

U.S. FDI in the European Union: The Experience of the United Kingdom

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This paper examines the determinants of U.S. FDI in the United Kingdom from 1986 through 2010 using stepwise and OLS multiple regression techniques. The paper confirms that Eurozone membership may have significantly influenced U.S. investment decisions on where to enter or expand within the European Union, by testing empirically our model for Belgium and comparing the regression outcomes. The results confirm that U.S. FDI in the United Kingdom has been influenced by market growth, and statutory corporate tax rates, but also that the country's attractiveness to U.S. investors may have been negatively impacted by the creation of the Eurozone. For Belgium, the results suggest that membership in the Eurozone and E U enlargement had a positive impact on U S FDI.

INTRODUCTION

FDI has grown rapidly in recent years in an increasingly integrated global economy until the recent financial and economic crisis spread globally in 2008, but accelerating again by 2010. FDI flows into the E U and the U S continue to grow. However, the emerging former Soviet-bloc countries of Central and Eastern Europe, Southeast Asia, China, and India, having transitioned to market economies during the last twenty years, have stimulated global FDI flows with China now second behind the U S as a recipient of FDI. Global FDI inflows in 1985 were estimated to be \$53 billion, however, by 1990 aggregate FDI had reached \$234 billion and data for 2011 indicate global FDI of \$1.5 trillion (UNCTAD, 2011).

Economic restructuring and growth in the major recipient and investing countries, global capital markets, and continued economic transition and political stability in emerging economies strongly influenced investor behavior and strategy. The acceleration of FDI through 2010 has been fueled by the increasing globalization of transnational organizations of their production networks, the policy liberalization of host countries regarding FDI in service industries and real estate, growth in mergers and acquisitions, and the expanding investment opportunities in regionally integrated markets and newly privatized sectors in both industrialized and developing countries.

The economic and financial crisis, which developed in 2008, did have an immediate but relatively brief negative impact on 2008 foreign direct investment flows. The global pattern of FDI throughout the period of this study has been dominated by OECD countries, particularly by the U.S. and the European Union. The “triad” of the U.S. Japan, and the European Union accounted for approximately 65% of FDI inflows in 2007. In 2008, record inflows of FDI into developing nations were reported (\$630 billion) but the “triad” still dominated both as a home and host nations of new FDI. The U.S. continued to be the

largest as well as the preferred home and host country of FDI and the U K continued to be the leading E U recipient of U S FDI receiving over \$51 billion in 2010, compared to \$46 billion in Germany. In fact, since 2004 UK FDI inflows have been greater than any other E U recipient and the current stock of FDI in the UK is estimated to be \$1.2 trillion, the second largest globally to the U S (UNCTAD, 2011). However, as a result of the global financial crisis, global FDI flows declined significantly in 2008 and 2009 and rose modestly in 2010.

The E U as a region was the largest recipient of U S FDI inflows during the period of this study. The allocation of FDI by U S investors strongly favored the larger E U members, particularly the U K, Germany and France, in that order. Because of cultural and geographical proximity and a long history of economic and financial linkages, the U K has continued to be the largest recipient of US FDI in Europe. Of the total stock of FDI in the UK in 2010, it is estimated that approximately 30% came from the U S or \$315 billion (Office of National Statistics 2011).

This paper analyses the economic determinants of U S FDI in the UK for the period 1986 to 2010. Throughout the period, the UK remained the primary destination for U S FDI with some volatility from 1986 and rapid growth from 1994 until 2000. In the last decade, US FDI inflows into the U K fell in 2001, the introduction of the Euro, in 2005, the first year of the enlargement to eventually 27 countries, and in late 2007, early 2008, the year of the global financial crisis (BEA,2011). Of course, one cannot assume causality but the raw data confirms correlation with these unique events. Since 2011, the recent economic and financial crisis in the EU and the economic slowdown in the UK have had a negative impact on US FDI in the region. Past studies of investment in the UK confirm that economic integration into the EU and the Single Market Act had a positive impact on US FDI in the U K but also suggest that the introduction of the Euro and the expansion of the Eurozone may have had a negative impact on FDI in the U K. To more fully analyze the U K experience within the EU, this paper also applies our FDI model to Belgium, a smaller but Eurozone recipient of US FDI to explore the likely impact of the Euro.

