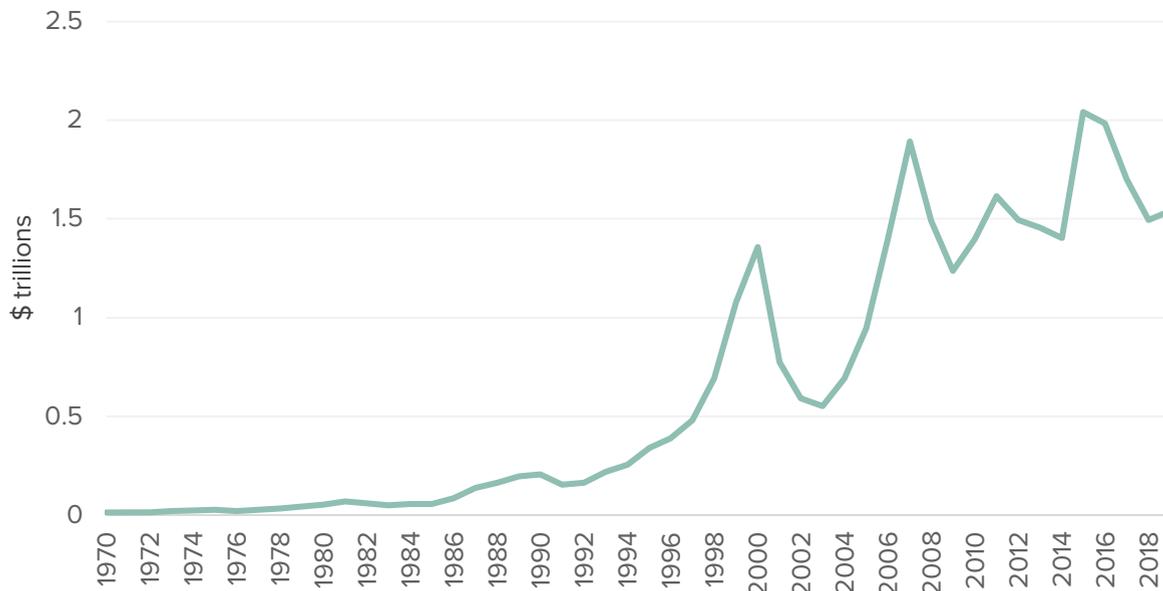
In general, there are four dominant types of mechanism that advanced economies use to attract foreign direct investment:<sup>14</sup>

- Direct grants;
- Tax incentives, both at a corporate and executive level;
- Investment promotion agencies;
- Regulatory liberalisation.

Across those types of mechanisms, place-based frameworks tend to combine different elements (for example, development zones or special economic zones sometimes employ both tax incentives and regulatory flexibility with differing degrees of success). The below section will evaluate each type, including a summary of evidence of what works and data on FDI flows.

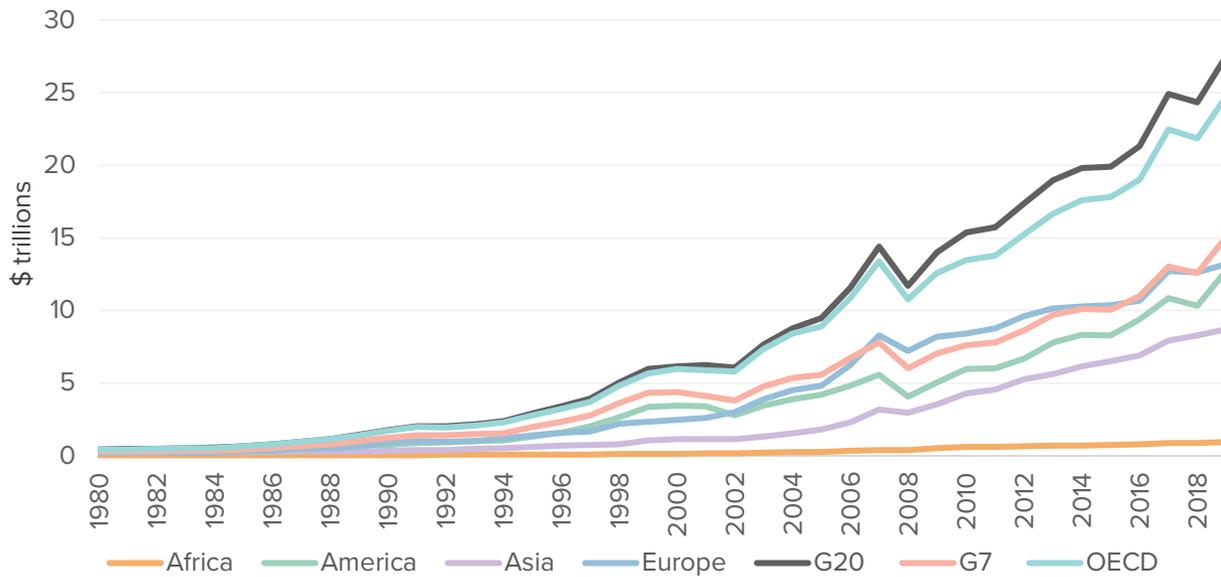
**Figure 13: Global FDI inflow**

Source: UNCTAD<sup>15</sup>



**Figure 14: Global inward FDI stock**

Source: UNCTAD



## Direct grants

In absolute terms, governments worldwide dedicate significant levels of spending to attract FDI projects. The UK is an outlier internationally in that discretionary grants are not routinely deployed to attract or retain FDI projects. Of the 2,189 state level programmes to attract investors to the United States 24% (537) are grants. Kline and Moretti highlight examples of FDI attraction in the United States, including: \$102 million in state incentives to Panasonic in 2011 to move its North American headquarters to Newark, along with an additional \$4 million in tax breaks from the city or \$307 million to Ford from the state of Kentucky in 2007 and 2008 in exchange for keeping its two plants in Louisville and expanding them.<sup>16</sup>

In Germany, the federal government reduces the cost of setting up factories and other manufacturing units, with grants of up to 30% of eligible expenditures for small enterprises, while small enterprises situated in the regions bordering Poland can receive up to 40% funding. In Israel, two development areas have been identified with grants of up to 24% available for approved investors. In South Korea, if a foreign investor is proposing to establish or expand research facilities, global headquarters or certain types of facilities, the government can provide subsidies worth up to 40% of the construction value.<sup>17</sup>

In South Africa, to attract FDI projects, the government provides up to 15 % of the value of new machinery per entity for relocation to South Africa; provides up to 50% of training costs and 30% of worker salaries for a maximum of three years; offers a tax allowance of up to 100% (maximum of \$86 million per project) on the cost of buildings, plant and machinery (for strategic investments of at least \$70 million). The government also incentivises automotive FDI to relocate to South Africa through a bespoke sectoral scheme, which provides a non-taxable cash grant of 20% of the value of qualifying investment in productive assets and 25% of the value of qualifying investment in productive assets.

The challenge for governments when awarding direct grants is to what extent they are subsidising economic activity that would happen regardless of the incentive (deadweight cost), or whether genuinely new economic activity is being attracted. Some evidence suggests grants do have an effect in attracting plants to specific geographic areas, but that firms are less responsive to incentives in areas where there are fewer existing plants in their industry.

Analysing the effect of the Regional Selective Assistance grants which the UK used to offer on the location of greenfield manufacturing FDI, Devereux et al found firms are less responsive to subsidies where few other plants in similar industries were located, but where clusters already exist grants had more of an impact.<sup>18</sup> In short, grants had more impact when growing the cluster rather than starting a cluster from scratch.

Wren, found that grants to lagging regions can promote employment and regional growth.<sup>19</sup>

Evidence on displacement effects is mixed. Some evidence shows that increases in employment due to place-based incentive are not purely due to the creation of jobs in eligible areas (and away from ineligible areas); while other evidence shows a decrease in employment in areas that neighbour incentivised areas.<sup>20</sup>

Importantly, Criscuolo et al studied a natural experiment created by changes in EU rules and found that the effects of incentives are not purely a result of displacement, albeit with the benefits of the incentives they studied limited to smaller businesses. They that found a 10-percentage point increase in an area's rate of maximum investment subsidy causes about a 10 percent increase in manufacturing employment and a 4 percent decrease in aggregate unemployment.<sup>21</sup>

The UK has one grant lever which could be used to attract FDI, but it is arguably not fit for purpose. In 2010, the Coalition Government established the Regional Growth Fund (RGF) to support private sector-led growth in select areas of England. In October 2016, it was confirmed that no future roads of the Regional Growth Fund were planned, but Government retained the use of the 'exceptional Regional Growth Fund' (eRGF) to respond to significant economic shocks. However, this framing plus the fact that its disbursement is slow and uncertain, means that its usefulness is strictly limited, and it is not an adequate tool to compete for mobile investments.

## Tax incentives

Amongst the G20 economies, the UK is one of the only countries not to boost its attractiveness to mobile investments through direct tax incentives.

Of the 2,189 state level incentives in the United States, almost half (951) are aimed at reducing the tax and regulatory burden on investors.<sup>22</sup> At a federal level, the Government offers tax incentives on a sectoral basis. For example, echoing efforts already underway in Taiwan and China, the US government is providing a 40% income tax credit for semiconductor equipment or manufacturing facility investment until 2026.<sup>23</sup>

In Australia, state and territorial governments can give rebates from land, stamp and payroll taxes for limited periods. The federal government also takes a sectoral approach. For example, within the extractives industry, the Australian Government offers deductions that can be earned by conducting business in one of a series of ways, such as establishing carbon sinks. In Canada, in some regions, the federal government offers a 10% Investment Tax Credit for capital investment as well as operating nine foreign trade zones that offer upfront tax exemptions. While in some Canadian provinces and territories, governments can offer income tax holidays for some corporations and sectors. In China, as well as offering widespread exemptions in sectors, the central government offers a 10% Investment Tax Credit.

The Japanese government has established 22 foreign trade zones with exemptions for locating companies from local taxes, as well as offering special depreciation rules and wage incentives. Similarly, as well as providing a tax holiday for qualifying firms, the Indonesian Government has established development zones in areas that offer a form of inbound investment incentives. However, in the UK, there are no dedicated foreign investment incentives.<sup>24</sup>

Beyond the G20 grouping, in other advanced economies around the world, the trend to focus on attracting mobile investment continues. In Sweden, perhaps to offset the high domestic tax rates, special income tax relief is available to attract highly skilled workers (such as international executives, experts and researchers). Under the scheme, qualifying employees are taxed on only 75 percent of income in their first three years of employment in Sweden and the remaining 25% is tax-free. The relief applies to all salaries and benefits, such as employers' payments of housing and living expenses, and also includes employers' contributions (i.e. 75 percent of the employee's total taxable income, rather than 100% of income as is normally the case). The Swedish Government also announced an Investment Tax Incentive that will enter into force in 2022.<sup>25</sup> In South Korea, for eligible investors, following approval from the government, both corporate and income tax can be reduced by 100% for the first five years and by 50% for the next two years.

