

# Foreign Direct Investment (FDI) in Tradable Services

## Introduction

1. FDI can provide a strong stimulus to economic growth in both national and regional economies. It generates employment opportunities and leads to the introduction of new and innovative products and processes which help raise productivity levels. The Northern Ireland Executive has set growing the economy as the top priority over the next three years and within this, securing high value inward investment is a key commitment.<sup>1</sup>
2. Despite a period of intense global competition in recent years, Northern Ireland (NI) has been very successful in attracting FDI. This has been concentrated in the manufacturing sector which accounted for over 80 per cent of total FDI to NI (over the decade to 2005). However, manufacturing's share of global FDI is declining and is continuing to migrate to much lower cost economies in Eastern Europe and Asia. At the same time, the growth in the size and importance of the tradable services sector<sup>2</sup> has brought with it new opportunities from increased FDI activity.
3. If Northern Ireland is to continue to attract high quality FDI, the attention of policy makers needs to focus increasingly on the tradable services sector. Therefore, the Department of Enterprise, Trade and Investment (DETI) appointed the consultancy firm Experian, to carry out a research study into current and future FDI trends in NI tradable services and to identify the areas where intervention is required, to ensure that NI is positioned to fully exploit future opportunities arising from FDI in the tradable services sector.

## Aim of the Research

4. The overarching aim of the research was:  
*“to improve understanding of the benefits that FDI in tradable services can bring to the local economy and, by examination of probable future trends in tradable services FDI, to identify the key sectors and markets which policy makers and those implementing policy should target.”*

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<sup>1</sup> The Programme for Government (2008 – 2011) includes a goal to secure inward investment commitments promising over 6,500 new jobs by 2011 the majority of which will provide salaries above the local private sector average.

<sup>2</sup> The definition of tradable services used in the report is the same as that used in DETI's Exporting Northern Ireland Services study ie Computer & Related Activities (SIC 72); Research & Development (SIC 73); Market Research (SIC 74.13); Business Management & Consultancy (SIC 74.14); Architectural & Engineering (SIC 74.2); Technical Testing & Analysis (SIC 74.3); Advertising (SIC 74.4); Creative Entertainment (SIC 92.1-92.3).

## **Methodology**

5. The research comprised a number of elements including an analysis of current relevant literature/statistics, stakeholder consultations, a survey of existing FDI firms and local supplier companies, and benchmarking against the experience of other economies, namely the Republic of Ireland, Sweden and Poland. Evidence of trends in tradable services FDI is provided through the analysis of official data at sectoral level, by geographic area and by country of ownership. Recent trends in and the total value of FDI in tradable services in NI are also considered.
6. Estimates of the direct and indirect employment/output benefits and wider indirect/induced benefits of tradable services FDI to NI were derived through the development of an economic model which enables the overall fiscal benefits from FDI flows to be estimated. The research included forecasting of future trends in tradable services investment inflows to Northern Ireland, and identification of the sectors showing greatest potential for future development. Finally the findings of the various elements were drawn together to inform the development of an appropriate policy response to specific issues raised.

## **Background**

7. FDI benefits the economy to which it flows in a number of ways. The direct impacts of FDI are primarily evidenced through increased employment opportunities and enhanced Gross Value Added (GVA). However, FDI brings with it a range of other benefits including the introduction of new products and processes, improved management practices, new technologies, the development of new skills and enhanced job quality. In turn, this facilitates a range of spillover effects within the local economy through, for example, the expansion of local businesses/new business start-ups to supply goods and services to the FDI company, the transfer of skills and knowledge between firms both up and down the supply chain in response to the needs/demands of the company, the transfer of skills and knowledge through employees moving from the foreign owned firm to indigenous employers, and the exposure of staff to innovative and international standard work practices.
8. FDI also brings with it benefits to society through, at times, the location of companies in areas of high deprivation and contributing to wider economic, social and physical regeneration objectives. This continues to be a central plank in Invest NI's FDI approach, and a key target of the organisation is to locate 70% of new FDI projects secured within 10 miles of an area of economic disadvantage.