ECONOMIC AND POLICY ENVIRONMENT

The U K economy during the years of this study performed quite well in terms of GDP and national income and in 2010 was the sixth largest economy in the world, second largest in the E U. In 1986, GDP was \$570 billion but by 2010, current GDP was approximately \$2.2 trillion with only three years of recession or negative growth, 1991, 2008 and 2009. The global economic slowdown of 1991 was moderate but the global crisis of 2008-2009 had a major impact on reducing the annual growth rate of GDP from a 3% annual average in 1993 - 2007 to recession in 2008 and worsening recession in 2009. The economic recovery however was significant in 2010, with GDP growth of 2.1%. Trade data for the entire period, as measured by export and import values rose each year except for 2009. Labor cost indices through the period continued to show increases while the statutory corporate tax rates declined from 35% to 28% but remained above the EU average (IMF selected volumes, IFS Yearbooks).

The United Kingdom has had an essentially “open door” policy toward FDI inflows throughout the period. There have been no significant restrictions on economic sector, however, there has been a consistent industrial policy focused on the development of regions of the country that have had persistent structural and employment problems. Investment incentives and strong regional marketing initiatives have targeted foreign investors through Regional Development Agencies, often leading to strong regional competition. Overall, promotion of the U K to foreign investors has been the task of the national agency, UK Trade and Investment, UKTI, for the period of this study and which recently has intensified its country wide focus and reduced budgets for many RDAs. Surveys of U S investors indicate continued attractiveness of the U K for market-seeking U S FDI based on quality of life, domestic and European market access, culture and language, stable and welcoming political environment, infrastructure and educational and technological attributes (Ernst & Young, 2012).

The U S and the U K have the world’s largest FDI partnership. U S FDI stock in the U K was \$309.4 billion in 2010 and the U K stock of FDI in the U S totaled \$284.9 billion. In 2010, U S FDI reached approximately \$22 billion of the estimated \$50 billion FDI inflows to the U K. As expected, more and

more U S FDI has shifted from manufacturing to financial services, utilities, energy and environmental sectors. Recently, concerns have grown about the economic stability of the EU, particularly the Eurozone economies and the commitment of the U K to the centralization of more economic and political authority in Brussels. Pro-E U sentiment in the U K has diminished as the public and the current government assesses the continuing crisis in the Eurozone.

In comparison, this paper examines briefly the FDI experience of Belgium, a founding member of the E U in 1957 and a committed member of the Eurozone. As a smaller E U economy, Belgium has been the sixth or seventh recipient of U S FDI in Europe during the period of this study, averaging about \$8 billion and in 2010, reaching \$13.5 billion. In 1986, Belgian GDP was \$118.5 billion and in 2010 was approximately, \$471 billion. Annual GDP growth averaged over 2.4% but Belgium in 1993 experienced recession, no growth in 2008, and in 2009 a severe recession, as was the case in the U K. Trade rose each year with the exceptions of 2009 and 2010. As in the U K, indices of labor cost show annual increases. The statutory corporate tax rates have fallen from 45% in 1986 to a low of 33.99 in 2010, still significantly higher than the E U average. As the U K and most other E U countries, Belgium has an “open door” policy toward FDI in most sectors and region, with some competition between the Flemish and Walloon regions. Its infrastructure, membership in the Eurozone, and central location in Europe continually make it an attractive region for FDI. Its small domestic market, language and cultural issues, and stronger regulatory environment make it a less attractive European host for U S FDI than the U S. In 2010, US FDI inflow reached approximately \$6.1 billion.