In the Netherlands, the Government allows companies to deduct up to 36% of the investment costs for an environmentally-friendly investment on top of the regular investment tax deductions and an Energy Investment Allowance (which allows firms to reduce upfront investments costs for energy saving equipment by deducting 45.5% of the cost from profits). Portugal introduced a time limited investment tax credit of up to 20% of investment expenses (up to EUR 5 million), the tax credit is limited to 70% of CIT liability but may be carried forward for five years.

Analysing the specific effect of tax rates on FDI attraction requires care. For example, headline corporation tax rates in the UK, as well as elsewhere in the world, have been reduced considerably over recent decades. However in the UK this headline rate reduction since the 1980s has been achieved partly by broadening the base and reducing capital allowances. In the case of Ireland, low headline rates have combined with complicated interactions with other countries' tax systems (particularly the US) to make it very attractive to inward investment, but prompting official analysis of how much real activity has been moved to the country.

While international evidence would suggest that areas that receive place-based stimulus can benefit. US Empowerment Zones - areas that received support from the Federal Government in the form of tax breaks as well as subsidies - had strong positive employment and wage effects, albeit with some deadweight loss.<sup>26</sup> The challenge for policy makers is to minimise the loss.

Although empirical evidence on the redundancy ratio is rare; in some countries where tax incentives have been deployed, the ratio is up to 85%.<sup>27</sup> However, in some cases, extending tax holidays by 10 years increases FDI by only one percentage point of GDP but in weaker investment climates the effect of tax incentives is significantly less effective.<sup>28</sup>

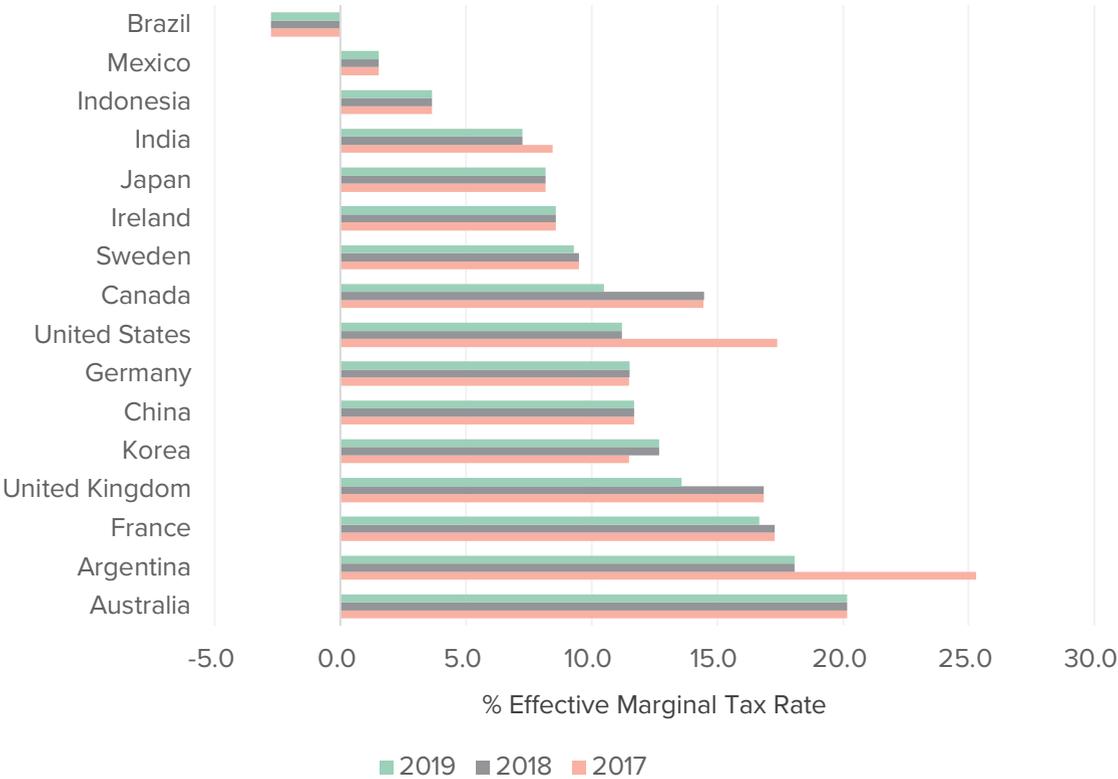
As noted in Onward's previous report *Firing on All Cylinders*, a study by the Oxford University Centre for Business Taxation found that in 2015 the UK's capital allowances were the least generous in the G20. Looking at the interaction of a low headline rate with unfavourable capital allowances, the study found that while the UK was ranked first in the G20 on its low headline rate, it ranked only 10th of 20 on the effective marginal rate. Globally significant variation remains in the effective corporate marginal tax rate.

The Super Deduction relief announced in the 2021 Budget aimed to rectify that by making the UK's capital allowance regime internationally competitive. The capital allowance expansion makes the value of plant and machinery allowances the most attractive in the OECD - up from 30th before the super deduction announcement. However, the deduction is currently only scheduled to last for two years. While a survey of economists for Vox EU found most thought it would aid recovery and avoid investment forestalling, many firms will not be able to mobilise investment plans on that time scale, limiting any longer term effects.<sup>29</sup>

The absence of a bespoke mechanism to incentivise inward investment to the UK, or areas of it, in a similar manner to South Korea, Sweden or Canada seems to be a gap in our arsenal.

**Figure 15: Effective corporate marginal tax rate**

Source: OECD<sup>30</sup>



## Investment Promotion Agencies

Competition over FDI projects is increasingly fierce. Since the turn of the millennium, national and sub-national IPA registrations with the World Association of Investment Promotion Agencies have increased by over half. The evidence suggests that IPA activities are worthwhile. In countries with regulatory barriers or information asymmetry, active investment promotion led to higher FDI flows. Furthermore, investment promotion efforts appear to be cost effective: a dollar spent on investment promotion in developing economies was found to increase FDI inflows by \$189 on average.<sup>31</sup>

There is also some evidence to suggest that IPAs are becoming growingly competitive. For example, in 2013, Hong Kong's IPA launched StartmeupHK. This has grown since its launch and before the onset of the pandemic held week-long trade expo that matched companies with investors, which has now evolved into an annual event.<sup>32</sup> Similarly, the Singapore Economic Development Board offers online tools to illustrate the executive and corporate costs of setting up in Singapore, including a cost calculator and cost of living calculator, which offer high level estimates on the costs based on sector, revenue and staff.<sup>33</sup>

A recent survey of IPAs found that 70% of such bodies have a multi-year strategy. While the average IPA has eight mandates – in the survey, a mandate is defined as a strategic priorities that go beyond investment promotion such as export or tourism promotion or policy advocacy - about half of all agencies (53%) have between six and 10 mandates.<sup>34</sup> In spite of existing evidence highlighting the importance of targeting in attracting greater FDI flows, and targeting being particularly effective at the sub-national level (targeting efforts of a regional investment agency can lead to an increase of around 23% in the inflow of FDI), the average IPA has 11 priority sectors.<sup>35</sup> Although the number of mandates within an IPA is not directly inverse to successful FDI attraction, as shown below, the more successful IPAs in the OECD have fewer mandates.

Aside from territory covered, the autonomy of IPAs differentiates ability to attract FDI inflows. 63% of IPAs are autonomous, with only 31% of IPAs acting as a unit or department of government; many other advanced economies, including the well-known example of IDA Ireland operating with some degree of self-control.<sup>36</sup>

Ireland, outperforms similar sized economies in terms of average FDI inflows irrespective of classification of IPA autonomy. In terms of FDI inflows as a percentage of GDP, as shown below, averaging inflows over the past five years shows that on average autonomous IPAs are most successful (autonomous IPAs attracting FDI inflows worth 4.041% of GDP between 2015 and 2019). However, looking at the country level FDI inflows reveals a significant degree of disparity between types of IPAs. While autonomy does not directly correlate to success in terms of attracting FDI inflows, with the exception of the Netherland's governmental IPA, on balance autonomous IPAs are more successful.

**Figure 16: OECD IPAs ranked by number of mandates with an average of FDI inflows, as a percentage of GDP, over five years.**

Source: World Bank



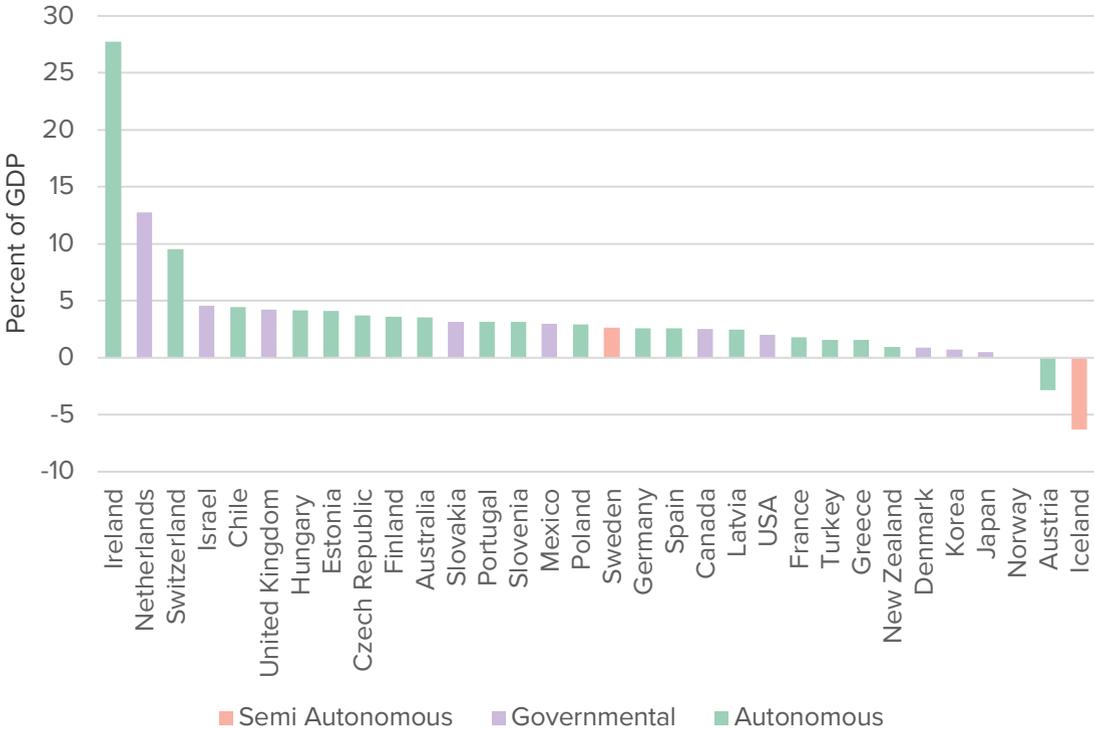
**Figure 17: Average FDI inflows, as a percentage of GDP, amongst OECD IPAs by type**