## **Tradable Services FDI and Northern Ireland – Key Features**

### **9. Recent Trends in FDI**

The economic slowdown at the start of this decade, combined with the events of 9/11, led to a sharp downturn in global FDI activity for a number of years. However, flows of FDI have picked up strongly since then with the strengthening of the global economy. Northern Ireland continued to attract significant flows of FDI throughout the period with much of the FDI flow concentrated in tradable services and, within this, in the IT, business and financial services sectors. Over the period 2002-2006 NI attracted 126 service sector<sup>3</sup> FDI projects, securing total capital investment of \$1,694m and creating 8,995 jobs.

### **10. Sources of FDI**

The US continues to be the largest FDI investor in NI accounting for 30 tradable service and 62 non-tradable investments to NI (between January 2002 and March 2007, generating 4,057 additional jobs). India is also a major source of FDI to NI having contributed 10 projects and 2,583 jobs since January 2002. Flows of FDI from the Republic of Ireland (RoI) have also witnessed a significant increase in recent years with the creation of 1,004 jobs between January 2002 and March 2007 through 22 projects. However, this has been concentrated in the non-tradable service sector (and in telecoms, finance and the food and drinks sectors).

### **11. Location of FDI Projects in NI**

Within Northern Ireland, the spatial distribution of FDI projects demonstrates that larger urban areas are the preferred choice of both tradable and non-tradable service FDI companies. Belfast and Derry~Londonderry are the most popular locations, reflecting the nature of tradable services FDI which tends to select city/urban locations, with a steady supply of appropriately skilled and frequently low-cost labour. Across both tradable and non-tradable service industries, however, there have been projects in a range of locations including the locations mentioned and others such as Armagh, Bangor, Larne, Newry, Antrim, Enniskillen, Strabane, Kilkeel and Carrickfergus.

### **12. Sub-Sectoral Concentration of Tradable Service FDI**

Over the period January 2002 – March 2007, the IT and software industry in NI has attracted the greatest percentage of FDI investments with the realisation of 30 investments and the creation of 1,842 jobs. However, it is within the business services sector that the greatest share of jobs has been

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<sup>3</sup> Of the 126 service sector FDI projects, 42 were in tradable services.

created with over 3,100 jobs created during this period. The financial services and food and drink sectors have also attracted significant levels of FDI, though this is primarily on the non-tradable side.

### **13. Quality of Jobs Created in NI through FDI**

A measure of the quality of jobs created/safeguarded through FDI is the percentage of jobs with wages above the NI average. Evidence indicates that manufacturing FDI projects are characterised by higher wage levels than is the case for FDI employment in the tradable services sector. Furthermore, safeguarded jobs, as opposed to new jobs, tend to display a higher percentage of jobs above the NI private sector average. This demonstrates that, whilst FDI has helped to safeguard a number of high wage jobs, many of the newer jobs created, particularly in the tradable service sector, offer lower wages. The recent Invest NI Performance Information<sup>4</sup> report concurs with this finding noting the much lower percentage of new jobs in business and financial services and in other services having wages above the private sector median.

## **Main Research Findings**

### **14. Survey Findings**

The survey indicates that the experience of FDI companies in NI is generally positive with such companies generating wider benefits within the local economy. Similarly, supplier companies noted that FDI companies had provided opportunities though more could be done to ensure that local companies might further benefit from FDI linkages.

a) Tradable services FDI companies in NI:

- Are highly export oriented,
- Procure a significant share of their factors of production in NI,(and particularly suppliers of recruitment services and IT/office equipment),
- Continue to invest in their business in NI after their initial investment,
- Have established mutually beneficial links with local businesses/universities,
- Face some though limited skills issues,
- Do not appear to generate significant downstream benefits.

b) Supplier (Tier 1 beneficiaries) companies responded that:

- FDI companies in NI account for approximately one in ten sales made by supplier companies,
- Over the last five years whilst they have had some success in selling to larger FDI investors they have not secured any major contracts,

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<sup>4</sup> Invest NI Performance Information Report – 2002/03 – 2006/07 – published January 2008.