LITERATURE REVIEW

Classical models of FDI tend to follow Dunning’s (1980) ownership, location and internalization approach (OLI), relative factor endowments (Helpman, 1984), openness to trade (Hejazi and Safarian 1999), comparative advantage and institutional factors (Bush et al., 2003). Host country determinants of FDI tend to revolve around economic conditions, host country policies and MNE strategies and have been well documented (Lall, 1997). Specific FDI determinants in developed economies tend to focus on location attractiveness such as market size and infrastructure, risk reducing policies, stability and strength of the currency, membership in international trading organization, and state incentives (Blonigen, 2005). In addition to the “classical” market attractiveness, FDI determinants in emerging markets tend to emphasize labor costs and labor skills and other attractiveness factors.

Of particular interest are studies focusing on FDI in the European Union. Barrell and Pain (1996 and 1997) developed a theoretical model to analyze U S FDI in Europe and concluded that market size and factor costs are important determinants as well as labor market efficiency and stability. Beer and Cory (1996) , in their empirical study of U S FDI in the European Union, add to traditional factors of market size, labor costs, and trade flows proxy independent variables for infrastructure and taxes. The authors use gross fixed capital formation and government tax revenues as a percentage of GDP as their proxies. For their sample of 11 E U counties, market size and wage differentials have a significant impact on U S FDI but neither of their proxies are validated as locational determinants. Bevan and Estrin (2004) established that country risk, labor costs, host market size, EU accession and gravity factors were significant determinants in attracting overall FDI in Europe. Wolf (2006) examined the effect of taxes on FDI inflows for the enlarged E U. Corporate tax rates controlling for country characteristics were insignificant for total inward FDI as were wage factors. Foad (2007) analyzed data on U S FDI in seventeen European countries from 1983 to 2004 and validates export market access and Euro membership as factors having an impact on U S FDI. He also estimates his model assuming that the U K adopted the Euro and concludes that the U K would have attracted cumulatively \$30 billion more U S FDI during the period. The significance of market size and labor cost were confirmed by Torrisi et al (2009a) who also found taxes and privatization to be important in attracting foreign investment into Poland and that E U enlargement and Euro membership were significant positive factors in FDI inflows into Spain (Torrisi, 2011).

There have been a number of descriptive studies of FDI specifically in the United Kingdom. A paper by the U K Trade and Investment Agency (2004) concludes that the U K had substantial growth in inward (and outward) FDI since E U accession. FDI inflows responded to E U membership in the eighties and nineties because of access to a larger market, greater economies of scale, and agglomeration benefits. Ernst & Young (2011) confirms the importance of domestic demand, regional market access, and qualitative factors such as language and cultural proximity, political stability, and technology and infrastructure proxies. The Vale Columbia Center on International Investment (2012) in a profile of Inward FDI in the U K summarizes thirty years of continued attractiveness of the U K based on cumulative FDI stock, location, economic strength and liberal and consistent policy measures.

MODEL SPECIFICATION AND METHODOLOGY

The dependent variable in the FDI models estimated for the United Kingdom is annual U S FDI in dollars from 1986 to 2010 as reported by the U S Bureau of Economic Analysis databases. Thus, the measure includes all reinvested earnings as well as new capital inflow and provides a consistent time series of annual FDI. Annual GDP is measured in current dollars for the time period analyzed, as specified by UNCTAD and IMF sources. Data for additional independent variables examined in our FDI models are primarily from these international sources as well as OECD data banks. For each variable, there exists a consistent time series as provided by these organizations and agencies.

Models of FDI determinants in advanced economies emphasize groups of macroeconomic factors. Extending the classical models of FDI and the many empirical studies of FDI in OECD countries, macro-economic variables that are available in consistent time series from international and/or governmental sources are included in the regression models estimated, i.e. market size, market growth, trade openness, statutory tax rates and wage indices. This paper examines these economic factors for impact on U S FDI in the U K during a period of rapid growth in global FDI and in the E U “single market” and continued trade and investment liberalization. However, additional less quantifiable, non-economic factors may be FDI determinants, such as political stability, institutional efficiency, cultural similarity, and infrastructure proxies. For the U K, these variables have had an obvious and positive influence on U S FDI, although in many existing studies summarized in this paper the statistical results are varied and not always robust! This paper does attempt to explore the impact of external events, through the use of dummy variables, that may have influenced the political and economic environment for FDI in the U K, such as the adoption of the Single Market Act in 1993, the introduction of the Euro in 2001, and the major enlargement by ten countries in 2004.