Source: OECD, World Bank



**Figure 18: OECD IPAs ranked by autonomy with an average of FDI inflows, as a percentage of GDP, over five years**

Source: OECD, World Bank

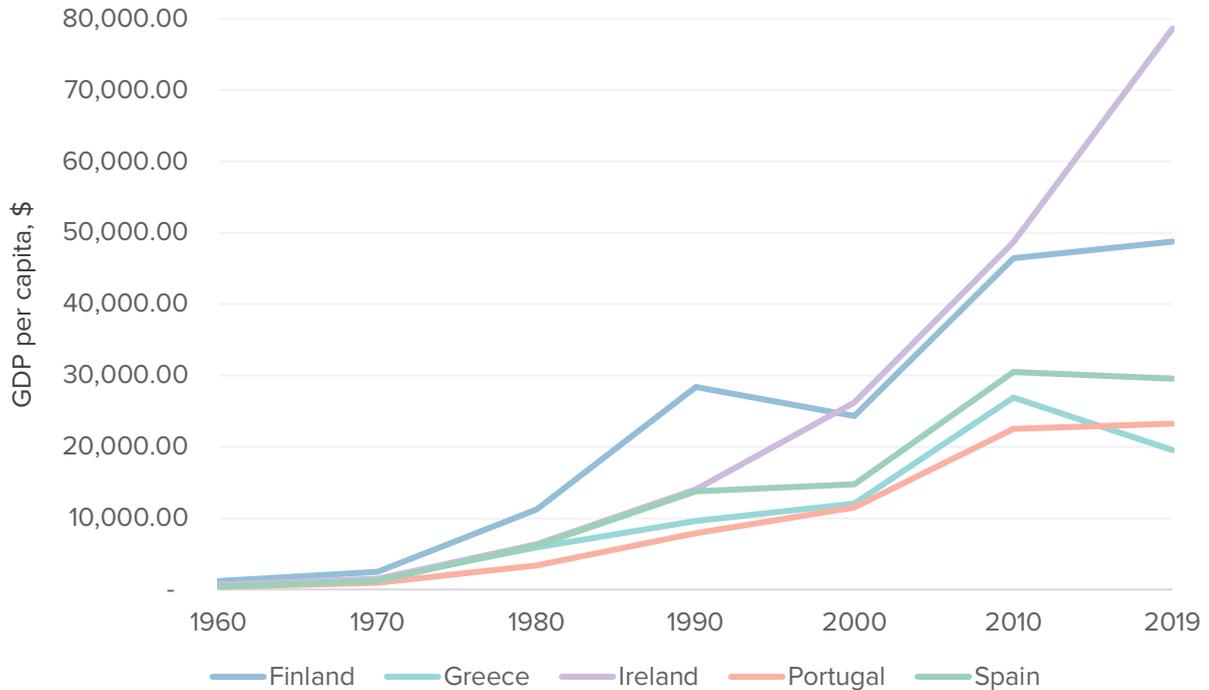


Indeed, the Republic of Ireland has grown its share of FDI from 0.3% in 1990 to 5% of worldwide annual FDI flows in 2019, in turn doubling its stock of FDI from 1.7% of global FDI to 3.1%.<sup>37</sup> While Ireland ranked marginally behind both Finland and Greece in terms of GDP per head in 1970, by 2019 Ireland’s GDP per head was almost four times the size of Greece’s and more than one and a half times larger than Finland’s.<sup>38</sup>

The investment attraction environment within the UK is uneven. At a national level, the Department for International Trade (in addition to negotiating trade agreements and supporting UK businesses’ export promotion) acts as the UK’s IPA. This role has recently been boosted by the creation of the Office for Investment. Sub-nationally, each of the devolved governments has an Investment Promotion Agency, namely: Invest Northern Ireland; Trade & Invest Wales; and Scottish Development International - complete with discretionary powers, such as the ability to attract FDI projects through grants.

**Figure 19: GDP per capita, USD, current prices.**

Source: World Bank



Scottish Development International – voted as the best sub-national IPA in Eastern, Western Europe and Central Asia in 2020 - showed the value in sub-national IPA when it published its inward investment strategy last year, which targeted sectors and 50 leading international companies.<sup>39</sup> In 2012, the nine previous Regional Development Agencies that covered England were abolished, with the responsibility for inward investment having been taken up by Local Enterprise Partnerships. Since then city regions have developed an inward investment function, while local councils retain their traditional powers and responsibilities.<sup>40</sup>

However, not all IPAs are equal. The consequence is that an area or business in Glasgow is better served in terms of investment promotion than an equivalent in Newcastle. Variation in powers, discretionary finance, ability to operate at scale and capacity displace the results. This situation is not inevitable. Collective municipal action in Canada has seen 12 of the largest urban areas join together, and through the *Consider Canada City Alliance* covers over half of the Canadian population and almost two thirds of GDP, to increase scale and pool resources – offering “a deep understanding of Canada’s economic strengths and business versatility”.<sup>41</sup> Since the Alliance was founded in 2012, the members have undertaken trade and investment delegations to Europe, Brazil, Japan, China, South Korea and Taiwan acting as a match making service with investors.

## Regulatory liberalisation

Better business environments attract more FDI projects. The LSE found that per capita FDI inflows were larger in economies with more flexible business regulations.<sup>42</sup> Since 1997, South Korea has been the biggest reformer of FDI regulations since 1997.<sup>43</sup> This liberalisation, once a critical mass had been achieved, likely had a strong impact on the growth of South Korea's FDI stock in absolute terms as well as boosting competitiveness. However, liberalisation did not have an immediate corresponding effect on the growth of FDI inward stock within either South Korea or China - the two countries that saw the most change in regulatory liberalisation and flexibility since 1997. However, the rise of Chinese FDI inflows in Figure 21 suggests there may be a lagging effect.

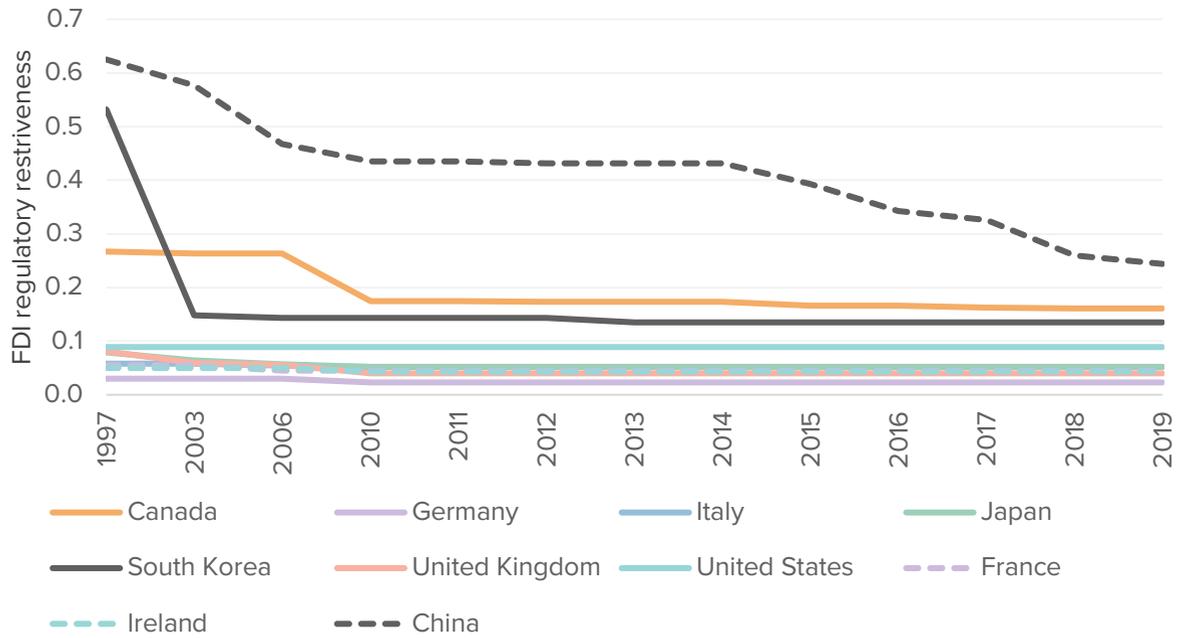
Furthermore, while regulatory flexibility and liberalisation are supportive of FDI attraction, it may not be the sole determinant. In the World Bank's Ease of Doing Business Index, the UK is ranked 8th out of 190 nations with New Zealand ranked as the best country for ease of doing business. As a percentage of global stock, the value of its FDI stock was 0.22%. In terms of average FDI inflows (as a percentage of GDP over a five year period), New Zealand lags behind Ireland and Singapore in terms of FDI attraction even though both countries are ranked lower in terms of ease of doing business. While there may be a correlation, in terms of impact on the ability of FDI projects to a host country at a national level, it is not the determining factor.

Over the last 25 years, there has been a significant growth in the number of placed-based regulatory flexibility. The number of Special Economic Zones (SEZs) has grown from 845 in 1997 to nearly 5,400 in 2018. More than 1,000 SEZs were established in the last five years, and around 500 more zones have been announced and are expected to open in the coming years.<sup>44</sup> However, as shown below, the almost exponential growth in the establishment in the number of zones, the number of countries offering such zones have not been increasing at the same rate.

The main benefit of SEZs is a flexible regulatory regime (within a clear geographic area) distinct from the rest of the host economy (most often customs and fiscal rules, but potentially covering other relevant regulations, such as foreign ownership rules, access to land or employment rules).<sup>45</sup> The most common in advanced economies is the free trade zone that aims to reduce logistical barriers, as well as support cross border supply chains.