- The majority do not have links with universities – those who do use them for graduate recruitment/training only,
  - More could be done by the public sector to help indigenous suppliers work with FDI companies eg by identifying suitable contacts/raising awareness,
  - FDI will improve technology transfer between NI companies through engagement in specialist or business support networks,
  - Over the last five years the volume of FDI in their local geographic area has increased.
15. The survey suggests there is little evidence that FDI has helped indigenous companies to access new export markets or make changes to the quality of their product/service to meet the demands of the FDI investor.

### **Factors Affecting the FDI Location Decision**

16. In general, there are a number of specific factors which impact on a company's choice of investment location. The Ernst & Young Global Attractiveness Monitor<sup>5</sup> lists 19 key criteria. Whilst corporation tax rates are found to be very important (by 46% of firms surveyed), the following criteria all received a higher ranking:
- transport and logistics infrastructure (54%),
  - low labour costs (52%),
  - the potential for enhanced productivity (48%),
  - strong telecommunications infrastructure (48%) and
  - a transparent and stable political, legal and regulatory environment (47%)
17. The importance of skilled local labour and the country/region's domestic market were also considered to be very important by circa 45% of those surveyed. Perhaps somewhat surprisingly, the availability of "aid, subsidy and support from local authorities" was viewed as being very important by only 24% of firms surveyed.
18. Against many of the criteria listed, Northern Ireland scores relatively well. However, it is equally clear that, given the priority accorded to low labour costs, and the presence of much lower labour cost destinations, NI will find it increasingly difficult to compete on this basis. It must therefore reposition itself to compete on the basis of other strengths, including its telecoms and other infrastructure, skilled labour force, stable legal and regulatory environment and enhanced political stability. Previous research noted that companies gave the following reasons for choosing not to locate in NI, namely, the unfavourable tax regime, a small critical mass in comparison to other regions, distance from customers and concerns over security and

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<sup>5</sup> Ernst & Young Global Attractiveness Monitor 2006

political stability. With the exception of the last factor, the researchers conclude that the remaining three issues are still relevant today.

## **Output**

19. The net overall impact of tradable services FDI in Northern Ireland is significant, standing at £747m per annum (2.9% of total GVA). This includes both the direct impact (£586m) and indirect impacts. Indirect impacts include supply chain linkages between investors and indigenous firms (£132m) and the expenditure of employees of FDI investors and employees of the companies who serve them (£29m). In comparison, the impact of tradable services FDI on the UK economy is proportionately much smaller, around £1,041m (0.01% of total GVA).

## **Employment**

20. Tradable services FDI companies make an important contribution to employment in NI, generating 30,752 jobs both directly (24,106) and indirectly (6,646), representing 3.8% of total employment. In the UK, however, such companies were found to generate a much smaller percentage of employment, at 42,845 jobs or 0.2% of total employment.

## **Job Quality**

21. Although Tradable Services FDI has helped to safeguard a number of high wage jobs, many of the new jobs created in recent years have been lower value added/lower paid. However, there is good evidence that Northern Ireland can secure FDI projects where salaries are significantly above the national average, though the numbers of jobs in these projects will be fewer.

## **Spillovers**

22. The research found evidence that increases in FDI levels in Northern Ireland are linked to an expansion in the less-developed private services sector (ie through increased demand for goods and services produced locally). Furthermore, FDI investors are willing to train and invest in the skills of their staff which, in turn, improves the general skills level of the NI labour force.

## **Fiscal Benefits**

23. In the absence of transfer pricing, it is estimated that the UK exchequer benefits by an estimated £311m from tradable services FDI companies in NI. This is through a variety of sources, including VAT, income tax, national insurance and corporation tax receipts. However, as many multinational

corporations use sophisticated accounting practices to repatriate profits to reduce their tax bill, the actual figure may be somewhat lower.

### **Locational Factors**

24. Research findings indicate that there are a number of specific features of NI which have impacted on the location decisions of tradable service companies. This reflects many of the key investment criteria listed in the Ernst & Young Global Investment Monitor and includes:
  - the quality and supply of labour,
  - the presence of Docklands style developments and modern office space,
  - good accessibility by road and air to other European or global locations,
  - the formation of devolved government in Northern Ireland and the political will that exists (ie political support at the most senior level can have an enabling effect on FDI.)
  