The U K has experienced significant increases in FDI in the past decades, maintaining its lead in Europe in attracting FDI with the U S being the largest investor and until 2010 was annually the second or third largest recipient of FDI inflows. This empirical study examines key macro-economic variables that may influence U S FDI. This paper extends and updates past research through 2010, examining a number of these determinants. During this same period, however, three significant events occurred as mentioned previously which altered the regional economic linkages of the U K and may have had a major impact on the investment climate and competitiveness of the U K for market-seeking U S FDI. In our regression models estimated, a number of different dummy variables were tested to determine whether there exists a significant once and for all impact of these E U events on FDI in the U K.

Market size is measured by annual Gross Domestic Product in dollars and is expected, as confirmed in many empirical studies, to be a significant and positive determinant of FDI. Per capita GDP was also included. Market growth measured as the annual growth rate of GDP is also examined, as foreign investors who are market seeking may be more motivated by economic growth experience and potential rather than current economic activity. The strength (or weakness) of the national currency to the dollar has often been used as a proxy for the level of relative inflation, general economic uncertainty, and instability, and the purchasing power of the foreign investor. One model tested included the annual market mid-year exchange rate of the pound to the dollar. A theoretical expectation would normally be of a negative and significant relationship to FDI inflows. Appreciation of the host country currency might

diminish foreign investors motivation to acquire real and financial assets and to reinvest all earnings.. However, as in some previous studies, there was no evidence in the models tested of a significant relationship to the value of the pound. And its inclusion did not improve the regression results.

As a large E U economy with a highly skilled and productive labor force, the U K attracts FDI in manufacturing, services, energy and environmental sectors. However, it also must compete from a cost and efficiency point of view with other and lower cost E U members for U S FDI. Thus, a wage index from the National Statistics Office of the U K, is included in our regressions. During a period of rising wages, as was the case in the U K, the theoretical expectation would be that resulting higher labor costs of production would reduce FDI inflows into the region. However, if FDI inflows are also attracted by domestic demand conditions and cultural and institutional proximity, wage costs may not be a significant determinant of FDI. It also certainly could be argued that rising labor costs are an indicator of improving productivity and rising domestic purchasing power, which might attract more FDI.

Many previous studies of FDI argue that trade “openness” of the host economy may be positively associated with FDI inflows. If much of FDI is export oriented and requires the import of complementary intermediate and capital goods, trade volume increases overall and as a percentage of economic activity. Also, trade openness can be a proxy for successful economic liberalization and favorable trade policies. Thus, a trade openness variable measured as the annual total of exports plus imports is also included in some of our models estimated, with an expected positive and significant coefficient. As an alternative trade variable influencing FDI, annual exports plus imports as a percentage of GDP was also examined. As in earlier EU studies, this paper examines the impact of the introduction of the Euro and of E U enlargement as represented by dummy variables, the Euro dummy equal to zero from 1986 to 2000 and to one for 2001 to 2010 an Enlargement dummy equal to 0 from 1986 to 2003 and to one from 2004 to 2010. A similar dummy for the implementation of the Single Market Act in 1993 was tested separately. The academic literature and indeed the experience of smaller economies joining the EU suggests that the benefits of accession and membership to regional free trade blocs include increased FDI inflow as access to a growing regional market enhances a country’s attractiveness to investors. The expectation is of a positive and significant relationship to FDI in the U K.

In much of the literature on FDI in advanced economies, empirical studies include a variety of risk factors or proxies, both economic and financial. Given the subjective nature of these measures, the inconclusiveness of the results in many of the previous studies, the relative absence of political and economic risk and the lack of validation of specific risk variables in past research on FDI in the EU, our models estimated do not include specific risk factors. However, it may be that our foreign exchange and growth variables may capture some of perceived market risk or uncertainty. Although previous studies (WOLFF, 2006) suggest that corporate tax rates are insignificant factors for overall FDI across the E U, this paper examines their impact of FDI in the U K specifically. Other factors that might influence FDI such as existing FDI stock, and incentives have been examined with mixed or insignificant results in studies of FDI inflows in other countries and are not validated in this paper. In future research, the authors will attempt to measure some of these factors by more extensive data search and the design of comparative regional variables that may capture some of their potential impact on FDI inflows.