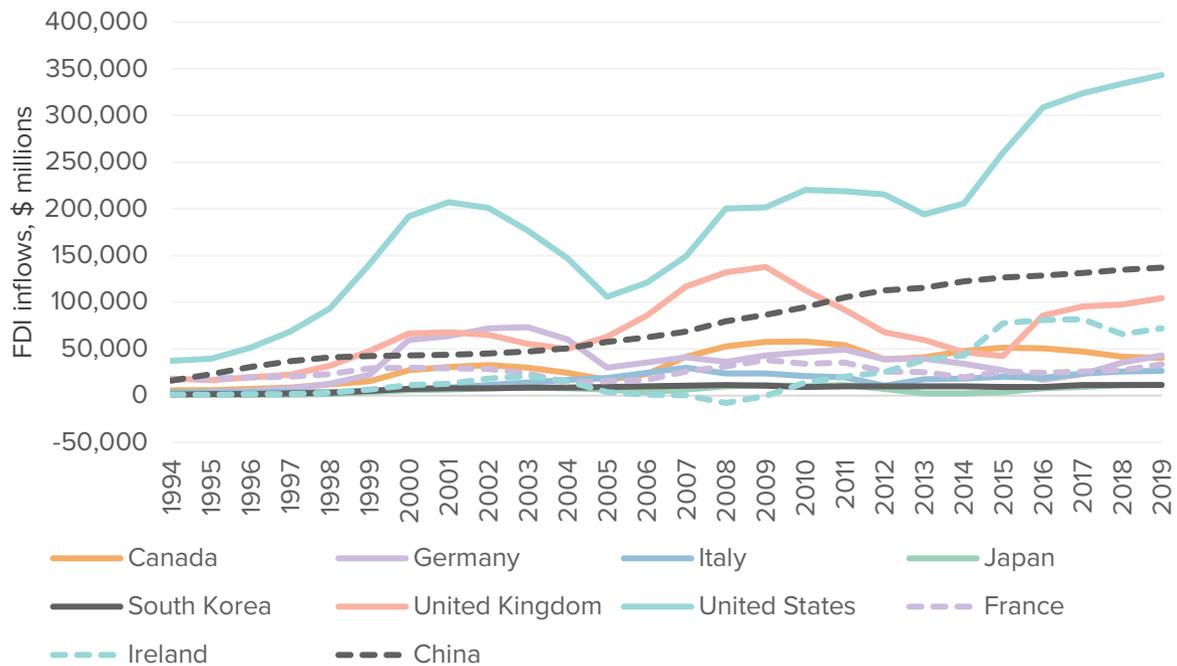
**Figure 20: FDI Regulatory Restrictiveness Index<sup>46</sup>**

Source: OECD



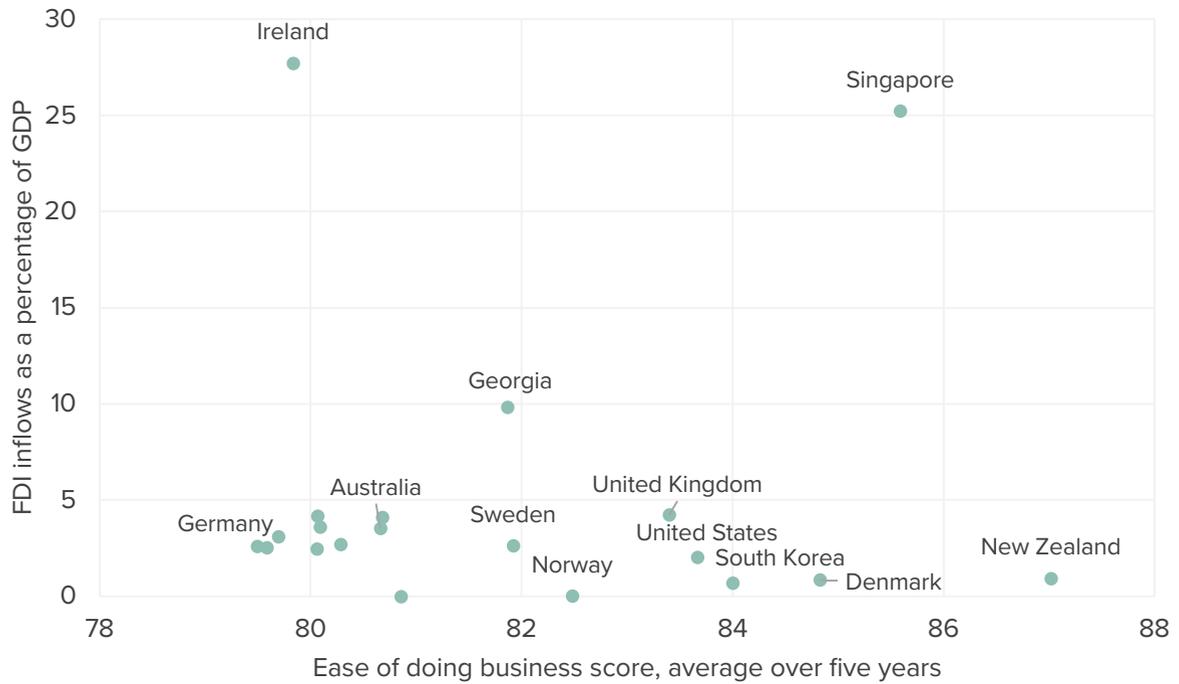
**Figure 21: FDI inflows, USD million (current)<sup>47</sup>**

Source: OECD, World Bank



**Figure 22: Top 20 countries for Ease of Doing Business, against FDI inflows as a percentage of GDP**

Source: Five year averages, 2015-2019, World Bank



**Figure 23: Growth of Special Economic Zones (SEZs)**

Source: UNCTAD



In China, starting in the late 1990s, high-tech development zones (HTDZs) were established offering access to corporate income tax exemptions for the first two years, a preferential 15% corporation tax rate, exemptions from tariffs on specialist equipment and benefits for employees at the discretion of each zone, such as exemptions from income tax or car and housing allowances. By the end of 2017, China had established 156 HTDZs that contributed 11.5% to China's GDP. In these zones, the ratio of R&D expenditures to total production value was 6.5%, three times the average in the national economy. Patents granted to enterprises in the zones account for 46% of all business patents granted nationwide.<sup>48</sup> In 2010, SEZs in China contributed to 22% of GDP, 45% of total national foreign direct investment, 60% of exports and have been estimated to have created over 30 million jobs.<sup>49</sup>

In the United States, there are around 250 foreign trade zones, and over 500 foreign trade subzones. In 2016 alone, 2,500 organisations used freeports in the U.S. employing 420,000 people. The use of free ports considerably picked up when a policy was passed to eliminate duty on all value-added activity, meaning no duties would be payable on labour costs, profit or domestic parts used in manufacturing.

In South Korea, the Government has established designated Foreign Investment Zones, where foreign investors are eligible for a full discount on corporate tax and income tax for seven years and then 50% for another three years. Since they were established in 2003, the nine zones have grown to employ 167,000 workers in over 5,700 businesses.<sup>50</sup>

While the evidence is mixed, based in part on international evidence, from the OECD and UNCTAD as well as academic literature, some believe SEZs – specifically freeports – could positively influence UK FDI attraction.<sup>51</sup> For example, the UK Trade Policy Observatory found that freeports could benefit economic growth in lagging regions although it was also highlighted that protections would need to be put in place to prevent displacement.<sup>52</sup>

Research by the Centre for Cities suggested that free ports are unlikely to promote high skilled jobs that would create future growth. Comparing freeports to Enterprise Zones, the Centre for Cities concluded that of the 54,000 jobs advertised as being created, 41,000 of these were diverted from more privileged areas rather than created and most of those that were created made little impact to long term regeneration. In a review of Enterprise Zones, the What Works Centre for Local Growth found that while most evidence showed positive impacts (positive effects on wages, poverty levels and reduced levels of unemployment) there is little evidence at the aggregate level stating “we have little evidence on whether overall effects at the wider area level are positive, or whether displacement is the main effect of EZ-type schemes”.<sup>53</sup>

The below offers an illustrative breakdown of FDI attraction mechanisms used by advanced economies and neighbouring competitor economies. Although illustrative, and not a complete picture, it offers an example of the scale of effort that other countries put into FDI attraction.

## Countries and their FDI attraction mechanisms.

Country	FDI attraction mechanisms.
Argentina <sup>54</sup>	<p><b>Special Economic Zones:</b> There are 11 special economic zones in Argentina. Goods entering zones are exempt from duties on importation for consumption, apart from charges paid for services provided. They are also exempt from national taxes on utilities (e.g. telecommunications, gas, and electricity) provided within the zones.</p> <p><b>Industrial promotion:</b> Investment promotion usually takes the form of tax credits, covering the theoretical fiscal cost of the project. Other mechanisms include: tax exemptions, special import regimes, accelerated depreciation for machines, equipment and infrastructure development. Sectoral tax incentives are available in the mining, forestry, biotechnology and energy sectors, as well as for investments in specific regions (like the Tierra del Fuego).</p> <p><b>IT Tax Exemptions:</b> IT firms benefit from a reduced income tax rate of 15%, exemption from value-added tax, deduction of a fixed amount of employer contributions, and a tax credit for the payment of income tax and value-added tax.</p>
Australia <sup>55</sup>	<p><b>Tax incentives for early stage innovation companies:</b> A 20% non-refundable carry forward tax offset for qualifying investments, capped at AUD200,000 for each investor and their affiliates per income year; modified capital gains tax treatment for qualifying investments held for more than one year but less than ten years.</p> <p><b>R&amp;D:</b> A refundable tax offset equal to 43.5% for the first AUD100 million of eligible expenditure is provided for eligible companies with an aggregated turnover of less than \$20 million a year and a non-refundable tax offset equal to 38.5% for the first \$100 million of eligible expenditure is provided for other eligible companies.</p> <p><b>Conservation incentives:</b> By donating property with a minimum value of AUS\$5,000 to eligible environmental bodies, donors benefit from the capacity to claim tax deductions on the price of the donation. This is particularly appropriate for those who are asset rich and cash poor. The payment comes in the form of deductions in tax over a period of years. If a donated property is worth AUS\$100,000, the payment comes in the form of tax deductions in a selected number of years. Over 5 years, for instance, the donor would receive AUS\$20,000 tax deduction every year.</p> <p><b>Income tax offsets:</b> Foreign income tax offsets are available in order to avoid double taxation. A corporation or individual is able to claim a FITO if they have paid a certain amount of income tax in a foreign country where they are partly operating. They must declare all income, whether having paid tax or not and then apply for a FITO. To be granted the FITO, the paid income tax must be visible in assessable income so that the Australian Tax Office can prove the tax payment.</p> <p><b>Sectoral promotion:</b> Other incentives are available based on the industry the investor is involved in. For example, within the mining and natural</p>

resources industry, the Government offers accelerated deductions. These deductions are earned by complying and/or conducting business in one of a series of ways, such as reusing and establishing carbon sink forests.