25. However, there are other factors which may constrain the flow of tradable services FDI to NI, particularly in higher value added sectors such as:
  - the large numbers of workers with only basic or intermediate skills,
  - the large number of graduates leaving NI to take up jobs in the RoI/GB.
  - the over-reliance on the public sector,
  - the corporation tax differential between the UK and RoI.

### **Forecast Trends**

26. International investment is expected to remain a key driving force in the global economy in coming years, due to the increasing integration of global markets, the favourable business outlook, growing inter-nationalisation of services and the desire for greater technology and efficiency gains. However, geopolitical uncertainties and sharp exchange rate fluctuations are factors which have the potential to significantly constrain future FDI activity. Despite this, FDI flows to developed economies are forecast to increase by 7% per annum over the period 2007- 2010. The UK is expected to remain a popular destination for FDI and is forecast to receive a greater inflow of investment than any other European economy over this timeframe.
  
27. The good performance of Northern Ireland in attracting tradable service FDI since the mid-1990's (measured by project numbers and investment flows) is expected to continue. In terms of output growth, each of NI's tradable service sectors is expected to grow at a rate above the whole economy average over the medium term, with the IT and communications sectors expected to grow most strongly. Output growth for NI's tradable services sector is also expected to remain above the UK average at an average annual rate of 2.9 per cent. Forecasts indicate that investment to NI (from

outside the UK and across all sectors) will continue to be concentrated in flows from North America (mainly the US), Ireland and India. It is estimated that between 2005/6 - 2015/16 NI could receive as much as £620 million of future tradable services FDI, the majority of which is likely to be in high value sectors such as business & financial services and software & computer services.

### **Future FDI Tradable Services Potential – Key Sectors**

28. Within the exportable services sector, Computer & Related Activities is the sector displaying the greatest future potential for FDI into NI. Solid expansion prospects in international software development will provide substantial opportunities for further investment flows to NI in this area. The Research & Development (R&D) sector is identified as a further sector where FDI to NI should be boosted in coming years, as NI capitalizes on its ability to provide research bases linked to manufacturing facilities. This is consistent with recent research commissioned by DETI on “Innovation in Tradable Services”, which finds that Computer Services and R&D emerge as the sectors with the highest levels of service innovation and R&D in Northern Ireland, considerably above the average for the service sector as a whole. The sectors also display strong performance across the board compared to their UK counterparts. Furthermore, the research notes that there is a strong concentration of Invest NI support to services in the Computer Services or ICT sector.
29. There is also some potential to attract future tradable services FDI flows to NI in other subsectors, including creative entertainment, architectural and engineering services, market research, business management and consultancy, however, the opportunities are much more limited.

### **Benchmarking - International Examples**

30. The benchmarking exercise concludes that those economies which have experienced particular success in attracting FDI tend to have - a clear and cohesive approach, a favourable corporation tax regime focused on those sectors where they are likely to have a competitive advantage, and have a ready supply of appropriately skilled labour.
31. The RoI experience demonstrates how the development of an international financial service centre can help increase levels of knowledge based employment, boost export activity and provide improved access to financial services for local businesses. However, a key enabling factor behind this success is the low rate of Corporation Tax prevalent in the RoI.
32. Sweden has been an attractive destination for FDI due to a number of features including - the deregulation of its business environment, a world

class telecommunications infrastructure and its education system. The experience of Sweden also highlights that the availability of grants and preferential income tax rates for inward investors is effective in attracting FDI.

33. In recent years, Poland has become a more attractive FDI location due mainly to increased market access and the presence of a relatively young, skilled and low cost labour force. Consequently, it has been successful in attracting a number of significant manufacturing investments.

## **Recommendations**

34. Based on the evidence gathered during the research, analysis and consultation stages and the resultant conclusions, a number of specific policy recommendations have been proposed.