Thus, our models included many independent variables examined in past studies of FDI inflows as well as additional variables specific to the experience of the U K in the European market for U S FDI.. We specified and estimated a number of FDI models for the U K, although constrained by some data limitations. Using OLS multiple regression methodology with lagged and non-lagged variables, this paper reports only those models and results that were robust and consistent, and produced acceptable regression test statistics.

Model 1: $FDI = f(GDP, GDP\ GROWTH, EURO, TAX, WAGE, EU\ ENLARGE)$

EMPIRICAL RESULTS

Various regression models were tested. The two most significant and robust are reported below. Lagging the dependent variable did not improve the overall regression results or change the significance of some determinants. As a result, this paper defines the dependent variable as annual U S FDI in the U K using BEA data. It is also worth noting that current GDP, the wage index and trade openness (measured as export plus import as a percentage of GDP), were never significant in any regression models tested. As was noted in the literature review, FDI in the U K may be influenced by language and cultural proximity to the US and the E U economic environment more than current market size and non-productivity adjusted wages.

Table 1 shows that, as expected, the growth rate of the domestic market is a positive and very significant FDI determinant while the corporate tax rate and the dummy variable representing the introduction of the Euro are both negative and very significant. The other variables have the expected signs but were insignificant in all estimates.

**TABLE 1
THE BASIC MODEL**

Independent Variables	Coefficients	t	Significance
GDP	.3.401E-9	.230	.821
GDP Growth	2336.7	1.974**	.055
Euro Dummy	-17211.7	-2.435**	.026
Corporate Tax Rate	-7767.1	-2.441**	.026
Enlargement Dummy	5448.3	.476	.640
Wage Index	-175.39	-.312	.759

R² .657 Durbin Watson 2.706 ** Significant at 5%

For this model, both the R square and Durbin Watson are acceptable suggesting good overall explanatory power and very low autocorrelation. This model confirms the importance of the domestic market growth rates and that tax rates and the introduction of the Euro likely had a negative impact on U S FDI. However, rising labor costs and the enlargement of the EU in 2004 did not have a significant impact. There also in no evidence that current UK market size was a determinant of FDI as growth rates were more important. The second model in Table 2 includes per capita GDP to reexamine the market size hypothesis and a trade openness variable which is common in the literature. As shown in Table 2, the R² for this model is .722 suggesting the model has significant explanatory value, while the Durbin-Watson statistic is in the appropriate range symptomatic of low autocorrelation.

$$\text{Model 2: FDI} = f(\text{GDP, GDPGROWTH, TO, WAGE, GDPPC, EURO, TAX})$$

TABLE 2
FDI MODEL WITH PER CAPITA GDP AND TRADE OPENNESS

Independent Variables	Coefficients	t	Significance
GDP	3.467	.296	.771
GDP Growth	2827.5	2.69**	.015
Trade Openness	-.3249	-1.11	.284
Wage Index	-74.9	-.145	.885
GDP per capita	-1.243	-.163	.872
Euro Dummy	-17190	-2.38**	.0289
Corporate Tax Rate	-8742.1	-2.48**	.0241

R² .722 Durbin Watson 2.743 ** Significant at 5%

For this model, the results are robust and confirm the significance of GDP growth, the Euro dummy and the corporate tax rate. The GDP per capita and trade openness variables were insignificant but improved slightly the explanatory value of the FDI regression.

For purposes of comparison to a competitor country in the EU with a smaller domestic market but a member of the Eurozone, the two models presented for the U K were tested for US FDI in Belgium for the same period, 1986 to 2010. The regression results are quite different but suggest interesting implications for smaller countries of E U enlargement and membership in the Eurozone.