**Bilateral Investment Treaties:** BITs are agreements between two countries that include rules to promote and protect two-way investment between those countries. These investment rules provide protections and greater certainty for domestic investors overseas (and foreign investors in host countries), the Australian Government is undertaking a bilateral investment treaty review, which will unfold over four years and include options for reform and strengthen safeguards.

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## Brazil<sup>56</sup>

**Manaus Free Trade Zone:** The companies entitled to benefit from the Manaus Free Trade Zone have the following tax incentives: Exemption from import duty on goods imported into the zone, if locally consumed or re-exported; corporate income tax reduced by 75%.

**Special customs regime for export and import of goods for exploration and production of petroleum and natural gas:** A tax incentive that allows the import of certain goods to be used directly for the exploration and/or production of oil and gas, by suspending import duty, federal excise tax, PIS-importation, COFINS-importation and freight surcharge for merchant marine vessels.

**Place-based incentives:** The Federal Government provides a tax reduction or exemption on construction, expansion, modernisation or diversification projects in industries considered to be priorities for regional development in the some areas. The reductions and exemptions include: a reduction of 75% of corporate income tax; an accelerated depreciation for calculation of corporate income tax; and time fixed capital deductions.

**Special regime of incentives for the development of infrastructure:** A tax incentive suspends certain levies on the sale or import of new machines, instruments and equipment, construction materials and some services, used or incorporated in infrastructure projects in the transport, port, energy, basic sanitation and irrigation industries.

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## Canada<sup>57</sup>

**Special Economic Zones:** There are nine foreign trade zones in Canada, offering: upfront relief of duties, refund on duties for exported goods, upfront relief of GST/HST on some imports and domestic purchases.

**Scientific Research and Experimental Development tax incentive:** Foreign companies can apply for tax incentives indirectly by forming a Canadian subsidiary company to perform eligible R&D work in Canada for itself or on a contractual basis on behalf of the parent company, where they may deduct eligible expenditures and claim a 15% non-refundable tax credit.

**Accelerated Investment Incentive:** the Accelerated Investment Incentive provides an enhanced capital cost allowance including: full expensing in the first year for manufacturing and processing and clean energy equipment purchases, and a 50% increase in the available capital cost allowance deduction for property acquired in a fixed timeframe.

**Strategic Innovation Fund:** A \$1.26 billion fund, profiled over five years, dealing with funding requests over \$10 million. Projects are

and commercialization of new intellectual property in Canada; development of new and improved products, services or processes; and significant R&D creating technology with the potential for market disruption.

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#### China<sup>58</sup>

**Economic Development Zones:** China's EDZs are areas with preferential business policies that differ from those governing the country as a whole. Examples include Special Economic Zones and Economic and Technological Development Zones. There are over 2,000 EDZs, each with unique investment incentives and accreditation at different levels of government.

**Tax exemptions:** Investors can export goods duty-free, as well as being exempt from local taxes in certain industries. Companies under losses are completely exempt from corporation tax. Once a company does start to generate a profit, its corporation tax rate remains reduced for five years. SEZs also have a decreased income tax level, being as low as 15% in Hong Kong, compared to 33% in mainland China.

SEZs have contributed 22% of China's GDP, 45% of total national foreign direct investment, and 60% of exports. SEZs are estimated to have created over 30 million jobs, increased the income of participating farmers by 30%, and accelerated industrialization, agricultural modernization, and urbanization.

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#### France<sup>59</sup>

**Special Economic Zones:** there are 99 Urban Free Zones in France. Enterprises located or planning to locate in these areas benefit from a scheme of exemption from tax burden and social charges for a period of five years.

**R&D tax credit:** A corporate tax incentive for R&D expenses incurred by trading companies located in France, regardless of sector or size. It allows companies to benefit from a: 30% partial refund (either by way of tax reduction or tax reimbursement) of expenses under €100 million; 5% partial refund (either by way of tax reduction or tax reimbursement) of expenses exceeding €100 million.

**Corporation tax:** Foreign investors are subject to corporation tax on income attributable to French business activity, as well as on income from real estate located in France. The rate stands at 26.5% for companies with profits of less than €500,000 and 27.5% for companies with profits exceeding €500,000.

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#### Germany<sup>60</sup>

**Special Economic Zones:** There are five free trade zones in Eastern Germany.

**Cash Incentives Programme:** The cash incentive programme is a national scheme that helps to reduce the cost of setting up factories and other units. Individual states have their own incentive programmes with the same conditions for foreign and domestic investors. Regions with the highest incentives rates offer grants of up to 30% of eligible expenditures for small

enterprises. Small enterprises situated in the regions bordering Poland can receive up to 40% funding.

**R&D tax credit, grants and loans:** Companies with tax status in Germany and performing R&D activities are eligible for a tax credit of up to EUR 500,000 annually. R&D loans are provided by different governmental programs. For instance, the ERP Innovation Program offers 100 percent financing of eligible R&D project costs up to EUR 5 million.

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## India<sup>61</sup>

**Special Economic Zones:** There are 265 operational special economic zones in India. Companies in the zones are eligible for a total exemption from tax for the first 5 years and a 50% exemption from the tax due for the next five years.

**Corporation tax:** New power generation companies benefit from a reduced corporate tax rate of 15%. The move comes after the Indian Government last year announced that newly incorporated domestic companies in the manufacturing sector would benefit from a 15% corporate tax rate where they start manufacturing by 31 March 2023. The corporate tax rate was also dropped from 30% to 22% for existing manufacturers.

**Infrastructure investment tax breaks:** The 2020 Budget announced include plans to grant a tax exemption to sovereign wealth funds in respect of their interest, dividend and capital gains income from investments made in infrastructure in India before the 31 March 2024. The exemption will only apply if the investment is held for at least three years, and the Indian Government has the power to extend the exemption to other sectors.

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## Indonesia<sup>62</sup>

**Tax Exemptions:** Foreign companies benefit from the removal of a tax on dividends provided they are reinvested in-country.

**Corporation Tax:** Corporate income tax is to be reduced from 25% to 20% by 2023.

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## Ireland<sup>63</sup>

**R&D:** An R&D tax credit at 25% is available for all qualifying R&D expenditure on a net of grant basis.

**Corporation tax:** Ireland's corporate tax rate is 12.5%. However, various bilateral treaties and interactions with the US tax system may well reduce the effective rate to a much lower level. For example, in 2016 the European Commission stated that "selective treatment allowed Apple to pay an effective corporate tax rate of 1% on its European profits in 2003 down to 0.005% in 2014."<sup>64</sup>

**Capital allowances and grants:** Capital allowances are available to the acquisition of wide range of intangible assets e.g. wear and tear allowances claims for qualifying plant and machinery – claimed at 12.5% over 8 years; industrial buildings allowances claims – typically claimed at 4% over 25 years. SMEs that employ 250 people on site are also eligible for grants to replace old equipment or acquire new upgrades.

**Go Green Grants:** This includes grants to increase the energy efficiency of the business, as well as support to increase environmental standards.

## Israel<sup>65</sup>

**Grants Programme:** Priority development areas have been defined as Development Areas A and B. Approved Enterprises in development area A may receive fixed asset grants of 24%, with development area B's rate at 10%.

**Tax Exemptions:** A total exemption from corporate tax on undistributed profits is available for ten years in development area A and for six years in development area B.

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## Italy<sup>66</sup>

**Tax credits:** Companies investing in strategic intangible assets can benefit from a tax credit of 15%, whereas those investing in machinery and capital goods qualify for a tax credit of 20-40%.

**Place based incentives:** Italy incentivises investment in certain regions. For example, companies investing in Basilicata, Calabria, Campania, Puglia, Sicily, Molise and Abruzzo within the end of 2020, can benefit of a tax credit of 25%, 35% or 45% depending on the size of the company.

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## Japan<sup>67</sup>

**R&D tax credit:** Companies with high R&D expenses compared to the previous 3 years average are entitled to a tax credit of up to 20% of the corporate tax.

**Capital Investment Benefit:** SMEs investing in machinery defined as 'energy saving' benefit from a 30% depreciation rate, or 7% tax credit, up to 20% of the corporate tax liability.

**Foreign Access Zones:** The Japanese Government has set up 22 zones, eligible companies benefit from exemption from local taxes (real estate purchase tax and property taxes), special depreciation rules (50% deduction for machinery, 25% deduction for buildings) and incentives for wage and productivity improvement.

**Capital investment tax breaks:** For buildings valued at 20 million yen or above (for SMEs this was reduced to 10 million yen), companies receive a tax deduction of 4% on the acquisition value.

**Employment promotion:** In the case of the establishment or expansion of headquarters functions, in eligible regions, companies are eligible for a tax credit of up to 600,000 Yen per new employee.

**Reshoring incentive.** In April 2020 Japan announced a US\$2 billion fund to support firms reshoring production back to Japan. At the end of the first round of applications in June 2020, the Japanese Ministry of Economy, Trade and Industry (METI) announced they would assist in shifting operations of 57 companies, including privately owned facemask-maker Iris Oyama Inc and Sharp to Japan. METI spent about \$536 million on this.<sup>68</sup>

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## Mexico<sup>69</sup>

**Special Economic Zones:** Exemption of income tax for the first 10 years; 50% reduction of income tax for the next five years; 0% VAT when acquiring goods for use in the zones.

**IMMEX Programme:** Duty-free imports for up to 18 months for raw materials and supplies for IMMEX certified companies; 0% VAT on exports, even

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when physically exported to a third party; VAI refunds within a 20 working day period for IMMEX certified manufacturers.

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#### Netherlands<sup>70</sup>

**Corporation tax:** Corporate income tax rates in the Netherlands are currently 15% for the first €245,000 of taxable profits and 25% for taxable profits exceeding €245,000. These rates have been lowered by the Dutch Government to stimulate a competitive tax environment for international businesses.

**Energy Investment Allowance:** This allows companies to deduct 45.5% of the investment cost of energy-saving equipment from the taxable profit in addition to the deduction of the customary depreciation.