## **Review of Existing FDI Strategy**

35. Invest NI currently produces an annual International Sales and Marketing Plan which is the strategy for attracting FDI into Northern Ireland. The strategy analyses market trends, assesses the competition and identifies Northern Ireland's strengths and weaknesses. It highlights NI's competitive advantages and sets out specific target sectors/locations upon which activity and resources to attract FDI to NI will focus. The strategy is approved by the Invest NI Board but for commercial reasons the plan is not published. It is recommended that the findings of this research are incorporated into the next International Sales and Marketing Plan. Furthermore, the strategic review of the future potential of the Business Services/Financial Services sectors (currently being undertaken by Invest NI) should inform and shape the development of future FDI strategy. It is important that there is consistency between key government objectives of increasing private sector productivity/supporting high value added employment<sup>6</sup> and the attraction of FDI.

## **Focus**

36. There are a number of high value added tradable services sectors that could realistically be attracted to Northern Ireland. Future tradable services FDI policies should specifically target new investments which are capable of adding value and fostering developmental links to indigenous businesses. Sectors which should be specifically targeted are: Computer & Related activities, R&D, Architectural and Engineering services, Business Management & Consultancy, Creative Entertainment, Financial

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<sup>6</sup> Key government objectives are set out in the Programme for Government and the associated Public Service Agreement framework.

Services/Intermediation, Legal Activities, Accountancy and Market Research.

### **Corporation Tax**

37. A common theme emerging from the literature review<sup>7</sup>, and from the responses to the stakeholder survey, is that the prevailing rate of corporation tax in NI is viewed as having a significant impact on NI's competitive position. It is recommended that the NI Executive and all interested stakeholders should continue efforts to secure a reduction in NI's Corporation Tax rate as such a change would deliver a significant boost to the levels of inward investment secured by NI<sup>8</sup>.

### **Skills in high-tech industries**

38. Workforce skills are an important driver of productivity growth for the economy as a whole, and also for attracting and retaining FDI companies in Northern Ireland. Primary research undertaken as part of this study does not provide conclusive evidence of skills gaps or shortages impacting on FDI companies located in Northern Ireland. But it is important that DEL and Invest NI continue to work closely together to monitor the skills requirements of both existing and prospective FDI companies and also work with education and training providers to ensure that the workforce has the necessary skills to continue to attract tradable services FDI.

### **Labour Market Effects of FDI**

39. The move in recent years to the creation, through publicly assisted FDI, of lower paid and lower value added employment within the tradable services sector is an issue which needs further consideration. The target for new FDI jobs promoted for 2008-2011 (as set out in the draft DETI Corporate Plan) has been set at 6,500. The target for new FDI jobs to be above the Private Sector Median wage has been set at 5,500. These targets indicate an increased emphasis on securing higher value added jobs from FDI.
40. The research notes that contact centres may have the potential to offer a range of occupations allowing the economically inactive to return to employment in less skilled roles, which are suited to their qualifications/experience and ultimately enable them to move up the value chain. Given the number of foreign owned contact centres which have been established in NI in recent years, a specific research study should be

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<sup>7</sup> This included consideration of recent research by the Economic Research Institute of Northern Ireland and the Ernst & Young Global Attractiveness Monitor

<sup>8</sup> The Review of Tax Policy In Northern Ireland – (Sir David Varney, December 2007) – stated that “there is no clear and unambiguous case to cut the corporation tax rate” in Northern Ireland.

undertaken to identify the impact of such centres on the labour market and, in particular, their ability to recruit from the economically inactive.

### **Measuring the impact of the Tradable Services sector**

41. The definition of tradable services currently employed by DETI includes only those groups defined as having high export potential. However, this limits the ability to measure FDI, underestimates the value of tradable services exports and weakens the validity of the underlying evidence base upon which an appropriate policy response should be based. Therefore, it is recommended that – at a minimum – the DETI definition of tradable services should be widened to include; Financial Intermediation, Legal Activities, Accountancy, Wholesale and Transport, Storage and Communication.

### **US Investment Conference**

42. Given the historic and current importance of the US as a source of FDI, and the forecast that this will continue in the coming years, the opportunities presented by the US Investment Conference (planned for May 2008) should be maximised. The Conference will provide a unique platform to exploit the opportunities arising from devolution and further promote NI to US based investors.

### **Conclusion**

43. The research has demonstrated the growing importance of tradable services FDI, both globally and to Northern Ireland. This is a trend which is expected to continue. Northern Ireland is characterised by specific attributes which make it an attractive destination for tradable service FDI.