TABLE 3
THE BASIC MODEL - BELGIUM

Independent Variables	Coefficients	t	Significance
GDP	6.751E-9	.551	.589
Growth rate	41.395	.637	.533
Wages	-37.9	-.484	.635
Euro Dummy	2109.5	1.746**	.098
Corporate Tax Rate	80.906	.364	.720
Enlargement Dummy	3043.5	1.789**	.091

R² = .786 Durbin Watson 2.487 **Significant at 5%

The analysis of the Belgian experience as a European market for U S FDI indicates that membership in the Eurozone and E U enlargement with ten new members in 2004 both had a significant and positive impact. As was the case for the U K, domestic market size and wages were insignificant variables. The growth rate of GDP and the corporate tax rate unlike for the U K were also insignificant determinants. As a small economy, perhaps much U S FDI is export oriented and the benefits to financial risk management and export pricing of membership in the Eurozone outweigh a slightly higher corporate tax rate.

Model 2 reported in this paper for the U K was also tested for Belgium. The inclusion of per capita GDP and trade openness variables slightly improved the explanatory power of the equation but neither were significant. Euro membership and EU enlargement remained positive and significant.

CONCLUSION AND FUTURE RESEARCH

The regression models presented in this paper show that, while macro-economic variables such as GDP growth positively and statutory corporate tax rates negatively impacted U S FDI in the United Kingdom, the decision to remain outside the Eurozone had a significant negative impact on U S FDI. Also, the results suggest that for the period 1986 to 2010 current GDP, wage rates, E U enlargement, and trade openness are not significant determinants of FDI. It may be that these traditional macroeconomic determinants of FDI are less important for the U K than language and cultural proximity to the U S, a stable political environment, liberal and open FDI policies, and favorable tax rates. Of course, access to the E U market from the open, predictable, and stable business environment and reliable infrastructure of the U K has also attracted much U S FDI.

For a smaller E U member, Belgium, there is strong statistical evidence that membership in the Eurozone and enlargement of the E U market had a significant and positive impact on U S FDI inflows. This suggests that many of the new members of the E U without the cultural and language advantages of the U K for U S investors may greatly benefit from adopting the Euro and future enlargement of the European Community. Of course, recent economic instability and uncertainty within the E U and Euro volatility may have a short term negative impact on U S FDI. However, there is no current research to confirm this outcome. World Bank projections are of continued growth in FDI flows into the E U with the exceptions of Greece and Portugal (World Bank, 2012). Thus future research should consider more comprehensive regional U S FDI analysis, developing and testing models using panel data with other E U countries as a group and for Eurozone members and non-Euro member countries separately. Also, extending the data set to better examine the FDI impacts of the global financial crisis and the more recent E U financial crisis may be important and valuable to both U S investors and the recipient European countries. Adding labor costs variables, adjusted for productivity gains, would also yield valuable insight into the relative determinants of FDI in the U K and the region.

Furthermore, analyzing the market share of U S FDI in Europe of the U K through the last 25 years may be useful in understanding the disadvantages of accelerating regional economic and monetary integration for member countries on the periphery geographically, institutionally, and culturally, such as the U K and Poland. Although the U K has remained the largest recipient of U S FDI, recent data clearly indicates a small decline in market share. Factors that may influence competitive and comparative advantage in the region and host country attractiveness, such as relative currency stability, relative growth of the domestic market, relative costs, risk assessment variables and relative tax rates could also be analyzed in different regression models. Insuring these new variables are consistent and reliable during a twenty five year time-series and across several countries will be a significant challenge.

For both European host countries and U S investors alike, gaining a greater insight into FDI determinants in a more rapidly integrating E U, but with divergent country commitment to the process and to centralization of supra-national authority in Brussels is well worth the challenge. The U K, the E U, the U S and the global economy need to accelerate FDI flows to maintain economic growth and business profitability. As more and more capital flows to newer and growing markets in the BRICs and non BRIC emerging economies, such research becomes critical in understanding dynamic capital markets and increasing competition for FDI inflows.

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