**Environmental Investment Deduction:** This allows companies to deduct up to 36% of the investment costs for an environmentally-friendly investment on top of the regular investment tax deductions.

**Innovation Box:** The Innovation Box has been introduced with the aim to encourage successful innovations in The Netherlands. The box offers an effective 80% tax advantage on profit derived from innovation. Qualifying innovative profits are effectively taxed against 5% instead of the regular 25% corporate income tax.

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#### Russia<sup>71</sup>

**Special Economic Zones:** Maximum profit tax rate may be reduced to 2% for manufacturing, and 0% for technology, innovation and tourism; property tax exemption for ten years; “free customs zone”.

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#### Saudi Arabia<sup>72</sup>

**Tax Exemptions:** Foreign direct investors benefit from the absence of personal income taxes, low utility rates and a relatively low corporate tax rate of 20%, while companies can carry over losses for tax purposes.

**Place-based Tax Breaks:** Additional tax breaks for investments are extended to the regions of Hail, Jizan, Najran, Al Baha, Al Jouf and Northern Borders in an effort to boost the employment of Saudi nationals. These incentives include tax reductions equivalent to up to 50% of the costs borne by companies in relation to the salaries, training and recruitment of Saudi nationals, as well as additional tax incentives for industrial projects.

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#### Singapore<sup>73</sup>

**Double Tax Deduction for Internationalization:** Companies can benefit from tax deductions of up to 200% for certain expenses related to “market expansion and investment development activities”.

**Double Tax Agreements:** Singapore has an extensive network of agreements with more than 80 countries. The key benefits are a) the avoidance of double taxes, b) lower withholding taxes, and c) preferential tax regime.

**Economic Expansion Incentives:** This act enables the Government to provide incentives, tax breaks (up to a period of 15 years) and loans (valued \$20 million or more) to businesses.

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#### South Africa<sup>74</sup>

**The Foreign Investment Grant:** Provides up to 15 % of the value of new machinery per entity for relocation to South Africa; provides up to 50% of training costs and 30% of worker salaries for a maximum of three years; offers a tax allowance of up to 100% (maximum of \$86 million per project) on the cost of buildings, plant and machinery (for strategic investments of at least \$70 million).

**Sector programmes:** The South African Government provide a range of incentives to encourage investment. For example, the Automotive Investment Scheme, which enables provides for a non-taxable cash grant of 20% of the value of qualifying investment in productive assets and 25% of the value of qualifying investment in productive assets by component manufactures and tooling companies for eligible companies.

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#### South Korea<sup>75</sup>

**Designated Foreign Investment Zones:** Foreign companies investing in specially designated investment zones are offered full discount on corporate tax and income tax for seven years and then 50% for another three years. They also receive various local tax exemptions e.g. acquisition tax, registration tax, property tax, and composite land tax for 8 to 15 years.

**Tax support:** For eligible investors, following approval from the Foreign Investment Committee, corporate tax and income tax are reduced by 100% for the first five years and by 50% for the next two years.

**Cash grants:** If the level of foreign investment is 30% (or 40% for research centres), and criteria are met, the Korean Government can provide subsidies for the establishment or expansion of certain plants, research facilities, or headquarters of global companies.

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#### Sweden<sup>76</sup>

**Corporation tax:** Sweden's corporate tax is 22% in nominal terms, though the effective rate can be lower as companies have the option of making deductible annual appropriations to a tax allocation reserve of up to 25% of their pre-tax profit for the year.

**Tax exemptions:** Investors benefit from tax exemptions on capital gains and dividends, as well as other competitive tax rules such as no withholding tax on interest, no stamp duty and an extensive double tax treaty network.

**Tax relief for key personnel:** Sweden offers special income tax relief to encourage highly skilled people, such as international executives, experts, researchers and others with special skills, to work in Sweden. Employees qualifying for the tax break are taxed on only 75% of income in their first three years of employment in Sweden. The remaining 25% is tax-free. The tax relief applies to all salaries and benefits, such as employers' payments of housing and living expenses. Employers' contributions are based on only 75% of the employee's total taxable income, rather than 100% of income as is normally the case.

**Foreign Trade Zones:** Sweden has foreign trade zones with bonded warehouses in the ports of Stockholm, Goteborg, Malmo, and Jönköping. Goods may be stored indefinitely in these zones without customs clearance.

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## Turkey<sup>77</sup>

**Investment Incentive Certificate:** Grants foreign investors VAT and custom duty exemption; tax deduction; social security premium support; interest rate support.

**Corporation Tax:** The current corporate income tax rate is 22% (subject to any applicable double taxation treaties)

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## United States<sup>78</sup>

**State level incentives:** To encourage new companies, state level governments have started competing to offer investors the best services and advantages possible. Across all states and territories, there are currently over 2,000 mechanisms – including tax credits (603), grants (537) and loans (436)– to attract investors.

**Federal incentives:** SelectUSA is the US Government programme to promote investment in the US. In addition, three federal agencies are aimed at attracting foreign investors. The Economic Development Administration offers long term loans, with preferential rates for projects that create or lead to jobs. The Small Business Administration offers guarantees for loans contracted by SME and can finance plants construction or material purchase by mid and long term loans. The Rural Development Office can guarantee up to 90% of the loans granted to commercial companies that create jobs in rural zones.

**Sector specific incentives:** The Federal Government has also created mechanisms to attract specific industries to the US. For example, the Creating Helpful Incentives to Produce Semiconductors for America Act, which would give manufacturers a 40% refundable investment tax credit for facilities and equipment, aims to attract semiconductor manufacturers to the United states.

**Special Economic Zones:** There are approximately 250 foreign trade zones and over 500 foreign trade subzones across the United States, where eligible businesses can enjoy reduced duty and customs-related costs. Semiconductors for America Act (CHIPS), which would give manufacturers a 40% refundable investment tax credit for facilities and equipment, aims to attract semiconductor manufacturers to the United states.

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# Solutions



The UK is an attractive destination for FDI investment, but its relative share of FDI inflows is declining over time and FDI is becoming increasingly concentrated in one part of the UK. This concentration risks limiting the benefits of FDI - higher productivity, R&D investment, and spillovers to local firms – and reinforcing existing disparities, especially in lagging parts of the UK. Over time, this could mean the UK becomes a less competitive place to invest.

Conversely, the UK's departure from the EU and the Government's commitment to level up regional growth offer a clear opportunity for the Government to prioritise FDI as a mechanism for growth in the coming years. The experience of other countries, including Ireland, Singapore and Japan, demonstrate that relative decline is not inevitable, and that with ambitious policies and the right incentives the UK could considerably grow its FDI attractiveness in the next decade.

There are two primary ways in which the UK could seek to increase levels of FDI to help level up regional growth and to spur the economic recovery post-COVID. First, by introducing formal tax and regulatory incentives for inward investment, as almost every other country in the G20 does. Second, by modernising the UK's institutional architecture for attracting FDI, which remains underpowered and under-resourced relative to our competitors.

There are different ways of doing each, with a sliding scale of intervention depending on the political and financial capital available. Our intention is not to prescribe one approach or the other, but to set out the different options available to ministers and to argue that they should do *something* in each of these areas to ensure that the UK retains its position as a leading destination for foreign investment - and to drive more of that investment to the places that would most benefit.

## Introduce a formal tax incentive for Foreign Direct Investment

As set out in the previous chapter, the UK is one of the only G20 countries not to have a set of formal tax and regulatory incentives for foreign direct investment. This is not to say the UK has restrictions or barriers to foreign investment. Quite the opposite: the UK has historically maintained an open approach to FDI since the 1980s and benefited materially from global flows of capital by doing so, especially in London, as we set out in previous chapters. As one senior executive told Deloitte in a recent report: "No other country in the world has made their market as open to investors."

There are arguments that the Government should maintain this strictly laissez faire approach. The UK benefits from strong fundamentals as a place to invest, including but not limited to: a longstanding commitment to the rule of law and intellectual property rights; and the lowest headline corporation tax rate in the G7 (even after 2023), augmented by greater capital allowances announced in the 2021 Budget.

These are all material advantages compared to many other jurisdictions where increasingly mobile flows of capital might choose to invest.

Introducing direct incentives could also lead to gaming - either by companies intending to invest anyway (creating deadweight costs for the taxpayer) or by investors abusing reliefs reduce their exposure on investments with limited public value, for example in the case of acquisitions intended to strip companies of their assets and intellectual property rather than to generate ongoing value in the UK. Indeed, these risks are already widespread. One study by the IMF and the University of Copenhagen recently found that up to \$15 trillion of FDI flows is “phantom capital” that passes through empty corporate shells with no real business activities, in order to take advantage of tax incentives. This “phantom FDI” has risen as a share of global FDI from about 30 percent at the time of the financial crisis to almost 40% of global FDI today.<sup>79</sup>

On the other hand, the UK may risk becoming uncompetitive without some formal investment attraction incentive given the growth of inward investment incentives in the rest of the G20 and the proliferation of investment destinations as a result of globalisation. When other countries are bending over backwards to attract the world’s leading companies and capital investors to their shores, some argue, the UK might consider that it needs to do the same in order to compete.

The timing is also apposite. As discussed earlier, the UK’s ability to introduce place-based policy schemes were limited as a member of the EU. Under the Assisted Areas scheme, the Government was able to provide support to businesses; however, aside from Northern Ireland, the areas were limited.<sup>80</sup> As the UK recovers from coronavirus and seeks to forge its way in the world after leaving the EU, ministers have discretion over the ability to intervene. Furthermore, sovereign discretion over trade policy also represents an opportunity to boost FDI flows. Using the impact that the passage of NAFTA had on Mexico FDI flows, economists estimate that the trade agreement generated FDI flows nearly 60 percent higher than they would have been without the agreement.<sup>81</sup> As Gerry Grimstone, the Investment Minister, has said: “the role of foreign-owned businesses in the UK economy has never been more important as we look to recover from Coronavirus. Securing investment from around the world is needed to boost growth and productivity, create jobs and help level up the whole of the UK”.

If the UK is to introduce a formal incentive to boost FDI including in Britain’s lagging regions, there are a range of non-exclusive options available to ministers:

### **1.1 National tax reliefs for foreign investment**

The UK Government could introduce a direct tax incentive for FDI at a national level, such as a multi-year corporation tax holiday or expanded capital allowances specifically for foreign investments. This is what Singapore did successfully when it introduced a five-year relief on corporation and dividend tax for foreign investors in the country in 1967.

A national scheme has the advantage of consistency, reducing distortive effects and gaming that can occur with regional or sectoral schemes. However national tax incentives are much more common in developing countries than in the industrialised world, and have been shown to be of limited value compared to more targeted incentives. A national relief would also be substantially more expensive than more targeted interventions: the ONS estimates that UK companies with FDI links represented 2.1% of all UK companies and generated £654.4 billion in GVA in 2018.

### **1.2 Regional tax incentives for FDI**

If the Treasury wanted to target any FDI incentive, one option would be to do so geographically, in order to level up FDI in the places that need it most. This is common among both developed and developing countries: one UNCTAD survey found that 70% of countries surveyed offered some kind of regional FDI incentive.<sup>82</sup> Italy, for example, offers a variable tax credit to investors investing up to €50 million in poorer regions of the South of Italy, with reliefs of 25% for large firms, 35% for medium firms or 45% for small firms. These incentives can be operated at a national level - as in Italy - or at a regional level. The latter however has the disadvantage of spurring competition between places which can invite gaming from companies: in 1996, for example, competition between the US states of Alabama, Georgia, Nebraska, North Carolina, South Carolina and Tennessee for a Mercedes Benz car plant resulted in the state of Alabama spending \$250 million in subsidy to the company for a total investment of \$300 million.

### **1.3 Sectoral tax incentives for FDI**

The other way that countries have typically targeted FDI incentives is by sector or industry. In the UNCTAD survey mentioned earlier, 85 % of the countries surveyed offered such incentives. These can be formal or informal. For example, Margaret Thatcher's Government arguably operated a sectoral FDI policy towards advanced automotive firms, offering tax incentives to companies such as Nissan and Honda, as well as others, to establish manufacturing sites in towns such as Sunderland and Swindon. More formal examples include Ireland's Manufacturing Companies Relief, which offered a 10% corporation tax rate to manufacturing until 2000 and India's incentives for firms engaged in tourism or travel, exempting them from taxes on profits provided their earnings are received in convertible foreign currency. Sectoral incentives have the advantage of being highly targeted and sending a clear signal to investors, although in doing so there is a risk that the Government distorts market activity.

### **1.4 Tax incentives for specific types of FDI**

Another option available to ministers is to introduce incentives specific for certain kinds of investment, which due to industrial composition may materially benefit some regions or sectors more than others. Examples include investment allowances and accelerated depreciation policies, which allow capital intensive firms such as in manufacturing to offset some of the costs of plant and machinery against their future profits.

The Chancellor's recent policy of temporary Super Deductions, while not limited to FDI, is an example of such a policy. Such incentives tend to have lower levels of revenue leakage than tax holidays and mean the exchequer cost only materialises after capital investments are made and. However, when they are time limited they can discriminate against long term investment cause distortions in high inflation environments, as borrowing becomes disproportionately attractive.

### **1.5 National policies that are tuned up in certain sectors or regions**

Of course, the options outlined above are not mutually exclusive. For example, Taiwan introduced a national tax incentive that was both highly regionally and sectorally targeted when it introduced a five year income tax holiday for any company in desirable industries (such as semiconductors) choosing to locate in the Hsinchu Science Industrial Park. This approach, which combined a special economic zone and sectoral targeting set at national level, has been highly successful, turning Hsinchu into one of the most successful innovation clusters in the world.

**The table below summarises different approaches.**

**Table 1: Advantages and disadvantages of different FDI tax incentives**

Incentive	Advantages	Disadvantages	Example
Accelerated depreciation and investment allowances	<p>Reduces revenue leakage compared to tax holidays.</p> <p>Supports expansion in existing firms and encourages long-term investment (if consistently applied).</p> <p>Benefits are only gained if capital investments are made.</p>	<p>High deadweight cost if reliefs are time limited.</p> <p>Distortive towards capital-intensive firms (although this can be an advantage).</p>	China: The Tax Refund for Re-investment gave foreign firms a tax refund of 40% on profits reinvested to increase the capital of the firm or launch another firm.
Sectoral incentives	<p>Signalling effect from Government.</p> <p>Often linked to wider industrial policy to maximise returns.</p>	<p>Artificially distorts the market towards certain sectors.</p> <p>Establishes a precedent for others to demand incentives.</p>	UK: Thatcher Government's use of tax and land reliefs for Japanese auto manufacturing into the UK in the 1980s, bringing Nissan to Sunderland and Honda to Swindon.
Regional incentives	<p>Signalling effect from Government.</p> <p>Targets investment in places that may not otherwise receive it.</p>	<p>Dependent on capacity of regional administration if devolved.</p> <p>Opens up tax competition between regions that can displace activity and increase costs.</p>	Italy: Companies investing up to €50m in Southern Italy can benefit from a tax credit of 25% (large), 35% (medium) or 45% (small).
Tax holidays	<p>Flexible approach that can be used to target different industries over time.</p> <p>Immediate benefit to profitable firms.</p>	<p>Can lead to tax leakage and avoidance through transfer pricing.</p> <p>Rewards short term investment in "footloose" industries.</p>	Singapore: From 1967, Singapore offered tax holidays that exempted foreign investors from corporation tax for a period up to five years as well as from dividend tax on profits.

We recommend that the Government considers the different options with the intention of introducing a direct incentive for foreign direct investment in the UK. One specific option is to retain the “Super Deduction” introduced in the 2021 Budget explicitly for foreign direct investment in plant and machinery in specific regions of the UK economy.

At present, the Super Deduction will only be available between April 2021 and March 2023, during which companies will be able to claim 130% of the capital costs of qualifying plant and machinery investments against their corporation tax bill. While this will make the UK capital allowances regime amongst the world’s most competitive and disproportionately help regions where capital intensive industries, such as manufacturing, dominate, it will only do so for a limited period of time. The risk, as the IFS and others have warned, is that it only supports firms to bring forward planned investment rather than generating additional capital investment in the UK economy.

If the UK Government were to extend the Super Deduction indefinitely for foreign direct investment beyond its current sunset clause in 2023, this would give foreign investors long term certainty about the favourable tax treatment of capital investments in plant and machinery in the UK. It would also disproportionately benefit the manufacturing industry in parts of the UK where growth has historically been slower and where the spillover effects of FDI are likely to be transformative.

While some will baulk at the idea of tax reliefs targeted at foreign investors, the example of Nissan, explored earlier in this report, offers some precedent for taking a regionally specific approach. In 1984, when Nigel Lawson planned to abolish capital allowances, Margaret Thatcher agreed a site specific grant for Nissan’s Sunderland site modelled on Regional Development Grants. Without the grant, the abolition of the capital grants would have led to up to £27.5 million in start-up costs by 1986 – equal to around £82 million updated for inflation - and the viability of the project would have been in doubt. This example further reinforces the upfront capital costs faced by FDI manufacturing projects.

## Extend tax incentives to executives as well as firms

As discussed earlier, firm level decisions to locate or invest in other jurisdictions are influenced by a variety of factors, not least the regulatory, effective rates of corporation tax, labour flexibility and institutional concerns such as the rule of law and intellectual property rights. But other factors play a role and ministers would do well to consider the personal motivations of decision-makers. On one level, the UK is an attractive destination for high powered executives, with global cities and access to top class public services. On the other hand, the UK has a relatively high rate of income tax and complex immigration system.

One way to encourage greater levels of FDI in the UK would be to make it more attractive for the people taking the decisions to move company capital and operations here. The UK already uses immigration rules to attract certain high value migrants to the UK through the Tier 1 Investor Visa, which is available to people who want to invest £2,000,000 or more in the UK.

The number of people taking up these visas has been extremely small. Just 216 Investor Visas were issued in 2020, down 40% on the year earlier. They are also highly geographically concentrated: when the Migration Advisory Committee reviewed Tier 1 Investor visas in 2014, 51% of the visas issued between 2008 and 2013 were issued to Chinese or Russian nationals. In Q4 last year, more than a third (36%) of the visas were issued to Chinese nationals, including those from Hong Kong. There have been repeated concerns about the provenance of visa applicants' funds, including concerns over money laundering and illicit gains, and about the value that these visas create for the UK economy, given that many investors simply "invest" in UK gilts that do little to directly generate jobs or growth.

**Table 2: Number of Tier 1 Investor visas issued since 2014**

Source: Home Office, Managed Migration Statistics

	2014	2015	2016	2017	2018	2019	2020
Investor Visas	1172	192	215	355	376	360	216

There is therefore an *a priori* case for reforming the Tier 1 Investor Visa to improve checks and balances and to better generate economic value. One option for doing so would be to tie the investor visa explicitly to FDI projects - rather than simply a cash payment - and to sharpen the incentives for applicants to encourage much greater take up.

We recommend that the Government replace the Tier 1 Investor Visa with a route that offers fast track visa entry for the senior executives in FDI projects. This could offer a single visa entitlement for each £2 million of investment, capped at say 10 visas per project. This would therefore generate the same level of investment in UK plc for each visa offered, but it would tie the visa offer to an FDI project in the UK that is likely to generate jobs and productivity growth. As is the case for the existing Investor route, the visa would be for 3 years and 4 months, with an option to extend for a further 2 years, meaning that the immigration implications would be similar.

If the Government wanted to sharpen the incentive for FDI, this visa route could be combined with a beneficial tax rate for investors entering as FDI investors. This is used in other countries. For example, Sweden offers qualifying high value foreign employees a tax break that means they are taxed on only 75 % of income during their first three years in Sweden, with the remaining 25 % treated as tax-free. In South Korea, in designated foreign investment zones, firms are eligible for income tax exemptions.

In addition to local tax exemptions, eligible foreign companies are offered 100% discount on income tax for seven years and then 50% for another three years.

The UK could do the same, reducing executives' personal tax liability to zero for the first two or three years of an FDI scheme – while still requiring investors to pay the immigration health surcharge – to encourage executives to invest in the UK and move here personally for the first few years of their investment. This would be controversial: offering a lower or zero tax rate to foreign citizens than that paid by domestic citizens is inevitably politically challenging. But the hyper-competitive nature of cross-border investment, and the growing list of potential FDI destinations available to global investors, suggests that the Government should be radical in incentivising decision-makers.

## Transform the UK's investment promotion architecture

In addition to formal incentives, it is clear that other countries are doing far more than the UK to actively promote their economies for inward investment. The UK has historically focused far more on export promotion than inward attraction, and has an underpowered institutional architecture compared to other countries. There are a number of options for reforming the UK's FDI infrastructure.

### **2. Invest heavily in the Office for Investment**

There is good evidence, as set out in the last chapter, that Investment Promotion Agencies (IPAs) are important for growing FDI flows and supporting companies to invest in lagging areas. Yet the UK has until now had limited capacity for inward investment, focusing much more on export and with a limited regime in place within UKTI and now DIT.

The Government has recognised this deficiency. Last year the Government launched the Office for Investment to attract investment in the UK as well as identify potential barriers to investment. The Government has acknowledged that it was launched in response to “extensive engagement with investors, who have indicated that as global competition intensifies, a more structured approach will better support existing investors and land high-value, high-impact investment.”

However the current level of resources given to the OFI remains limited. There is also an imbalance between export financing, which enjoys deep institutional weight and a large budget, and inward investment, which has neither. UK Export Finance is a statutory body that, while not without criticism, has a network of offices around the world - as well as a base in London - and works with financial institutions to ensure that UK companies can access export finance. While DIT has a network of offices in cities throughout the world, the UKEF network is distinct from the rest of DIT activity, and its sole function is to support UK exports. The Office for Investment - while an important statement of intent and already achieving results - does not yet have anywhere near the same level of reach or scale. If

the UK is to compete with the Investment Promotion Agencies of other countries, this is a major gap in our arsenal.

It is important to recognise what an upgraded IPA for the UK needs to be able to do. There are three core functions that IPAs typically serve, each of which it should focus on:

- 2.1** Creating a front door to investing in the UK.  
The OFI needs to act as a first point of contact for *prospective* inward investment approaches, to help foreign investors to understand the benefits of investing in the UK and to match investors to opportunities across the UK.
- 2.2** Supporting continued investment.  
In Ireland and elsewhere, IPAs act as a kind of concierge service for *active* foreign investors, smoothing the process of investing as much as possible. This may mean helping investors to assemble land or navigate the UK planning system; supporting firms to identify skilled labour, materials or supply chains; or linking investors with different parts of government to discuss funding or policy programmes. The effect not only being that the UK's increases its efforts in FDI attraction, but also retentions and expansions as well.
- 2.3** Reviewing the UK's competitiveness.  
The UK's competitors are continually changing their incentives for FDI and data in this area is extremely patchy. The Government could usefully continually review the UK's competitiveness against other FDI regimes around the world, as our competitors are doing (e.g. the Australian Government's review of Bilateral Investment Treaties) to ensure the UK remains an attractive place to invest. It should include working with the ONS on far more robust data about FDI flows, stock, value generation and industry mix.

This set of functions will require considerable resources and a standalone remit to represent the UK. It makes little sense that Scotland and London have larger standalone investment promotion agencies than the whole UK. We recommend the Government set out a plan to upgrade the Office for Investment over time into HM Investment Promotion Agency, with a statutory underpinning such as UKEF and HMRC, and a permanent presence outside London. This would also provide the opportunity for profile-raising opportunities outside of London; for example, London's ability to attract FDI projects.

It should be autonomous from government, but work closely with departments, regional and local government and the devolved nations of the UK. As with UKEF, it should be accountable directly to the Trade Secretary and work to governmental priorities. This would be similar to the Business Secretary's strategic steer to the Competition and Markets Authority, and would enable the Trade Secretary to highlight sectors or regions in particular for inward investment. For example, with this ability the relevant minister would be able to recommend further efforts to attract green FDI outside of London and the greater South East.

### **3. Review local inward investment attraction with a view to giving Mayors and Combined Authorities a statutory role in FDI attraction**

As well as having an underpowered architecture at national level, the UK suffers from complexity at a sub-national level. When Local Enterprise Partnerships were established in 2011, they did not take on all of the FDI functions previously performed by Regional Development Authorities, which included FDI promotion and aftercare, and instead were told they “may have a role in bidding to be a delivery agent for nationally commissioned trade development support”.<sup>83</sup> As a review for the Government Office for Science in 2013 warned, “this raises the possibility of regional agents not being as flexible in response mode to inward investors as the RDAs had been previously”.<sup>84</sup>

As discussed earlier, the effect has been to create a highly differentiated picture, where some parts of the UK have highly effective investment promotion agencies, and other parts of the UK have very little institutional capacity at all to attract inward investment.

For example, London’s promotion agency, London & Partners, has a combined annual budget of £25 million in 2019-20, funded in large part by commercial activities, and claims to have helped 123 overseas companies to set up or expand their business in London, supporting 2,188 jobs adding £95 million to London's economy in London's key sectors. There are strong agencies for Scotland (Scotland Development International), Wales (Trade and Invest Wales) and Northern Ireland (Invest NI).

Similar agencies on a smaller scale exist in Manchester (MIDAS), and the West Midlands (West Midlands Growth Company). In other regions, LEPs and local authorities play a role but with limited budgets and powers, supported by the Department for Trade’s network of 275 International Trade Advisers (ITAs) who offer one-to-one support to businesses.

This complex landscape is problematic for a number of reasons. First, it means that some parts of the UK are much better equipped to attract inward investors than others, skewing an already severely imbalanced economy. Second, it is likely to be confusing for inward investors to navigate, undermining the ability of the UK as a whole to attract and promote inward investment in the UK. If the UK is serious about using FDI as a tool to drive levelling up, it should build stronger partnerships between national efforts to attract FDI and regional agents.

As part of its efforts to boost the capacity for the Office for Investment, the Government should review local and regional apparatus for inward investment, with a view to building distinct capacity in every region to liaise with investors and actively promote FDI, under the national umbrella of the OFI. LEPs are unlikely to be the right locus for this activity: they lack power, democratic accountability and many of the levers over planning, skills and transport investment that should be joined up with FDI promotion.

Mayors and combined authorities might be better placed for this reason. Mayors such as Andy Street in the West Midlands and Ben Houchen in Tees Valley have demonstrated

their ability to use their existing powers to attract inward investors even without many formal levers.

A networked approach between Elected Mayors' authorities could prevent competition between areas of England, and foster collaboration to promote the overall level of investment instead. This approach has been used successfully in Canada through the *Consider Canada City Alliance*, which acts as a network of sub-national investment promotion agencies for the 12 largest municipal regions.<sup>85</sup>

However, this would still leave a question for areas without mayors, which have typically seen slower population and productivity growth over the last couple of decades. A review would need to consider how to manage the use of existing sub-national incentives in a fair way. For example, at the sub-national level, within the UK, IPAs are using discretionary finance to attract foreign investors. Invest Northern Ireland through grants offers companies financial support to attract FDI. For example, in 2007, Invest NI secured a third FDI project from Fujitsu worth £8.8 million with £2.2 million of support from Invest NI. The move created 150 jobs with the previous two investment wins creating around 430 jobs, with £21.2 million investment. Whereas Trade & Invest Wales offers grants worth up to 45% of costs for capital expenditure on inward investment projects for select projects. We might think this makes sense as Northern Ireland and Wales have high levels of deprivation, but other similarly deprived areas like the North East or South Yorkshire currently lack equivalently powerful tools.

# Conclusion



As shown earlier in this paper, the UK has a strong record in terms of attracting inward investment. But the benefits have become geographically focused in recent years and some types of foreign investment are more beneficial to the UK economy than others. Given the potential wage and productivity benefits, ministers should be working flat out to increase the share of greenfield FDI projects locating in lagging areas. If they can successfully and sustainably increase the share of overseas investment to areas that have been left behind, then the growth in those local areas will be boosted and the objective of levelling up the affected communities will be within reach.

The Government rightly acknowledges the potential that inward investment can have on future growth, as shown by the establishment of the Office for Investment. This paper sets out recommendations to build on that instinct, and comprehensively overhaul the UK's offer to international businesses. Without action, the UK may become less competitive over the coming years.

For build back better to be more than a slogan, and to be meaningful and lasting in communities across the country, the Government needs to set out its approach to increasing overseas investment. The success of levelling up may depend on it.

# Annex

*The difference that FDI can make*



Around the world, evidence has shown the direct benefits as well as spillover benefits that FDI attraction can bring to a country. The Department of International Trade found that a one percent increase in foreign direct investment (FDI) stock can lead to an increase in gross value added of 0.0391%, an increase in employment of 0.0382% and an increase in annual wages of 0.0290%.

FDI can be a positive and significant influence on regional growth. Evidence from Korea found that for every 1 percent increase in the stock of FDI, regional value added increased by 0.09 percent. While evidence from Spain between 1987-2000, showed a strong positive correlation between FDI and broader economic growth, as well as GDP per employee.

Griffith et al. highlight that the presence of FDI projects in an economy can increase competition amongst firms, and thereby productivity, through domestic firms increasing their efficiency to remain competitive with their new market entrants. Analysis from the Department for International Trade highlighted that a 1 percent increase FDI stock leads to on average a 0.031 percent increase in labour productivity.

Where it is embedded, FDI also has the potential to create spillover horizontal spillovers (impacts on firms in the same industry in the host country) and vertical spillovers (on other businesses in the supply chain). Data from the ONS shows that over a period of three years, when controlling for some variables (such as size, industry and time constraints) firms with inward FDI were 74% more productive than non-FDI firms. While the productivity of the average FDI firm (£172,000) was around three times that of a firm that not received FDI (£48,000) in 2015. In addition, some evidence shows that downstream businesses in the host country benefit from FDI through linkages into the supply chain from the source company. For example, in Ireland, foreign owned businesses integrate domestic businesses into global supply chains and domestic sourcing accounts for 24% of foreign owned output; although this is lower than the OECD average of 41%, it is in line with other smaller advanced economies. There is also some evidence showing that FDI attraction also drives entrepreneurship within the labour market. In one six year period, in Ireland, one in three people who started a business had previously worked at a foreign firm.<sup>86</sup>

Furthermore, FDI inflows can also boost R&D expenditures and innovation related activities in host countries. Anecdotal evidence from the Taiwanese electronics industry demonstrated not only a strong correlation between FDI and the growth of R&D intensive activity but that they can be mutually reinforcing.<sup>87</sup> Between 1996-2013, studying ten developing economies in Asia, a 1 percentage point increase in the amount of FDI inflow is associated with 0.83% increase in R&D expenditures, 0.42 percent increase in patent applications in those countries.<sup>88</sup>

This evidence would suggest that the right type of FDI project in an economy can create jobs, increases wages, and grow both the local and the nationwide economy.

# Endnotes



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# About the Levelling Up Taskforce

The Taskforce is made up of more than 60 Conservative MPs from constituencies right across the country. It aims to champion ideas that boost Britain's lagging areas and ensure that everyone has the opportunity to make the best of their talent, no matter where they are from.

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